

1. Which of the following statements best describes the optimal capital structure?
 - a. The optimal capital structure is the mix of debt, equity, and preferred stock that maximizes the company's earnings per share (EPS).
 - b. The optimal capital structure is the mix of debt, equity, and preferred stock that maximizes the company's stock price.**
 - c. The optimal capital structure is the mix of debt, equity, and preferred stock that minimizes the company's cost of equity.
 - d. The optimal capital structure is the mix of debt, equity, and preferred stock that minimizes the company's cost of debt.
 - e. The optimal capital structure is the mix of debt, equity, and preferred stock that minimizes the company's cost of preferred stock.
2. Which of the following statements is CORRECT?
 - a. A firm can use retained earnings without paying a flotation cost. Therefore, while the cost of retained earnings is not zero, its cost is generally lower than the after-tax cost of debt.
 - b. The capital structure that minimizes a firm's weighted average cost of capital is also the capital structure that maximizes its stock price.**
 - c. The capital structure that minimizes the firm's weighted average cost of capital is also the capital structure that maximizes its earnings per share.
 - d. If a firm finds that the cost of debt is less than the cost of equity, increasing its debt ratio must reduce its WACC.
 - e. Other things held constant, if corporate tax rates declined, then the Modigliani-Miller tax-adjusted tradeoff theory would suggest that firms should increase their use of debt.
3. Which of the following statements is CORRECT?
 - a. In general, a firm with low operating leverage also has a small proportion of its total costs in the form of fixed costs.**
 - b. There is no reason to think that changes in the personal tax rate would affect firms' capital structure decisions.
 - c. A firm with high business risk is more likely to increase its use of financial leverage than a firm with low business risk, assuming all else equal.
 - d. If a firm's after-tax cost of equity exceeds its after-tax cost of debt, it can always reduce its WACC by increasing its use of debt.
 - e. Suppose a firm has less than its optimal amount of debt. Increasing its use of debt to the point where it is at its optimal capital structure will decrease the costs of both debt and equity financing.
4. Companies HD and LD have identical amounts of assets, operating income (EBIT), tax rates, and business risk. Company HD, however, has a much higher debt ratio than LD. Company HD's basic earning power ratio (BEP) exceeds its cost of debt (r_d). Which of the following statements is CORRECT?
 - a. Company HD has a higher return on assets (ROA) than Company LD.
 - b. Company HD has a higher times interest earned (TIE) ratio than Company LD.
 - c. Company HD has a higher return on equity (ROE) than Company LD, and its risk, as measured by the standard deviation of ROE, is also higher than LD's.**
 - d. The two companies have the same ROE.
 - e. Company HD's ROE would be higher if it had no debt.
5. Which of the following statements is CORRECT?
 - a. Generally, debt-to-total-assets ratios do not vary much among different industries, although they do vary among firms within a given industry.
 - b. Electric utilities generally have very high common equity ratios because their revenues are more volatile than those of firms in most other industries.
 - c. Drug companies (prescription, not illegal!) generally have high debt-to-equity ratios because their earnings are very stable and, thus, they can cover the high interest costs associated with high debt levels.
 - d. Wide variations in capital structures exist both between industries and among individual firms within given industries. These differences are caused by differing business risks and also managerial attitudes.**
 - e. Since most stocks sell at or very close to their book values, book value capital structures are almost always adequate for use in estimating firms' costs of capital.