CHAPTER 36

OVERVIEW OF EQUITY SECURITIES

1. (C) **Statutory voting system.**

   Explanation

   In a statutory voting system, a shareholder can vote in each separate board election based on the number of shares she owns. Under cumulative voting, the shareholder may choose to cast her total number of votes (200 in this example) for a candidate in one of the elections.

   (Study Session 12, Module 36.1, LOS 36.a)

   Related Material

   SchweserNotes - Book 3

2. (C) **putable, option-free, callable.**

   Explanation

   Putable shares are the least risky because the investor can sell the shares back to the issuer at a predetermined price. Callable shares are the most risky because the issuer can buy the securities back at a predetermined price, which limits the upside for the investor.

   (Study Session 12, Module 36.2, LOS 36.e)

   Related Material

   SchweserNotes - Book 3

3. (C) **ratio of the firm's net income to its average book value.**

   Explanation

   The ratio of the firm's net income to its average book value is the firm's return on equity, which can be greater than, equal to, or less than the firm's cost of equity. Cost of equity for a firm can be defined as the expected equilibrium total return in the market on its equity shares, or as minimum rate of return that investors require as compensation for the risk of the firm's equity securities.

   (Study Session 12, Module 36.2, LOS 36.h)

   Related Material

   SchweserNotes - Book 3

4. (A) **acquire the assets necessary to carry out its operations.**

   Explanation

   While issuing equity securities can improve a company's solvency ratios and increase the firm's visibility with the public, the primary reason to issue equity is to raise the capital needed to acquire operating assets.

   (Study Session 12, Module 36.2, LOS 36.0

   Related Material

   SchweserNotes - Book 3

5. (C) **Provide a higher average return.**

Explanation

Common stock is more risky than preferred stock and is expected to provide higher average returns. Preferred stock promises fixed periodic dividends. Common stock can be dividend-paying or non-dividend paying and the dividends are at management's discretion.

(Study Session 12, Module 36.2, LOS 36.e)

Related Material

SchweserNotes - Book 3

6. (A) **Class B shares.**

Explanation

Some firms have different classes of common stock (e.g., Class A and Class B shares). These classes may be distinguished by factors such as voting rights and priority in the event of liquidation. Participating and non-participating, cumulative and non-cumulative refer to characteristics of preferred stock.

(Study Session 12, Module 36.1, LOS 36.b)

Related Material

SchweserNotes - Book 3

7. (A) **exchange traded fund of depository receipts.**

Explanation

A basket of listed depository receipts (BLDR) is an exchange traded fund that represents a portfolio of depository receipts.

(Study Session 12, Module 36.2, LOS 36.d)

Related Material

SchweserNotes - Book 3

8. (C) **Unsponsored depository receipt.**

Explanation

In an unsponsored DR, the depository bank retains the voting rights of the equity shares of the foreign firm. In a sponsored DR, the investor in the DR has the voting rights. For an American depository receipt, an American depository share is the underlying security that trades in the issuing firm's domestic market. A global registered share is an equity security that trades in the local currencies on stock exchanges around the world.

Related Material

SchweserNotes - Book 3

9. (A) **Book value of equity.**

Explanation

Book value of equity is the company's assets minus its liabilities. For a non-dividend paying firm, positive net income will increase the book value of equity.

An increase in book value of equity may or may not increase the market value of equity. An increase in net income that does not meet investors' prior expectations may decrease the market value of equity.

(Study Session 12, Module 36.2, LOS 36.g)

Related Material

SchweserNotes - Book 3

10. (B) **Brower and Sutter own different classes of stock.**

Explanation

Companies may issue classes of stock (e.g., Class A and Class B shares) that differ in aspects such as voting rights, dividends, or priority of claims in liquidation.

(Study Session 12, Module 36.1, LOS 36.b)

Related Material

SchweserNotes - Book 3

11. (C) **Venture capital.**

Explanation

Venture capital providers invest in firms that are early in their life cycles. Stages of venture capital financing include seed stage, early stage, and mezzanine financing. In a leveraged buyout, an investor purchases all of a public firm's equity, taking the firm private. In a private investment in public equity (PIPE), an investor purchases private equity issued by a public firm.

(Study Session 12, Module 36.1, LOS 36.c)

Related Material

SchweserNotes - Book 3

12. (A) **Net income decreases by 5% and average book value of equity decreases by 10%.**

Explanation

Return on equity is net income divided by average book value of equity. If the book value of equity decreases relatively more than net income decreases, return on equity will increase. This illustrates that an increase in ROE is not necessarily positive for the firm. An analyst must examine the reasons for changes in ROE.

(Study Session 12, Module 36.2, LOS 36.h)

Related Material

SchweserNotes - Book 3

13. (C) **callable and non-cumulative.**

Explanation

Callable shares have more risk than otherwise equivalent non-callable shares because the possibility of the shares being called limits their potential price gains. Putable shares have less risk than otherwise equivalent non-putable shares because the option to put the shares back to the issuer for a predetermined price effectively places a floor under their price. Cumulative preference shares have less risk than otherwise equivalent non-cumulative preference shares because any scheduled dividends the issuer misses are still owed to the preferred shareholder.

(Study Session 12, Module 36.2, LOS 36.e)

Related Material

SchweserNotes - Book 3

14. (C) **realize different returns.**

Explanation

The return to the U.S. investor is affected by the return on the shares in Japanese yen and by the dollar/yen exchange rate. The U.S. investor therefore faces additional currency risk, which will most likely result in returns that differ from those a Japanese investor would realize. ADRs do not necessarily offer greater transparency to foreign investors than that which is available to domestic investors.

For Further Reference:

(Study Session 12, Module 36.2, LOS 36.d)

CFA® Program Curriculum, Volume 4, page 285

Related Material

SchweserNotes - Book 3

15. (A) **putable.**

Explanation

Putable securities give the investor the right to sell the securities back to the firm at a predetermined price. Callable securities give the issuer the right to buy the securities back at a predetermined price. Convertible securities give the investor the right to exchange the securities for a predetermined number of the firm's common shares.

(Study Session 12, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 3

16. (C) **Average book value.**

Explanation

When book values are not stable, analysts should calculate ROE based on the average book value for the period. When book values are more stable, beginning book value is appropriate.

(Study Session 12, Module 36.2, LOS 36.h)

Related Material

SchweserNotes - Book 3

17. (C) **Outside the issuer's home country and denominated in U.S. dollars.**

Global depository receipts are issued outside the U.S. and the issuer's home country and are most often denominated in U.S. dollars. Depository receipts issued in the United States and denominated in U.S. dollars are called American depository receipts. Global registered shares are denominated in the home currencies of the exchanges on which they trade.

(Study Session 12, Module 36.2, LOS 36.d)

Related Material

SchweserNotes - Book 3

18. (B) **By both public and private firms.**

Explanation

Private equity securities are not registered for public trading but may be issued by firms that have issued publicly traded common stock (public firms) as well as firms that do not have any publicly traded securities (private firms). A private investment in public equity (PIPE) is an example of private equity securities issued by a public company.

For Further Reference:

(Study Session 12, Module 36.1, LOS 36.c)

CFA® Program Curriculum, Volume 4, page 282

Related Material

SchweserNotes - Book 3

19. (A) **book value of equity.**

Explanation

Book value of equity is equal to balance sheet assets minus liabilities. Market value of equity is equal to shares outstanding times the share price. Intrinsic value of equity is typically estimated using one or more valuation models.

(Study Session 12, Module 36.2, LOS 36.g)

Related Material

SchweserNotes - Book 3

20. (A) **Common shares.**

Explanation

While common shares have voting rights, preference shares typically do not. With unsponsored depository receipts, the depository bank retains the right to vote the shares.

(Study Session 12, Module 36.1, LOS 36.b)

Related Material

SchweserNotes - Book 3

21. (A) **Equity capital is typically used for the purchase of long-term assets and expansion into new areas.**

Explanation

Equity capital is used for the purchase of long-term assets, equipment, research and development and expansion into new businesses or geographic areas. Book value and market value of equities are almost always valued differently. Management can only indirectly affect the market value of equity.

(Study Session 12, Module 36.2, LOS 36.f)

Related Material

SchweserNotes - Book 3

22. (C) **U.S. investor who reinvests dividends.**

Explanation

Sources of return on equity securities include price appreciation or depreciation, dividend income, and foreign exchange gains or losses for investors outside the country. In an increasing equity market, reinvesting dividends is likely to increase returns compared to not reinvesting dividends. If the currency is depreciating, investors from outside the country will experience foreign exchange losses that decrease their returns.

Related Material

SchweserNotes - Book 3

23. (A) **Minus its liabilities.**

Explanation

The book value of equity is the balance sheet value of a firm's assets minus its liabilities. (Study Session 12, Module 36.2, LOS 36.g)

Related Material

SchweserNotes - Book 3

24. (B) **Callable and non-cumulative.**

Explanation

Preference shares (preferred stock) has more risk for the investor if they are non-cumulative than if they are cumulative, because with cumulative preference shares the firm must pay the holder any omitted dividends before it can pay any dividends to common shareholders. Callable shares have more risk for the investor than non-callable shares because the call option limits their potential for price appreciation.

(Study Session 12, Module 36.2, LOS 36.e)

Related Material

SchweserNotes - Book 3

25. (B) **Callable common share.**

Explanation

Callable shares have more risk than putable shares because the issuer can exercise the call option (which limits the investor's potential gains) while the investor can exercise the put option (which limits the investor's potential losses, assuming the firm is able to meet its obligation). Preferred shares have less risk for the investor than common shares because preferred shares have a higher priority claim on the firm's assets in the event of liquidation, and because preferred dividends typically must be paid before common dividends may be paid.

(Study Session 12, Module 36.2, LOS 36.e)

Related Material

SchweserNotes - Book 3

26. (B) **a fixed percentage of par value.**

Explanation

Similar to the interest payments on a debt security, dividends on non-participating preference shares (preferred stock) are typically fixed. Unlike the interest payments on a debt security, the company is not contractually obligated to pay preferred dividends. Preferred dividends are typically higher than a firm's common dividends.

(Study Session 12, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 3

27. (C) **Cumulative preference shares only.**

Explanation

Cumulative preference shares (cumulative preferred stock) must receive any dividends in arrears before the firm may pay any dividends to common shareholders. Not all preference shares are cumulative. Participating preference shares may receive extra dividends if the firm's profits are greater than a predetermined level.

(Study Session 12, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 3

28. (A) **Disclose less financial information.**

Explanation

Private equity firms are not held to the same financial reporting requirements as publicly traded firms. Less public scrutiny and limited financial disclosure may lead to weaker corporate governance. However, with less pressure from public shareholders, a private equity firm is typically more able to focus on long-term performance.

(Study Session 12, Module 36.1, LOS 36.c)

Related Material

SchweserNotes - Book 3

29. (B) Are illiquid and do not have quoted prices.

Explanation

Private equity securities are illiquid and do not trade in public securities markets. Holders of private equity must negotiate with other investors to sell the securities. Private equity securities are typically issued to qualified institutional investors.

(Study Session 12, Module 36.1, LOS 36.c)

Related Material

SchweserNotes - Book 3

30. (B) Owns a different class of stock than Gray.

Explanation

Different classes of common stocks can have different features with respect to dividends, stock splits, voting power and seniority if the firm's assets are liquidated. If Gray owns preferred shares, she would be more likely to receive a dividend than Tower's common shares. If Gray had purchased shares before an ex-dividend date and Tower purchased the same class of shares after that ex-dividend date, Gray would receive a dividend that Tower did not.

(Study Session 12, Module 36.1, LOS 36.b)

Related Material

SchweserNotes - Book 3

31. (A) Receive extra dividends if firm profits exceed a predetermined threshold.

Explanation

Participating preference shares receive extra dividends if firm profits exceed a predetermined threshold. Convertible preference shares can be exchanged for common stock at a conversion ratio determined at issuance. Putable common shares give the shareholder the right to sell the shares back to the firm at a specific price.

(Study Session 12, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 3

32. (B) Inventories.

Explanation

Equity securities are typically issued to finance a firm's long-lived assets, such as equipment, and long-term projects such as research and development.

(Study Session 12, Module 36.2, LOS 36.f)

Related Material

SchweserNotes - Book 3