Questions on Capital Structure

Optimal capital structure  

1. Which of the following statements is most correct?  
   a. As a rule, the optimal capital structure is found by determining the debt-equity mix that maximizes expected EPS.  
   b. The optimal capital structure simultaneously maximizes EPS and minimizes the WACC.  
   c. The optimal capital structure minimizes the cost of equity, which is a necessary condition for maximizing the stock price.  
   d. The optimal capital structure simultaneously minimizes the cost of debt, the cost of equity, and the WACC.  
   e. None of the statements above is correct.

Leverage and capital structure  

2. Which of the following statements is most correct?  
   a. A reduction in the corporate tax rate is likely to increase the debt ratio of the average corporation.  
   b. An increase in the personal tax rate is likely to increase the debt ratio of the average corporation.  
   c. If changes in the bankruptcy code make bankruptcy less costly to corporations, then this would likely reduce the debt ratio of the average corporation.  
   d. All of the statements above are correct.  
   e. None of the statements above is correct.

Leverage and capital structure  

3. Which of the following statements is likely to encourage a firm to increase its debt ratio in its capital structure?  
   a. Its sales become less stable over time.  
   b. Its corporate tax rate declines.  
   c. Management believes that the firm’s stock is overvalued.  
   d. Statements a and b are correct.  
   e. None of the statements above is correct.

Leverage and capital structure  

4. Which of the following factors is likely to encourage a corporation to increase the proportion of debt in its capital structure?  
   a. An increase in the corporate tax rate.  
   b. An increase in the company’s degree of operating leverage.  
   d. The company’s assets become less liquid.  
   e. An increase in expected bankruptcy costs.
5. Which of the following statements is most correct?
   a. The optimal capital structure minimizes the WACC.
   b. If the after-tax cost of equity financing exceeds the after-tax cost of debt financing, firms are always able to reduce their WACC by increasing the amount of debt in their capital structure.
   c. Increasing the amount of debt in a firm’s capital structure is likely to increase the costs of both debt and equity financing.
   d. Statements a and c are correct.
   e. Statements b and c are correct.

6. The possibility of bankruptcy will do all of the following except:
   A) increase financial distress costs.
   B) reduce the current market value of the firm.
   C) reduce the interest rate on debt.  \(\text{Answer: C) reduce the interest rate on debt.} \)
   D) reduce the possible payoff to stockholders.

7. The tax savings of the firm derived from the deductibility of interest expense is called the:
   a. Interest tax shield.
   b. Depreciable basis.
   c. Financing umbrella.
   d. Current yield.
   e. Tax-loss carryforward savings.

8. The optimal capital structure is the mixture of debt and equity which:
   I. Maximizes the value of the firm.
   II. Maximizes the firm’s weighted average cost of capital.
   III. Maximizes the market price of the firm’s bonds.
   a. I only
   b. III only
   c. I and II only
   d. I and III only
   e. I, II and III
Which of the following statements about capital structure theory is most correct?

a. Signaling theory suggests firms should in normal times maintain reserve borrowing capacity that can be used if an especially good investment opportunity comes along.

b. In general, an increase in the corporate tax rate would cause firms to use less debt in their capital structures.

c. According to the “trade-off theory (case III discussed in our class),” an increase in the costs of bankruptcy would lead firms to reduce the amount of debt in their capital structures.

d. Statements a and c are correct.