

Reading 47: Overview of Equity Securities

Question #1 of 34

Question ID: 415253

An equity security that requires the firm to pay any scheduled dividends that have been missed, before paying any dividends to common equity holders, is a:

- ✓ **A)** cumulative preference share.
- X **B)** participating preference share.
- X **C)** convertible preference share.

Explanation

Cumulative preference shares (cumulative preferred stock) must receive any dividends in arrears before the firm may pay any dividends to common shareholders.

References

Question From: Session 14 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #2 of 34

Question ID: 415279

When analyzing an industry characterized by increasing book values of equity, return on equity for a period is *most* appropriately calculated based on:

- ✓ **A)** average book value.
- X **B)** ending book value.
- X **C)** beginning 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.

References

Question From: Session 14 > Reading 47 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #3 of 34

Question ID: 415275

The difference between a firm's balance sheet assets and liabilities is equal to the firm's:

- ✓ **A)** book value of equity.
- X **B)** intrinsic value of equity.
- X **C)** market value of equity.

Explanation

Book value of equity is equal to balance sheet assets minus liabilities.

References

Question From: Session 14 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #4 of 34

Question ID: 415265

Global depository receipts are *most likely* issued:

- X **A)** outside the issuer's home country and denominated in the exchange's home currency.
- X **B)** in the United States and denominated in U.S. dollars.
- ✓ **C)** outside the issuer's home country and denominated in U.S. dollars.

Explanation

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.

References

Question From: Session 14 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #5 of 34

Question ID: 415276

For a non-dividend paying firm, an increase in net income must increase:

- X **A)** market value of equity.
- ✓ **B)** book value of equity.
- X **C)** both book value and market 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.

References

Question From: Session 14 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #6 of 34

Question ID: 434377

Compared to publicly traded firms, privately held firms have which of the following characteristics?

- ☐ A) Less ability to focus on long-term prospects.
- ☒ B) More limited financial disclosure.
- ☐ C) Higher reporting costs.

Explanation

Private firms have fewer financial disclosure requirements, and therefore lower reporting costs, because they are not listed on an exchange. Private firms generally have greater ability to focus on long-term results because they do not experience pressure from public shareholders.

References

Question From: Session 14 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #7 of 34

Question ID: 415261

Private equity securities *most likely*:

- ☐ A) are issued to individual investors.
- ☒ B) are illiquid and do not have quoted prices.
- ☐ C) trade in over-the-counter dealer markets.

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.

References

Question From: Session 14 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #8 of 34

Question ID: 415252

Two seats on a board of directors are to be elected. A voting system in which the owner of 100 shares may cast 100 votes in each of the board elections is a:

- ☐ A) cumulative voting system.
- ☒ B) statutory voting system.
- ☐ C) proportional 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.

References

Question From: Session 14 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #9 of 34

Question ID: 415262

Hodges Fund provides mezzanine stage financing to private companies. In which type of private equity investing is Hodges Fund most likely involved?

- ☐ A) Private investment in public equity.
- ☒ B) Venture capital.
- ☐ C) Leveraged buyout.

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.

References

Question From: Session 14 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #10 of 34

Question ID: 415271

Compared to preferred stock, common stock is *most likely* to:

- ☒ A) provide a higher average return.
- ☐ B) exhibit a lower standard deviation of returns.
- ☐ C) pay more frequent dividends.

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.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #11 of 34

Question ID: 434380

The book value of equity is equal to a firm's assets:

- ✓ **A)** minus its liabilities.
- X **B)** plus its accumulated other comprehensive income.
- X **C)** plus its retained earnings.

Explanation

The book value of equity is the balance sheet value of a firm's assets minus its liabilities.

References

Question From: Session 14 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #12 of 34

Question ID: 434376

Securities that can be sold back to the issuing firm at a specific price are *best* described as:

- X **A)** callable.
- X **B)** convertible.
- ✓ **C)** puttable.

Explanation

Puttable 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.

References

Question From: Session 14 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS

Question #13 of 34

Question ID: 415278

Which of the following changes would *most likely* cause a firm's return on equity to increase?

- ✓ **A)** Net income decreases by 5% and average book value of equity decreases by 10%.
- X **B)** Net income increases by 5% and average book value of equity increases by 5%.
- X **C)** Net income increases by 5% and average book value of equity increases 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.

References

Question From: Session 14 > Reading 47 > LOS h

Related Material:

- Key Concepts by LOS

Question #14 of 34

Question ID: 434379

Which of the following statements about the role of equities in financing a company's assets is *most accurate*?

- X **A)** The book value and market value of equities is usually the same.
- X **B)** Management can directly increase the market value of equity by increasing net income.
- ✓ **C)** 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.

References

Question From: Session 14 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS

Question #15 of 34

Question ID: 415264

A security that represents an equity share in a foreign firm and for which the voting rights are retained by the depository bank, is a(n):

- ✓ **A)** unsponsored depository receipt.

- X **B)** American depository share.
- X **C)** global registered share.

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.

References

Question From: Session 14 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #16 of 34

Question ID: 434378

Common equity share types ranked from least risky to most risky are:

- ✓ **A)** putable, option-free, callable.
- X **B)** callable, putable, option-free.
- X **C)** option-free, putable, 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.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #17 of 34

Question ID: 415269

Other things equal, preference shares have the *most* risk for the investor when they are:

- X **A)** non-callable and non-cumulative.
- X **B)** putable and cumulative.
- ✓ **C)** callable and non-cumulative.

Explanation

Callable shares have more risk than otherwise equivalent non-callable shares. Putable shares have less risk than otherwise equivalent non-putable shares. Cumulative preference shares have less risk than otherwise equivalent non-cumulative preference shares.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #18 of 34

Question ID: 415263

Liquidity of private equity is *most likely*:

- ☐ A) greater than liquidity of public equity.
- ☐ B) about equal to liquidity of public equity.
- ☒ C) less than liquidity of public equity.

Explanation

Private equity securities are not registered to be traded in a public market, and therefore are less liquid than public equity.

References

Question From: Session 14 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #19 of 34

Question ID: 415270

In a period when U.S. equity prices are increasing and the U.S. dollar is depreciating, which of the following investors in U.S. equities is *most likely* to earn the highest return in the investor's local currency?

- ☒ A) U.S. investor who reinvests dividends.
- ☐ B) Non-U.S. investor who does not reinvest dividends.
- ☐ C) Non-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.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #20 of 34

Question ID: 434381

Which of the following statements about book value of equity is *most accurate*?

- ☐ A) Book value of equity reflects the market's perception of the firm's prospects.
- ☐ B) Increases in retained earnings decrease book value.
- ☒ C) The primary goal of firm management is to increase the book value of the firm's equity.

Explanation

Increasing book value is the primary goal of firm management. Increases in retained earnings increase book value. The market value of equity reflects investor perception of the firm's future value.

References

Question From: Session 14 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #21 of 34

Question ID: 415254

Dividends on non-participating preference shares are typically:

- ☐ A) lower than the dividends on common shares.
- ☒ B) a fixed percentage of par value.
- ☐ C) a contractual obligation of the company.

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.

References

Question From: Session 14 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #22 of 34

Question ID: 415258

Cheryl Brower and Todd Sutter each own 100 shares of Hills Company stock. In a recent proxy vote, Brower had 100 votes but Sutter had 10 votes. The *most likely* reason for this difference in voting rights is that:

- ☒ A) Brower and Sutter own different classes of stock.
- ☐ B) Brower is a director of Hills Company.
- ☐ C) Hills Company uses a statutory voting method.

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.

References

Question From: Session 14 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #23 of 34

Question ID: 415260

Compared to a publicly traded firm, a private equity firm is *most likely* to:

- ☐ A) be more concerned with short-term results.
- ☐ B) exhibit stronger corporate governance.
- ☒ C) disclose less information about its financial performance.

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.

References

Question From: Session 14 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #24 of 34

Question ID: 415267

Preference shares will have the *most* risk for the investor if the shares are:

- ☐ A) callable and cumulative.
- ☒ B) callable and non-cumulative.
- ☐ C) non-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.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #25 of 34

Question ID: 415256

Johnson Company shuts down and is liquidated. Bob Smith owns 100 common shares of Johnson, but has a lower priority of claims than Al Jones, who also owns 100 common shares. Smith *most likely* owns:

- X **A)** non-cumulative shares.
- ✓ **B)** Class B shares.
- X **C)** non-participating 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.

References

Question From: Session 14 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #26 of 34

Question ID: 415274

Pearl River Heavy Industries shows the following information in its financial statements:

Total Assets	HK\$146,000,000
Total Liabilities	HK\$87,000,000
Net Income	HK\$27,000,000
Price per Share	HK\$312
Shares Outstanding	200,000

The equity securities of Pearl River have a:

- X **A)** book value of HK\$62,400,000.
- ✓ **B)** book value of HK\$59,000,000.
- X **C)** market value of HK\$146,000,000.

Explanation

Book value = Total assets – total liabilities = 146,000,000 – 87,000,000 = HK\$59,000,000

Market value of equity = Market price per share × shares outstanding = HK\$312 × 200,000 = HK\$62,400,000

References

Question From: Session 14 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS

Question #27 of 34

Question ID: 415255

Participating preference shares *most likely*:

- ✓ **A)** receive extra dividends if firm profits exceed a predetermined threshold.
- ✗ **B)** give the shareholder the right to sell the shares back to the firm at a specific price.
- ✗ **C)** can be exchanged for common stock at a ratio determined at issuance.

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. Puttable common shares give the shareholder the right to sell the shares back to the firm at a specific price.

References

Question From: Session 14 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #28 of 34

Question ID: 415272

The primary reason for a firm to issue equity securities is to:

- ✗ **A)** increase publicity for the firm's products.
- ✗ **B)** improve its solvency ratios.
- ✓ **C)** 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.

References

Question From: Session 14 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #29 of 34

Question ID: 415277

A firm's cost of equity capital is *least* accurately described as the:

- ✗ **A)** expected total return on the firm's equity shares in equilibrium.
- ✗ **B)** minimum rate of return investors require to invest in the firm's equity securities.
- ✓ **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.

References

Question From: Session 14 > Reading 47 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #30 of 34

Question ID: 415268

Other things equal, which of the following types of stock has the *most* risk from the investor's perspective?

- ✓ **A)** Callable common share.
- X **B)** Callable preferred share.
- X **C)** Putable 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.

References

Question From: Session 14 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #31 of 34

Question ID: 415266

A basket of listed depository receipts (BLDR) is *best* described as a(n):

- X **A)** special purpose vehicle for issuing depository receipts in multiple countries.
- ✓ **B)** exchange traded fund of depository receipts.
- X **C)** index of global depository receipts that trade on a specific exchange.

Explanation

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

References

Question From: Session 14 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #32 of 34

Question ID: 415273

Equity securities are *least likely* issued to finance:

- X **A)** equipment.
- ✓ **B)** inventories.
- X **C)** research and development.

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.

References

Question From: Session 14 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #33 of 34

Question ID: 415259

Two investors, Craig Tower and Erin Gray, own 100 shares each of the same company. Tower receives a quarterly dividend while Gray does not. This is *most likely* because Tower:

- X **A)** owns common shares while Gray owns preferred shares.
- X **B)** purchased his shares after Gray purchased her shares.
- ✓ **C)** 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.

References

Question From: Session 14 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #34 of 34

Question ID: 415257

With which of the following types of equity shares does the investor typically have the greatest voting power?

- ✓ **A)** Common shares.
- X **B)** Participating preference shares.
- X **C)** Un-sponsored depository receipts.

Explanation

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

References

Question From: Session 14 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS