Chapter 5: Capital structure and dividends

Self test questions

1. Common stocks are securities with:

   (a) No specified maturity ☐ True ☐ False
   (b) No predetermined returns ☐ True ☐ False
   (c) No property rights attached to them ☐ True ☐ False
   (d) A priority claim on the firm's income ☐ True ☐ False

2. Ordinary debt, such as bank loans and bonds, are securities with:

   (a) No specified maturity ☐ True ☐ False
   (b) No predetermined returns ☐ True ☐ False
   (c) No property rights attached to them ☐ True ☐ False
   (d) A priority claim on the firm's income ☐ True ☐ False

3. Which of the following financial contracts are for future delivery and payment?

   (a) Forward contracts ☐ True ☐ False
   (b) Future contracts ☐ True ☐ False
   (c) Options ☐ True ☐ False
   (d) Spot contracts ☐ True ☐ False

4. Debt contracts can be *secured*:

   (a) By collateral such as mortgages ☐ True ☐ False
   (b) By converting them into traded securities ☐ True ☐ False
   (c) By clauses in the debt contract, such as ratio clauses ☐ True ☐ False

5. Debt contracts can be *securitized*:

   (a) By collateral such as mortgages ☐ True ☐ False
   (b) By converting them into traded securities ☐ True ☐ False
   (c) By clauses in the debt contract, such as ratio clauses ☐ True ☐ False

6. Which of the following shares can be listed on stock exchanges in most western countries?

   (a) Common shares ☐ True ☐ False
   (b) Dual class shares (A or B shares) ☐ True ☐ False
   (c) Golden shares ☐ True ☐ False
   (d) Non-voting shares ☐ True ☐ False
   (e) Preferred shares ☐ True ☐ False

7. Bonds without regular interest payments but with one final payment at maturity (comprising both interest and repayment) are called:

   (a) Income bonds
   (b) Junk bonds
   (c) Zero coupon bonds
   (d) Catastrophe bonds
   (e) Convertible bonds

8. Bonds that have a very high interest rate and a very high default risk are called:

   (a) Income bonds
   (b) Junk bonds
   (c) Zero coupon bonds
   (d) Catastrophe bonds
   (e) Convertible bonds

9. Bonds that can be exchanged for shares during a certain period of time are called:

   (a) Income bonds
   (b) Junk bonds
   (c) Zero coupon bonds
   (d) Catastrophe bonds
   (e) Convertible bonds

10. Which of the following activities are part of financial engineering?

(a)	Arranging finance for large engineering projects	☐ True	☐ False
(b)	Constructing new securities from existing securities	☐ True	☐ False
(c)	Making securities accessible to, or customized for, groups of investors	☐ True	☐ False
(d)	Re-distributing risk and return	☐ True	☐ False

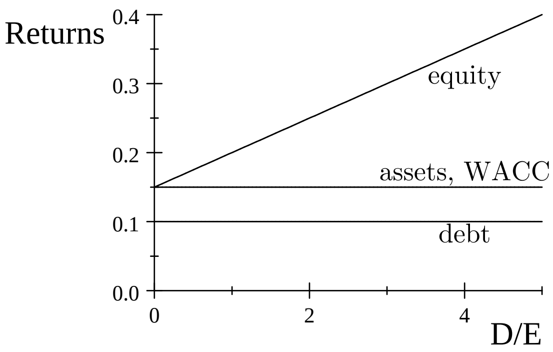
11. A firm's capital structure is:

    (a) The structure of its capital assets, e.g. fixed/current assets
    (b) The combination of capital categories it uses to finance its operations
    (c) The total value of the claims against the firm's possessions

12. In perfect markets:

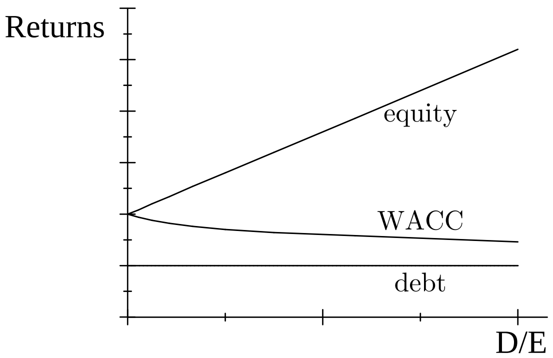
(a)	There are no taxes or transaction costs	☐ True	☐ False
(b)	All assets are marketable and perfectly divisible	☐ True	☐ False
(c)	There are no limitations on short selling	☐ True	☐ False
(d)	Investors have perfect foresight	☐ True	☐ False
(e)	There are no limitations on risk free borrowing or lending	☐ True	☐ False
(f)	Firms cannot create unique investment opportunities by changing their capital structures	☐ True	☐ False
(g)	There are large numbers of buyers and sellers, none of which can individually influence prices	☐ True	☐ False
(h)	All information is simultaneously and costlessly available to all investors	☐ True	☐ False

13. The following picture depicts Modigliani-Miller proposition 2:



(a) without taxes and with default risk/limited liability
(b) without default risk/limited liability and with taxes
(c) without taxes and without default risk/limited liability

14. The following picture depicts Modigliani-Miller proposition 2:

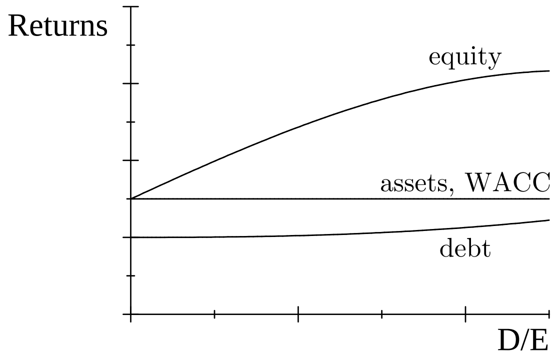


(a) with taxes and without default risk/limited liability
(b) with default risk/limited liability and without taxes
(c) with taxes and with default risk/limited liability
(d) None of the above

15. In a Modigliani-Miller world without taxes and without default risk/limited liability:

(a) The value of the firm increases with leverage
(b) The return on equity increases with leverage
(c) The return on debt increases with leverage

16. The following picture depicts Modigliani-Miller proposition 2:



(a) with taxes and without default risk/limited liability

(b) with default risk/limited liability and without taxes

(c) with taxes and with default risk/limited liability

17. Assume a Modigliani-Miller world *without taxes*. A company takes on some new projects and finances them with only equity so that the company's debt ratio becomes lower. This means that the required return on the company's equity:

(a) decreases

(b) stays the same

(c) increases

18. Assume a Modigliani-Miller world *with taxes*. A company takes on some new projects and finances them with only debt so that the company's debt ratio becomes higher. This means that the company's WACC:

(a) decreases

(b) stays the same

(c) increases

19. In a Modigliani-Miller world with taxes:

(a) The value of the firm increases with leverage

(b) The WACC increases with leverage

(c) The return on debt decreases with leverage

20. Why does the probability of financial distress increase with leverage?

(a) Because more creditors means a greater chance of trouble

(b) Because the financial risk of equity increases with leverage

(c) Because larger debt obligations mean a larger probability that the firm's cash flow is insufficient to meet them

21. According to the trade-off theory, optimal capital structure is reached when:

    (a) Lenders refuse to supply additional loans
    (b) The tax advantage is maximal
    (c) The expected costs of financial distress are minimal
    (d) The marginal expected tax advantage equals the marginal expected costs of financial distress

22. According to the trade-off theory, leverage *increases* with:

(a)	The proportion of growth opportunities in total firm value	☐ True	☐ False
(b)	The volatility of the firm's earnings	☐ True	☐ False
(c)	The tax rate	☐ True	☐ False
(d)	The firm's profitability	☐ True	☐ False
(e)	Firm size	☐ True	☐ False

23. According to the pecking order theory, leverage *decreases* with:

(a)	The proportion of growth opportunities in total firm value	☐ True	☐ False
(b)	The volatility of the firm's earnings	☐ True	☐ False
(c)	The tax rate	☐ True	☐ False
(d)	The firm's profitability	☐ True	☐ False
(e)	Firm size	☐ True	☐ False

24. According to the pecking order theory, when will equity be issued?

    (a) When equity is underpriced (good news is coming up)
    (b) When equity is fairly priced (no news is coming up)
    (c) When equity is overpriced (bad news is coming up)

25. How must dividend payments be financed to allow a proper anaysis of their effect on firm value?

    (a) By using the firm's cash
    (b) By issuing debt
    (c) By issuing shares

26. Which of the following market imperfection(s) can make dividends relevant?

(a)	Taxes and transaction costs	☐ True	☐ False
(b)	Assets are not perfectly divisible	☐ True	☐ False
(c)	Limitations on short selling	☐ True	☐ False
(d)	Information asymmetry	☐ True	☐ False

27. On what market 'mechanism' do the M-M irrelevance propositions rely?

    (a) Equilibrium in perfect markets
    (b) Arbitrage in perfect markets
    (c) Profit maximization

28. For managers with stock options, the main advantage of stock repurchases over cash dividends is that:

    (a) Stock repurchases do not change total shareholder value
    (b) Stock repurchases do not lower the stock price
    (c) Stock repurchases do not dilute the existing shareholders' claims