Question #1 of 67

Zoltan DeJainus is the Chief Financial Officer of Hilliard Veterinary Products (HVP). In a discussion with HVP's management team about the firm's capital structure, DeJainus makes the following comments:

Comment 1:	HVP's target capital structure is the same as its optimal capital structure.
Comment 2:	If market value fluctuations cause the firm's actual capital structure to vary from the target capital structure, HVP should buy or sell its own stock or bonds as necessary to make sure that the capital structure remains at its optimal level.

Should the members of HVP's management team agree or disagree with each of DeJainus' comments?

A) Agree with both.

B) Disagree with both.

C) Agree with only one.

Question #2 of 67

The *least likely* goal of an optimal capital structure decision is to target the amount of financial leverage that:

A) maximizes the stock price.

B) minimizes the cost of capital.

C) maximizes earnings per share (EPS

Question #3 of 67

A firm's capital structure affects:

A) return on equity and default risk.

B) default risk but not return on equity.

C) return on equity but not default risk.

Question #4 of 67

Gervase Jackson is a student in corporate finance class. Jackson is unsure how debt ratings tie into a company's capital structure and decides to talk to his professor after class. In their discussion, the professor makes the following statements:

Statement 1:	The most common way that firms use debt ratings in conjunction with capital structure is to set a certain minimum debt rating that the firm strives to stay above at all times.
Statement 2:	A change in debt rating from investment grade to speculative grade will significantly increase the firm's cost of debt capital.

With respect to the statements made by Jackson's professor:

A) both are incorrect.

B) only one is correct.

C) both are correct.

Question #5 of 67

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

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

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

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

Question #6 of 67

Katherine Epler, a self-employed corporate finance consultant, is conducting a seminar for executive management teams regarding issues related to a company's capital structure. In the morning session of the seminar, Epler makes the following two statements:

Statement 1:	Management teams will have a target capital structure for their firm because of an awareness of how competing firms finance their operations and a desire to keep their financial ratios close to industry averages.
Statement 2:	In order to reap the benefits that come with having a target capital structure, management must always raise capital in the exact proportions called for by the target.

With respect to Epler's statements:

A) only one is correct.

B) both are incorrect.

C) both are correct.

Question #7 of 67

Davis Streng, the corporate controller for the Cannizaro Corporation has been researching Modigliani and Miller's (MM) theories on capital structure. Streng would like to apply the theories to his firm's capital structure, but does not agree with MM's assumption of no taxes, since Cannizaro has a 40% tax rate. If Streng removes the assumption of no taxes, but keeps all of MM's other assumptions, which of the following would be the optimal capital structure for maximizing the value of the firm?

A) 100% debt.

B) The capital structure Streng chooses is irrelevant.

C) 100% equity.

Question #8 of 67

Which of the following statements about capital structure theories is *most* accurate?

A) In a world with taxes and bankruptcy costs one would expect there to be an optimal capital structure where the cost of capital is minimized and share price is maximized.

B) In a Modigliani and Miller (MM) world with taxes, but no bankruptcy cost, you would expect to see firms taking on very little debt.

C) Based on signaling theory, if a firm issues new common stock it means that the firm thinks future investment prospects are better than normal.

Tad Bentley, CFA, is the chief financial officer (CFO) for Industrial Inc., a manufacturer and distributor of cleaning supplies designed for commercial applications. Industrial Inc.'s current target market spans the entire United States, and possesses a large percentage of the national market. Senior management has formulated a strategy for expansion into Europe and Asia in the near future. The success of the expansion plans lay in large part upon the firm's ability to raise additional capital in the marketplace to finance the expansion. According to the preliminary time schedule for expansion into Europe and Asia, funds would need to be made available to the firm within the next eighteen to twenty four months.

Bentley is in charge of the team that is evaluating all financing options available to Industrial Inc. to determine which method would minimize the firm's weighted average cost of capital (WACC) while providing a capital structure that will maximize firm value and that is attractive to outside investors. The firm is considering either issuing additional debt or issuing a secondary equity offering to finance the venture. The firm's target capital structure will be utilized to determine what the specific advantages and disadvantages associated with the different methods of raising capital.

Industrial currently has $450 million of shareholders' equity outstanding. The company also has $100 million of 10-year notes issued with 4 years remaining to maturity. Industrial Inc.'s current rating is Aa by Moody's and AA by Standard and Poor's (S&P). Bentley is aware that any financing strategy must be considered in light of the potential impact the decision could have upon the company's current rating.

Any new acquisition of capital will be carefully analyzed in relation to Industrial Inc.'s current capital structure as well. Bentley is familiar with the different theories of capital structure and intends to determine which one is most applicable to Industrial Inc.'s current situation. Industrial Inc. is publicly traded on the New York Stock Exchange, and several analysts at large brokerage firms provide research on the stock. Bentley wants to ensure that the company's approach to raising additional capital will be acceptable to analysts and investors alike.

Top management of Industrial, Bentley included, collectively own a 20% equity stake in the firm, through either direct purchase of the stock or the receipt of executive stock options. This group is placing pressure on Bentley to recommend a strategy that would not significantly dilute their ownership position. Bentley realizes that he must recommend a strategy that will most effectively utilize the company's assets and that will be in the best interest of all of the company's stakeholders.

Question #9 of 67

Under a strict set of assumptions, Modigliani and Miller (MM) proposed a capital structure theory in 1958 in which Proposition I proves that:

A) the value of a firm is unaffected by its capital structure.

B) capital markets are perfectly competitive.

C) the cost of debt is lower than the cost of equity, so a firm should issue the maximum amount of debt before issuing equity.

Question #10 of 67

Under MM's Proposition II of their capital structure theory, will a firm that increases its use of debt *most* likely affect default risk, cost of equity, or both?

A) Increases only one.

B) Increases both.

C) Does not affect either.

Question #11 of 67

Bentley anticipates that whatever method of financing choice is utilized, it will be interpreted by investors as a signal of the firm's strategy and overall economic health. In accordance with the pecking order theory, which of the following methods are *least* likely and *most* likely to send "signals" to investors?

<u>Least Likely</u> <u>Most Likely</u>

A)	External equity	Debt
B)	External equity	Internally generated equity
C)	Internally generated equity	External equity

Question #12 of 67

Which of the following statements regarding the role of debt ratings is *least* accurate?

A) Historically, the difference in yield between an AAA-rated bond and a BBB-rated bond has averaged 100 basis points.

B) The lower the debt rating, the higher the level of default risk for both shareholders and bondholders alike.

C) Any rating Ba (from Moody's) or BB (from S&P) or higher is considered to be "investment grade".

Question #13 of 67

As a result of Industrial expanding its operations into Europe and Asia, Bentley anticipates an increase in foreign investors in the firm. Which of the following statements regarding international differences in leverage is *least* accurate?

A) Companies operating in countries that have active institutional investors tend to have less financial leverage than firms in countries with less of an institutional presence.

B) Companies in the U.S. tend to use shorter maturity debt than companies in Japan.

C) Companies in Japan and France tend to have more debt in their capital structure than firms in the U.S.

Question #14 of 67

In any firm, managers who do not have a stake in the company do not bear the costs of taking on too much or too little risk. The costs associated with the conflicts of interest between managers and owners are referred to as:

A) agency costs.

B) monitoring costs.

C) the costs of asymmetric information.

Question #15 of 67

According to the static trade-off theory:

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

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

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

Question #16 of 67

Which of the following statements regarding how different capital structure theories impact managers' capital structure decisions is *most* accurate? According to:

A) pecking order theory, issuing new debt is preferable to issuing new equity.

B) the static trade-off theory, debt will not be used if a company is in a high corporate tax bracket.

C) MM's propositions (assuming no taxes), companies have an optimal level of debt financing.

Question #17 of 67

High Plains Tubular Company is a leading manufacturer and distributor of quality steel products used in energy, industrial, and automotive applications worldwide.

The U.S. steel industry has been challenged in recent years by competition from foreign producers located primarily in Asia. U.S. producers are experiencing declining margins as labor costs continue to increase. In addition, most U.S. steel mills are technologically inferior to those of foreign competitors and U.S. producers have significant unresolved issues related to complying with environmental protection laws.

High Plains is not immune from the problems of the industry and is currently in technical default under its bond covenants. The default is a result of the firm's failure to meet certain coverage and turnover ratios. High Plains has argued that this is largely due to the favorable credit terms it has given to its customers (major customers are given 90 days to settle) in order to gain market share.

Earlier this year, High Plains and its bondholders entered into an agreement that will give High Plains time to come into compliance with the covenants. If High Plains is not in compliance by year-end, the bondholders can immediately accelerate the maturity date of the bonds. In that case, High Plains would have no choice but to file for bankruptcy.

High Plains follows U.S. GAAP. For the year ended 2014, High Plains received an unqualified opinion from its independent auditor. However, the auditor's opinion included an explanatory paragraph about High Plains' inability to continue as a going concern in the event its bonds remain in technical default. At the end of 2014, High Plains' Chief Executive Officer (CEO) and Chief Financial Officer (CFO) filed the certifications required by the Securities and Exchange Commission (SEC).

Jon Farnsworth, CFA, is reviewing High Plains' financial accounts to gain a better understanding of credit risk of the company. The first element that causes Farnsworth some concern is the cash flow statement. This is shown in Exhibit 1.

Exhibit 1: Cash Flow Statement

High Plains Tubular Cash Flow Statement		
	Year ended December 31,	
in thousands	**2014**	**2013**
Net income	$158,177	$121,164
Depreciation expense	34,078	31,295
Deferred taxes	7,697	11,407

Receivables	(144,087)	(24,852)
Inventory	(79,710)	(72,777)
Payables	36,107	22,455
Cash flow from operations	$12,262	$88,692
Cash flow from investing	($39,884)	($63,953)
Cash flow from financing	$82,676	$6,056
Change in cash	$55,054	$30,795

Exhibit 2: Selected Financial Footnotes

1. During 2008, High Plains' sales increased 27% over 2007. Its sales growth continues to significantly exceed the industry average. Sales are recognized when a firm order is received from the customer, the sales price is fixed and determinable, and collectability is reasonably assured.
2. The cost of inventories is determined using the last-in, first-out (LIFO) method. Had the first-in, first-out method been used, inventories would have been $152 million and $143 million higher as of December 31, 2008 and 2007, respectively.
3. Effective January 1, 2008, High Plains changed its depreciation method from the double-declining balance method to the straight-line method in order to be more comparable with the accounting practices of other firms within its industry. The change was not retroactively applied and only affects assets that were acquired on or after January 1, 2008.
4. High Plains made the following discretionary expenditures for maintenance and repair of plant and equipment and for advertising and marketing:

in millions	2014	2013	2012
Maintenance and repairs	$180	$184	$218
Advertising and marketing	94	108	150

5. During the fiscal year ended December 31, 2014, High Plains sold $50 million of its accounts receivable, with recourse, to an unrelated entity. All of the receivables were still outstanding at year end.
6. High Plains conducts some of its operations in facilities leased under noncancelable finance (capital) leases. Certain leases include renewal options with provisions for increased lease payments during the renewal term.
7. High Plains reclassified $2.9 million of inventory as other assets in 2014. This material had been reported within inventory as work-in-progress in 2013.

Exhibit 3: Bill-and-Hold Analysis

High Plains EBT margin	5.1%
Average tax rate	28%

Which of the following is *least likely* to prevent earnings manipulation?

A) SEC certification filed by High Plains' CEO and CFO.

B) The independent audit.

C) High Plains' bond covenants.

Question #18 of 67

Which of the following *best* describes the shape of the line depicting the value of a levered firm when plotted according to the static trade-off theory? Assume that the percentage of debt in the capital structure is the independent variable.

A) Always upward sloping.

B) U shaped.

C) Upside down U shaped.

Question #19 of 67

Which of the following statements about a firm's capital structure is *least* accurate?

A) If bankruptcy costs were included into the M&M analysis of capital structure in a tax world there would be an optimal capital structure between no debt and all debt.

B) The firm's share price is maximized when the firm maximizes its earnings per share while it minimizes its cost of capital.

C) The optimal capital structure is the one that minimizes the weighted average cost of capital and consequently maximizes the value of the firm's share price.

Question #20 of 67

Katherine Epler, a self-employed corporate finance consultant, is having a discussion with friends that are also in the corporate finance field. After talking about their families, the discussion turns to factors that tend to impact capital structure. During the course of the conversation, Epler makes two statements.

Statement 1:	Favorable tax rates on dividend income relative to interest income will reduce the value of the tax shield provided by debt in the static trade-off theory of capital structure.
Statement 2:	Evidence indicates that reductions in the net agency costs of equity tend to lead to lower financial leverage ratios.

With respect to Epler's statements:

A) both are correct.

B) only one is correct.

C) both are incorrect.

Question #21 of 67

Modigliani and Miller demonstrated that if corporate taxes and bankruptcy costs are introduced into an otherwise perfect world the weighted average cost of capital (WACC) will:

A) fall continuously as more debt is added to the capital structure.

B) fall, then bottom out, and finally start to rise.

C) rise, then plateau, and finally start to fall.

Question #22 of 67

Which of the following is *least likely* to be categorized as a cost of financial distress?

A) Legal fees paid to bankruptcy lawyers.

B) Having a potential merger partner pull out of a proposed deal.

C) Premiums paid for bonding insurance to guarantee management performance.

Question #23 of 67

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 finance a low risk project with 100% debt to improve the project's profitability.

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

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

Question #24 of 67

Which of the following is likely to encourage a firm to *increase* the amount of debt in its capital structure?

A) The firm's earnings become more volatile.

B) The corporate tax rate increases.

C) The personal tax rate increases.

Question #25 of 67

Michael Sherman is a finance professor at the University of Tuskaloosa. In a recent lecture concerning the factors an analyst should consider when evaluating the impact of capital structure on the valuation of a firm, Sherman makes the following statements:

Statement 1:	The changes that occur in a company's capital structure over time are irrelevant for assessing the impact of capital structure on valuation because changes in market conditions mean that only the current capital structure is relevant for analysis.
Statement 2:	If an analyst is comparing the capital structure of one firm to the capital structure of a competitor firm, it is important to adjust the analysis for differences in business risk.

Sherman's students should agree with:

A) only one statement.

B) both statements.

C) neither statements.

Question #26 of 67

The optimal capital structure:

A) maximizes expected EPS maximizes the price per share of common stock.

B) maximizes the stock price minimizes the weighted average cost of capital.

C) minimizes the required rate on equity maximizes the stock price.

Question #27 of 67

Schwarzwald Industries recently issued new equity to help fund a new capital project. What type of signal is Schwarzwald's choice of financing sending to investors about the future prospects of the firm under the information asymmetry signaling theory and pecking order theory respectively?

A) Positive signal under only one theory.

B) Negative signal under both theories.

C) Positive signal under both theories.

Question #28 of 67

Which of the following changes in debt ratings is *most likely* to have the greatest negative impact on a firm's weighted average cost of capital (WACC)? A change in debt rating from:

A) BBB to BB.

B) AA to A.

C) BB to BBB.

Question #29 of 67

Modigliani and Miller demonstrated that if corporate taxes are introduced into an otherwise perfect world, the optimal capital structure would be:

A) all equity.

B) all debt.

C) an equal amount of debt and equity.

Question #30 of 67

John Harrison is discussing the implications for Modigliani and Miller (MM's) propositions (assuming no corporate or personal taxes) for manager's decisions regarding capital structure with his supervisor, Harriet Perry. In the conversation, Harrison makes the following statements:

Statement 1:	According to MM's propositions, increasing the use of cheaper debt financing will increase the cost of equity and the net change to the company's weighted average cost of capital (WACC) will be zero.
Statement 2:	Since MM's propositions assume that there are no taxes, equity is the preferred method of financing.

What is the *most* appropriate response to Harrison's statements?

A) Agree with one only.

B) Agree with neither.

C) Agree with both.

Bavarian Crème Pies (BCP) has been baking and selling cakes, pies, and other confectionary items for more than 150 years. The company started out, like many firms, as a small Mom and Pop operation. Today the firm has more than 4500 employees at 10 facilities in Germany, France, Belgium, and Holland. BCP's stock has recently been under considerable pressure, and is trading at a 15-year low. The Bank of Munich, the firm's primary lender and also a major stockholder, has succeeded in forcing BCP's CEO into accepting an early retirement package.

The new CEO, Dietmar Schulz, is attempting to turn around the firm's loss of market value, and reviving the attractiveness of the firm as an investment. BCP's sales have been strong, growing by more than 5 percent during the past year to a new record. Firm profits, while not growing at the pace he believes that they can, remain positive, and measures of profitability remain within what he considers to be acceptable bounds. Therefore, he believes that the firm's valuation problem may emanate from the choice of capital structure, which is currently 30 percent equity and 70 percent debt.

Because of their financial interest in the firm, the Bank of Munich has made it clear that they will provide whatever assistance they can to help the effort. Schulz has enlisted the services of one of the bank's corporate finance team, Katarina Iben, CFA. Iben has advised other bank customers regarding capital structure, and has helped them to devise plans to improve shareholder value. Schulz has begun to prepare a list of topics that he wants to address with Iben when she meets with BCP's finance staff on Friday.

On the top of the list of questions is the matter of whether or not the sources of a firm's capital can affect firm value. Schulz recalls that during his days as a master's degree student at the London School of Economics his professors told about the M and M theories regarding capital structure. As it has been some time since he has thought about these theories, he plans to ask Iben to discuss them with his staff.

Schulz also recalls that many theoretical concepts are based upon assumptions about markets and market frictions. He is concerned that, whatever the outcome of the finance staff's discussions with Iben, any decisions made by BCP must remain grounded in the real world so that he can defend them to his board and to shareholders. To this end, he plans to foster a discussion with Iben and his staff concerning some of the practical matters that pertain to the firm's capital structure in the real world.

Three days later Iben has arrived at BCP's headquarters for the big meeting. Schulz opens the discussion by asking Iben to characterize the main objective concerning capital structure, and how one might go about assessing whether or not BCP was anywhere near meeting this objective.

Question #31 of 67

Which of the following statements correctly characterizes the main objective of the capital structure decision?

A) Maximize the WACC.

B) Maximize firm value.

C) Minimize firm risk.

Question #32 of 67

Which of the following statements *most* correctly characterizes MM proposition 1?

A) 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.

B) Increasing the use of relatively lower cost debt causes the required return on equity to increase such that the overall cost of capital is unchanged.

C) 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.

Question #33 of 67

Which of the following statements *most* correctly characterizes MM proposition 2?

A) 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.

B) Increasing the use of relatively lower cost debt causes the required return on equity to increase such that the overall cost of capital is unchanged.

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.

Question #34 of 67

Which of the following items is *least likely* to be a cost that has the potential to influence capital structure decisions?

A) Financial distress.

B) Agency.

C) Homogeneous expectations.

Question #35 of 67

The main outcome of the static trade-off theory is:

A) there is no optimal capital structure.

B) there is an optimal capital structure.

C) the value of the firm is not affected by the choice of capital structure.

Question #36 of 67

Which of the following factors is *least* applicable when an analyst is attempting to assess whether a firm's capital structure is value maximizing?

A) Changes in the structure over time.

B) The quality of the firm's corporate governance.

C) The proximity of the current structure to the stated target.

Question #37 of 67

Katherine Epler, a self-employed corporate finance consultant, is conducting a seminar concerning differences in financial leverage across different countries. In her seminar, Epler makes the following statements:

Statement 1:	Companies in developed countries tend to use less long-term debt when financing their operations compared with companies in emerging markets.
Statement 2:	Companies operating in Japan tend to have a greater reliance on shorter term debt financing than companies operating in the United States.

With respect to Epler's statements:

A) both are correct.

B) only one is correct.

C) both are incorrect.

Question #38 of 67

A firm's optimal debt ratio:

A) maximizes return.

B) is the firm's target capital structure.

C) minimizes risk.

Question #39 of 67

According to pecking order theory, which financing choice is *most* preferred, and which is *least* preferred?

	Most preferred	Least preferred
A)	New debt	New equity
B)	Internally generated funds	New debt
C)	Internally generated funds	New equity

Question #40 of 67

Katherine Epler, a self-employed corporate finance consultant, is working with another new client, Thurber Electronics. Epler is discussing the static trade-off capital structure theory with her client, and makes the following comments:

Comment 1:	Under the static trade-off theory, the graph of a company's weighted average cost of capital has a U shape.
Comment 2:	According to the static trade-off theory, every firm will have the same optimal amount of debt that maximizes the value of the firm.

With respect to Epler's comments:

A) both are incorrect.

B) both are correct.

C) only one is correct.

Question #41 of 67

Jayco, Inc. currently has a Debt/Assets ratio of 33.33% but feels its optimal Debt/Assets ratio should be 16.67%. Sales are currently $750,000, and the total assets turnover (Sales / Assets) is 7.5. If Jayco needs to raise $100,000 to expand, how should the expansion be financed so as to produce the desired debt ratio? Finance it with:

A) 25% debt, 75% equity.

B) all debt.

C) all equity.

Question #42 of 67

Rupert Jones, a manager with Oswald Technologies, is confused about agency costs of equity and how they can be managed at his firm. To try to gain a better understanding about agency costs, Jones asks Karrie Converse, a well known consultant for an explanation. In their conversation, Converse makes the following statements:

Statement 1:	Costs related to the conflict of interest between managers and owners of a business can be eliminated through a combination of bonding provisions and adequate monitoring through a quality corporate governance structure.
Statement 2:	The less a company depends on debt in its capital structure, the lower the agency costs the company will tend to have.

Are Converse's statements concerning the agency costs of equity *correct*?

A) Both are correct.

B) Only one is correct.

C) Both are incorrect.

Question #43 of 67

Vernon Hurd is an analyst that is covering Oswald Technologies. Hurd does not have the privilege of knowing the firm's exact target capital structure, but would like to determine whether or not the capital structure policies followed by Oswald's management is maximizing the value of the firm. Which of the following approaches would be most useful to Hurd to determine whether management's current capital structure policy is maximizing Oswald's value?

A) Cross-sectional ratio analysis with firms that have similar business risk to Oswald.

B) Scenario analysis.

C) Dupont analysis.

Question #44 of 67

Which of the following firms is *most likely* to utilize additional debt the next time it raises capital? The firm:

A) that has many new fixed assets.

B) in a high tax bracket.

C) firm that has experienced significant losses in recent years.

Bijou and Stephenson are old buddies both who have retired from careers in finance. Now in their 70s they like to meet once a week to discuss current affairs and finance related topics over a game of dominoes.

Bijou excitedly tells Stephenson that his grandson (Mihir) has got his first job working at a corporate finance house. Mihir is assessing the cost of capital in three different countries and has asked Bijou if he can help him with any insights.

The data Mihir has collect is as follows:

<u>Country 1 Company: Carnegie Inc</u>

	Scenario 1	Scenario 2	Scenario 3
Proportion of debt	0%	50%	80%

Cost of Equity	12%	16%	28%
Cost of Debt	8%	8%	8%

Country 2 Company: Sapata Inc

	Scenario 1	Scenario 2	Scenario 3
Proportion of debt	0%	50%	80%
Cost of Equity	15%	16%	18%
Cost of Debt	10%	12%	16%

Country 3 Company Fisher Ltd

	Scenario 1	Scenario 2	Scenario 3
Proportion of debt	0%	50%	80%
Cost of Equity	15%	16%	18%
Cost of Debt	10%	10%	10%

Stephenson turns to Bijou and says "It's all well and good to study M&M leverage theory but we must remember that it had a lot of restrictive assumptions. For example M&M's study assumed that capital markets are perfectly competitive and investors have homogonous expectations.

Bijou agrees with Stephenson but points out "The purpose of M&M is to tell us that in the real world capital structure matters precisely because one or more of these assumptions is violated. Once you introduce financial distress, irrational investors you move closer and closer to static trade off theory."

Mihir joins the discussion and noted that his supervisor mentioned the cost of asymmetric information increases as more debt is added to the firm's capital structure. Stephenson responds "The manager is confused as according to the Pecking Order theory the cost of asymmetrical information increases as we add more equity."

Question #45 of 67

Country 1 is most consistent with?

A) M&M Propositions without tax

B) Static trade off theory

C) M&M Propositions with tax

Question #46 of 67

Country 2 is most consistent with?

A) Static trade off theory

B) M&M Propositions with tax

C) M&M Propositions without tax

Question #47 of 67

Country 3 is most consistent with?

A) M&M Propositions with tax

B) Static trade off theory

C) M&M Propositions without tax

Question #48 of 67

Regarding Bijou and Stephenson's comments on M&M and leverage theory:

A) Both comments are correct

B) One comment is correct

C) Neither comment is correct

Question #49 of 67

Which factor(s) Bijou and Stephenson would *least* likely need to consider when evaluating a firm's capital structure?

A) Changes in the firm’s capital structure over time.

B) Capital structure of competitors with similar business risk.

C) Factors affecting agency costs such as credit ratings.

Question #50 of 67

Regarding Mihir's and Stephenson's comments on the cost of asymmetric information:

A) Neither comment is correct

B) Stephenson is correct

C) Mihir’s supervisor is correct

Question #51 of 67

The maturity structure for corporate debt is typically shorter in countries that have:

A) low rates of GDP growth.

B) more liquid stock and bond markets.

C) lower rates of inflation.

Question #52 of 67

Financial leverage ratios tend to be to low in countries that have:

A) inefficient legal systems.

B) a large institutional investor presence.

C) a high reliance on the banking system for raising debt capital.

Question #53 of 67

Katherine Epler, a self-employed corporate finance consultant, is preparing a new seminar concerning debt ratings and how they impact capital structure policy. As she is working on her presentation, Epler prepares two presentation slides that contain the following:

Slide 1:	Lower debt ratings will increase the cost of debt as well as the cost of equity financing.
Slide 2:	Managers would prefer to have the highest possible debt ratings.

With respect to Epler's slides:

A) both are correct.

B) both are incorrect.

C) only one is correct.

Question #54 of 67

Joseph Palmer is discussing the impact of the tax shield provided by debt with his supervisor, Ming Chou. During the course of their discussion, Palmer makes the following statements:

Statement 1:	The value of the tax shield provided by debt can be calculated by multiplying the pre-tax cost of debt by (1 – tax rate).
Statement 2:	If a company is profitable, the value of its tax shield will be positive and its value will increase as its leverage increases, all else equal.

With respect to Palmer's statements:

A) only one is correct.

B) both are incorrect.

C) both are correct.

Question #55 of 67

Which of the following companies is *most likely* to have the greatest expected cost of financial distress?

A) An airline company with strong management.

B) An information technology service provider with a weak corporate governance structure.

C) A steel manufacturer with an average debt to equity ratio for the industry.

Question #56 of 67

Steve Cooley, the Chief Financial Officer for Canberra Corporation, decides that he wants to use as much debt as possible in his firm's capital structure. Cooley knows that to use more debt, he will need to make a persuasive argument to his board. Which of the following arguments used by Cooley to help with his goal of raising large amounts of additional debt is *least* supported by empirical evidence?

A) Increasing the amount of debt has an insignificant impact on our credit risk premium.

B) The cost of debt is always cheaper than the cost of equity.

C) Raising additional debt provides a signal to our shareholders that our firm's future prospects are positive.

Question #57 of 67

Katherine Epler, a self-employed corporate finance consultant, is working with her newest client, Harbor Machinery. Epler is discussing various capital structure theories with her client, and makes the following comments.

Comment 1:	If we remove the assumption of no taxes from Modigliani and Miller's theory regarding capital structure, and if the firm holds some proportion of debt, increases in the corporate tax rate will result in the value of the firm being higher than the value of an otherwise identical zero debt firm.
Comment 2:	If we also include the costs of financial distress in Modigliani and Miller's assumptions, the optimal capital structure will not contain any debt financing.

With respect to Epler's comments:

A) only one is correct.

B) both are correct.

C) both are incorrect.

Question #58 of 67

Jeffery Pyle, a health care analyst for a major brokerage firm, is trying to determine how capital structure policy impacts the valuation of firms he covers. Which of the following factors is likely to be the *least* useful for his analysis?

A) How often management uses internally generated capital versus raising new capital in the capital markets.

B) Differences in capital structure across firms in his coverage universe.

C) Quality of corporate governance.

Question #59 of 67

Bhairavi Patel, an analyst for major brokerage firm, is considering how to incorporate the static trade-off capital structure theory into her valuation models for companies she covers. Patel is discussing the static trade-off theory with her colleagues, and makes the following statements:

Statement 1:	If a firm maintains a high debt rating, the firm cannot be at its optimal capital structure based on the static trade-off theory.
Statement 2:	The static theory implies that differences in the optimal capital structure across similar firms in different countries must be the result of different tax rates in those countries.

With respect to Patel's statements:

A) both are correct.

B) both are incorrect.

C) only one is correct.

Question #60 of 67

Assume that the debt rating given by Standard and Poor's for Oswald Technologies drops from AAA to BBB. Which of the following reflects the *most likely* increase in the cost of debt for Oswald Technologies?

A) 100 basis points.

B) 500 basis points.

C) 10 basis points.

Frank Collins, CFA, is managing director for Brisbane Capital Resources, an Australian fund manager. The firm has had great success through the years with its growth-oriented investment strategy, but has suffered when the markets change in favor of value investment strategies. Consequently, Collins is exploring how the firm might increase its presence in the value sector of the market.

Many of the firms that reside in the value sector are those that have fallen on hard times, and have underperformed their peers. During his examination of firms meeting various value criteria, Collins has noted that while falling sales and the lack of profits are sometimes the obvious causes of the substandard performance, in other cases sales and profits do not appear to be the root cause. He wonders if the way that these firms have been capitalized is having a negative impact on their values.

Collins recalls from his days of studying finance at the University of Queensland, that a Nobel Prize was awarded for one of the theories in the capital structure area. His recollection of the details is sketchy, so he has contacted Dr. Martin Gray from UQ's Department of Commerce to discuss capital structure in theory and in practice.

Gray tells Collins that his memory is indeed correct, that a Nobel Prize was awarded to Miller and Modigliani for their work in explaining the capital structure decision. Interestingly, he notes that their theories say that, under the right circumstances, capital structure is irrelevant. Obviously, the key is whether or not the right circumstances are relevant to what is observed in the real world.

Gray continues to tell Collins that there are a variety of matters that complicate the MM theory in practice. Firms pay taxes, managers may be motivated by their own self-interests, and adjustments to a firm's capital structure are not costless. All of these factors affect the MM theories, and have given rise to other theories that attempt to explain why firms finance themselves as they do.

Collins also wonders if capital structure decisions are affected in any way by the country in which the firm is domiciled. He knows that Australia tends to follow the Anglo-American financial model, but that firms in continental Europe, Japan, and other countries are more accustomed to relying upon banks for capital. He wonders if this affects the capital structures observed across firms, even when the firms have the same underlying business risk.

Finally, Collins asks Gray about corporate debt ratings. Gray tells him that ratings fall broadly across two classes—"investment grade and speculative—"with a variety of ratings within each class. Moreover, Gray advises that firms usually seek to maintain a credit rating in the investment grade class, since some fiduciary investors are precluded from holding debt in the speculative class. Collins wonders if a firm's debt ratings have any bearing upon the choice of capital structure.

Question #61 of 67

Which of the following statements *most* accurately characterizes the static trade-off theory of capital structure?

A) 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.

B) Increasing the use of relatively lower cost debt causes the required return on equity to increase such that the overall cost of capital is unchanged.

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.

Question #62 of 67

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

A) 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.

B) 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.

C) 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.

Question #63 of 67

When taxes are incorporated into the capital structure decision, the main result is that:

A) firms should increase the use of equity financing because of its inherent tax advantages.

B) the firm derives a tax shield benefit from using debt because the interest expense is tax-deductible.

C) the costs of financial distress become relevant to the analysis.

Question #64 of 67

Which of the following reasons is *least* accurate regarding why a firm's actual capital structure may deviate from its target capital structure?

A) The book values of outstanding debt and equity are different from their market values.

B) There may be economies of scale in issuing debt securities.

C) Management may believe that now is an opportune time to issue equity.

Question #65 of 67

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

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

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

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

Question #66 of 67

Which of the following statements concerning the use of leverage is *most* accurate?

A) A high degree of information asymmetry tends to reduce the use of debt in the capital structure.

B) The use of leverage in capital structures is broadly consistent in most developed economies.

C) Companies in countries where the use of bank debt (as opposed to issuing bonds) is more prevalent tend to use more leverage.

Question #67 of 67

Which one of the following statements about a firm's capital structure is *most* accurate? The optimal capital structure:

A) maximizes expected earnings per share (EPS), maximizes the price per share of common stock.

B) minimizes the required rate on equity, maximizes the stock price.

C) maximizes the stock price, minimizes the weighted average cost of capital (WACC).