

Assignment - 10  
As the amount of debt increase, the cost of Capital decreases - True or False. Give reasons.

\* False, The opposite relationship is true. The cost of equity increases as the company borrows more debt. The reason is that equity holders receive residual cash flows.

\* These are the cash flows left after the creditors receive their promised payments.

\* The higher probability of bankruptcy increases the risk to equity holders and thus increases the cost of equity to the firm.

As the amount of debt increases, the cost of Capital generally increases, not decreases, due to the following reasons:

\* Higher Financial Risk.

\* Increased Equity Cost.

\* Optimal Capital Structure and WACC

\* Potential for Financial Distress.

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