CHAPTER 31

CAPITAL STRUCTURE

1. (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.

(Study Session 10, Module 31.1, LOS 31.b)

Related Material

Schweser Notes - Book 3

2. (B) maturity 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.

(Study Session 10, Module 31.1, LOS 31.a)

Related Material

Schweser Notes - Book 3

3. (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.

(Study Session 10, Module 31.2, LOS 31.d)

Related Material

Schweser Notes - Book 3

4. (C) the firm's book value increases over time.

Explanation

Target capital structure weights are based on market values of debt and equity, not book (accounting) values. Changes in stock price will affect actual capital structure weights. Firms may issue debt (or equity) when they believe current market conditions make that a preferred alternative (e.g., interest rates are temporarily low).

(Study Session 10, Module 31.2, LOS 31.c)

Related Material

Schweser Notes - Book 3

5. (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.

(Study Session 10, Module 31.2, LOS 31.c)

Related Material

Schweser Notes - Book 3

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

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.

(Study Session 10, Module 31.2, LOS 31.d)

Related Material

Schweser Notes - Book 3

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

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.

(Study Session 10, Module 31.1, LOS 31.b)

Related Material

Schweser Notes - Book 3

8. (B) **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.

(Study Session 10, Module 31.1, LOS 31.b)

Related Material

Schweser Notes - Book 3

8. (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.**

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.

(Study Session 10, Module 31.2, LOS 31.d)

Related Material

Schweser Notes - Book 3