Question #1 of 12

Question ID: 1457986

Which of the following statements *most* accurately characterizes how debt ratings may affect a firm's capital structure policy?

A) A firm may be deterred from increasing the use of debt to avoid having its credit rating reduced below some minimum acceptable level. ✓

B) Firms that have their credit ratings reduced below investment grade are not able to issue additional debt. ✗

C) Because credit ratings are based upon cash flow coverage of interest expense, they are not influenced by the firm's capital structure. ✗

Explanation

Credit ratings can be factored into management's capital structure policy if a firm has a minimum rating objective, and this is likely to be adversely affected by issuing additional debt.

(Module 34.1, LOS 34.a)

Question #2 of 12

Question ID: 1457992

The conclusion of Modigliani and Miller's capital structure model with taxes is that:

A) capital structure decisions do not affect the value of a firm. ✗

B) there is a trade-off between tax savings on debt increased risk of bankruptcy. ✗

C) firms should be financed with all debt. ✓

Explanation

Because MM with taxes does not consider costs of financial distress, it concludes that tax savings of debt financing are maximized at 100% debt.

(Module 34.1, LOS 34.c)

Question #3 of 12

Question ID: 1463597

According to pecking order theory, which of the following lists *most* accurately orders financing preferences from most to least preferred?

A) Debt financing, retained earnings, and raising external equity.

B) Retained earnings, raising external equity, and debt financing.

C) Retained earnings, debt financing, and raising external equity.

Explanation

Financing choices under pecking order theory follow a hierarchy based on visibility to investors with internally generated capital being the most preferred, debt being the next best choice, and external equity being the least preferred financing option.

(Module 34.2, LOS 34.d)

Question #4 of 12

Question ID: 1457993

Under the assumptions of Modigliani and Miller's Proposition I, the value of a firm:

A) decreases as the use of equity financing rises.

B) increases as the use of debt financing rises.

C) is not affected by its capital structure.

Explanation

According to Modigliani and Miller's Proposition I, under certain assumptions, including the absence of taxes and bankruptcy costs, the value of a firm is unaffected by its capital structure.

(Module 34.1, LOS 34.c)

Question #5 of 12

Question ID: 1457995

Which of the following is *least likely* to be a reason why a firm's actual capital structure may vary from the target capital structure?

A) The firm decides to issue additional equity because management believes the firm's stock is overpriced.

B) The firm decides to issue additional debt due to a temporary discount in underwriting fees for corporate debt.

C) The firm decides to finance a low risk project with 100% debt to improve the project's profitability. ✓

Explanation

A firm should always finance a project based on the firm's weighted average cost of capital, although when evaluating a project, the firm may apply a risk factor to adjust the risk of the project. A corporate manager generally cannot deem some projects as being financed by debt and some by equity as all projects are effectively financed proportionately based on the firm's capital structure. In practice, a firm's actual capital structure will float around its target. For a firm that does have a target capital structure, the actual structure may vary from the target due to market value fluctuations, or management's desire to exploit an opportunity in a particular financing source.

(Module 34.2, LOS 34.d)

Question #6 of 12

Question ID: 1457994

Which of the following statements regarding Modigliani and Miller's Proposition II with taxes is *most accurate*?

A) Companies should use a 50% equity/50% debt capital structure to maximize value. ✗

B) The value of the firm is maximized at the point where the WACC is minimized. ✓

C) The tax shield provided by debt causes the WACC to increase as leverage increases. ✗

Explanation

The tax shield provided by debt causes the WACC to decrease as leverage increases. The value of the firm is maximized at the point where the WACC is minimized, which is 100% debt under the MM assumptions.

(Module 34.1, LOS 34.c)

Question #7 of 12

Question ID: 1457991

Removing the assumption of no taxes, but keeping all of Modigliani and Miller's other assumptions, which of the following would be the optimal capital structure for maximizing the value of a firm?

A) 100% equity. ✗

B) 50% debt and 50% equity.

C) 100% debt.

Explanation

If MM's other assumptions are maintained, removing the no tax assumption means that the value of the firm is maximized when the value of the tax shield is maximized, which occurs with a capital structure of 100% debt.

(Module 34.1, LOS 34.c)

Question #8 of 12

Question ID: 1457990

According to the static trade-off theory:

A) the amount of debt used by a company should decrease as the company's corporate tax rate increases.

B) there is an optimal proportion of debt that will maximize the value of the firm.

C) new debt financing is always preferable to new equity financing.

Explanation

The static trade-off theory seeks to balance the costs of financial distress with the tax shield benefits from using debt. Under the static trade-off theory, there is an optimal capital structure that has an optimal proportion of debt that will maximize the value of the firm.

(Module 34.1, LOS 34.c)

Question #9 of 12

Question ID: 1463598

Which of the following statements *most* correctly characterizes the pecking order theory of capital structure?

A) Firms have a preference ordering for capital sources, preferring internally-generated equity first, new debt capital second, and externally-sourced equity as a last resort.

B) Firms will seek to use debt financing up to the point that the value of the tax shield benefit is outweighed by the costs of financial distress.

C) Regardless of how the firm is financed, the overall value of the firm and aggregate value of the claims issued to finance it remain the same.

Explanation

The pecking order theory of capital structure assumes that firms have a preference ordering for capital sources. They prefer to use internally-generated equity first. When the internally-generated equity is exhausted, they issue new debt capital. As a last resort they will rely on externally-sourced equity. The reason that new equity is the last resort is that the issuance of new stock is assumed to send a negative signal to investors regarding firm value.

(Module 34.2, LOS 34.d)

Question #10 of 12

Question ID: 1457988

A company will typically use debt for the largest percentage of its financing during its:

A) maturity stage. ✓

B) start-up stage. ✗

C) growth stage. ✗

Explanation

Mature companies are able to support more debt than start-up companies or growth stage companies because they typically have predictable positive cash flows, lower business risk, and significant liquid assets.

(Module 34.1, LOS 34.b)

Question #11 of 12

Question ID: 1457996

When interest rates have fallen to low levels that are expected to persist, firms are *most likely* to have a preference for:

A) issuing debt. ✓

B) issuing equity. ✗

C) repurchasing equity. ✗

Explanation

When interest rates have fallen to low levels that are expected to persist, firms often increase their target proportion of debt to reflect its lower cost. Firms may issue equity when they perceive the market price of their stock to be temporarily high or repurchase their stock when they judge the price to be low.

(Module 34.2, LOS 34.d)

Question #12 of 12

Question ID: 1457989

Companies moving from the start-up stage to the growth stage *most likely* exhibit increasing:

A) debt financing costs.

B) business risk.

C) cash flow.

Explanation

For companies entering the growth stage, revenue and cash flow are typically increasing. Both debt financing costs and business risk tend to be somewhat reduced compared to the start-up stage.

(Module 34.1, LOS 34.b)