5 CHAPTER

Capital Structure

MULTIPLE CHOICE QUESTIONS

1. The assumptions of MM hypothesis of capital structure do not include the following:
(*a*) Capital markets are imperfect
(*b*) Investors have homogenous expectations
(*c*) All firms can be classified into homogenous risk classes
(*d*) The dividend-payout ratio is cent percent, and there is no corporate tax

2. Which of the following is irrelevant for optimal capital structure?
(*a*) Flexibility
(*b*) Solvency
(*c*) Liquidity
(*d*) Control

3. Financial structure refers to:
(*a*) All financial resources
(*b*) Short-term funds
(*c*) Long-term funds
(*d*) None of these

4. An EBIT-EPS indifference analysis chart is used for:
(*a*) Evaluating the effects of business risk on EPS
(*b*) Examining EPS results for alternative financial plans at varying EBIT levels
(*c*) Determining the impact of a change in sales on EBIT
(*d*) Showing the changes in EPS quality over time

5. The term "capital structure" means:
(*a*) Long-term debt, preferred stock and equity shares
(*b*) Current assets and current liabilities
(*c*) Net working capital
(*d*) Shareholder's equity

6. The cost of monitoring management is considered to be a (an):
(*a*) Bankruptcy cost
(*b*) Transaction cost
(*c*) Agency cost
(*d*) Institutional cost

7. The traditional approach towards the valuation of a firm assumes:
   (*a*) That the overall capitalization rate changes in financial leverage
   (*b*) That there is an optimum capital structure
   (*c*) That the total risk is not changed with the changes in the capital structure
   (*d*) That the markets are prefect

8. Market values are often used in computing the weighted average cost of capital because:
   (*a*) This is the simplest way to do the calculation
   (*b*) This is consistent with the goal of maximizing shareholder value
   (*c*) This is required by SEBI
   (*d*) This is a very common mistake

9. A firm's optimal capital structure:
   (*a*) Is the debt-equity ratio that results in the minimum possible weighted average cost of capital
   (*b*) 40 percent debt and 60 percent equity
   (*c*) When the debt-equity ratio is 0.50
   (*d*) When cost of equity is minimum

10. Capital structure of a firm influences the:
   (*a*) Risk
   (*b*) Return
   (*c*) Both risk and return
   (*d*) Return but not risk

11. Consider the below mentioned statements:
   1. A company is considered to be over-capitalised when its actual capitalisation is lower than the proper capitalisation as warranted by the earning capacity.
   2. Both over-capitalisation and under-capitalisation are determined to the interest of the society.

   State True or False:
   (*a*) 1–True, 2-False
   (*b*) 1-False, 2-True
   (*c*) 1-False, 2-False
   (*d*) 1-True, 2-True

12. A critical assumption of the Net Operating Income (NOI) approach to valuation is:
   (*a*) That debt and equity levels remain unchanged
   (*b*) That dividends increase at a constant rate
   (*c*) That Ko remains constant regardless of change in leverage
   (*d*) That interest expenses and taxes are included in the calculation

13. Which of the following steps may be adopted to avoid the negative consequences of over-capitalisation?
   (*a*) The shares of the company should be split up. This will reduce dividend per share, though EPS shall remain unchanged
   (*b*) Issue of bonus shares
   (*c*) Revising upward the par value of shares in exchange of the existing shares held by them
   (*d*) Reduction in claims of debenture-holders and creditors

14. Which of the following is not included in capital structure?

(*a*) Long term debt
(*b*) Preferred stock
(*c*) Current assets
(*d*) Retained earnings

15. Financial structure is ________concept while capital structure is ________concept

(*a*) inappropriate; appropriate
(*b*) appropriate; inappropriate
(*c*) narrow; broader
(*d*) broader; narrow

16. ________ denotes the level of EBIT for which the firms EPS equals zero.

(*a*) Financial break-even point
(*b*) Margin of safety
(*c*) Equilibrium point
(*d*) Operating break-even point

17. If the EBIT is less than the financial breakeven point, then the EPS will be -

(*a*) Positive
(*b*) Negative
(*c*) Zero
(*d*) Maximum

18. Benefit of Trading on Equity is available only if:

(*a*) Rate of Interest < Rate of Return
(*b*) Rate of Interest > Rate of Return
(*c*) Both (*a*) and (*b*)
(*d*) None of (*d*) and (*b*)

19. Indifference Level of EBIT is one at which:

(*a*) EPS is zero
(*b*) EPS is Minimum
(*c*) EPS is highest
(*d*) None of these

20. Financial Break-even level of EBIT is one at which:

(*a*) EPS is one
(*b*) EPS is zero
(*c*) EPS is Infinite
(*d*) EPS is Negative

21. Which of the following is not a relevant factor in EBIT EPS Analysis of capital structure?

(*a*) Rate of Interest on Debt
(*b*) Tax Rate
(*c*) Amount of Preference Share Capital
(*d*) Dividend paid last year

22. Between two capital plans, if expected EBIT is more than indifference level of EBIT, then

(*a*) Both plans be rejected,
(*b*) Both plans are good,
(*c*) One is better than other
(*d*) None of the above

23. X Ltd. is considering the following two alternative financing plans:

	Plan-I	Plan-II
Equity Shares (₹10 each)	4,00,000	4,00,000
12% Debentures	2,00,000	--
Pref. Shares (₹100 each)	--	2,00,000

The indifference point between the plans is ₹2,40,000. Corporate tax rate is 30%. Calculate rate of dividend on preference shares.

(*a*) 8.00% (*b*) 8.04%
(*c*) 8.40% (*d*) 8.80%

24. In case of Net Income Approach, the Cost of equity is:

(*a*) Constant (*b*) Increasing
(*c*) Decreasing (*d*) None of the above

25. In case of Net Income Approach, when the debt proportion is increased; the cost of debt:

(*a*) Increases (*b*) Decreases
(*c*) Constant (*d*) None of the above

26. Net Operating Income Approach, which one of the following is constant?

(*a*) Cost of Equity (*b*) Cost of Debt
(*c*) WACC & kd (*d*) Ke and Kd

27. NOI Approach advocates that the degree of debt financing is:

(*a*) Relevant (*b*) May be relevant
(*c*) Irrelevant (*d*) May be irrelevant

28. 'Judicious use of leverage' is suggested by:

(*a*) Net Income Approach (*b*) Net Operating Income Approach
(*c*) Traditional Approach (*d*) All of the above

29. In the Traditional Approach, which one of the following remains constant?

(*a*) Cost of Equity (*b*) Cost of Debt
(*c*) WACC (*d*) None of the above

30. Which of the following assumes constant kd and ke?

(*a*) Net Income Approach (*b*) Net Operating Income Approach
(*c*) Traditional Approach (*d*) MM Model

31. Which of the following is true?

(*a*) Under Traditional Approach, overall cost of capital remains same
(*b*) Under NI Approach, overall cost of capital remains same
(*c*) Under NOI Approach, overall cost of capital remains same
(*d*) None of the above

32. In MM Model with taxes, where r is the interest rate, D is the total debt and t is tax rate, then present value shields of debt would be:

(*a*) r × D × t (*b*) r × D
(*c*) D × t (*d*) (D × r)÷(l – t)

33. The overall capitalization rate and the cost of debt remain constant for all degrees of leverage. This is pronounced by ________.

(*a*) Traditional approach (b) Net operating income approach

(*c*) Net income approach (*d*) MM approach

34. M & M proposition, without taxes, states that:

(*a*) firms should borrow to the point where the tax benefit from debt is equal to the cost of the increased probability of financial distress.

(*b*) financial risk is determined by the debt-equity ratio.

(*c*) the cost of equity rise when financial leverage rises.

(*d*) it is completely irrelevant how a firm arranges its finances.

Answer Key

1. (*a*)	**2.** (*b*)	**3.** (*a*)	**4.** (*b*)	**5.** (*a*)	**6.** (*c*)	**7.** (*b*)	**8.** (*b*)	**9.** (*a*)	**10.** (*c*)
11. (*b*)	**12.** (*c*)	**13.** (*d*)	**14.** (*c*)	**15.** (*d*)	**16.** (*a*)	**17.** (*b*)	**18.** (*a*)	**19.** (*d*)	**20.** (*b*)
21. (*d*)	**22.** (*c*)	**23.** (*c*)	**24.** (*a*)	**25.** (*c*)	**26.** (*c*)	**27.** (*c*)	**28.** (*c*)	**29.** (*d*)	**30.** (*a*)
31. (*c*)	**32.** (*c*)	**33.** (*b*)	**34.** (*d*)						