31 CAPITAL STRUCTURE

1. 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) 50% debt and 50% equity.
   (B) 100% equity.
   (C) 100% debt.

2. A company will typically use debt for the largest percentage of its financing during its:
   (A) start-up stage.
   (B) maturity stage.
   (C) growth stage.

3. 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) Debt financing, retained earnings, and raising external equity.
   (C) Retained earnings, debt financing, and raising external equity.

4. The least likely reason that a firm's actual capital structure weights fluctuate around its target capital structure weights is that:
   (A) the firm may opportunistically finance its growth with debt.
   (B) the firm's stock price fluctuates.
   (C) the firm's book value increases over time.

5. 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.

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

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

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

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

7. According to the static trade-off theory:

(A) new debt financing is always preferable to new equity financing.

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

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

8. 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) firms should be financed with all debt.

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

9. 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 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) 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.