Session 18a: Post Class tests

1. Assume that the legislators are looking at enacting a new tax law, aimed at getting companies to pay out more of their earnings as dividends. As part of this law, companies will pay two different tax rates on net income: a 35% tax rate on retained earnings and a 15% tax rate on earnings paid out as dividends. What effect will this have on corporate financing behavior?
    a. None. Debt ratio should remain unchanged
    b. Debt ratios should go up over time, as companies pay more dividends
    c. Debt ratios should go down over time.
2. Asker Inc. is an all-equity funded firm that is considering borrowing $ 1 billion at a market interest rate of 6%. If the loan is a balloon payment loan for 10 years (only interest paid for the next 10 years and the principal at the end of year 10) and Asker faces a 40% marginal tax rate, what is the value of the tax benefits that Asker will get just from the ten-year loan?
    a. $24 million
    b. $176.64 million
    c. $240.00 million
    d. $264.96 million
    e. $1 billion
3. The argument for debt as a mechanism to discipline management is built around the premise that stockholders generally have little power over managers. If this argument holds true, a company that borrows more money should
    a. Invest more in good projects after the borrowing
    b. Invest less in good projects after the borrowing
    c. Invest more in bad projects after the borrowing
    d. Invest less in bad projects after the borrowing
    e. None of the above
4. A cost that has to be weighed into the debt decision is the expected cost of bankruptcy. As that cost rises, companies should borrow less money. Assume that you are looking at a European power company that has historically enjoyed monopoly power and has funded itself with a significant amount of debt. The power market has now been opened up to competition. What change would you expect to see in the company's debt policy?
    a. None. It is still a profitable company
    b. Debt ratio should go up.
    c. Debt ratio should go down.

    Explain.

5. Agency costs arise any time there is a conflict between stockholder interests and lender interests. Assuming that agency costs are high at a company, relative to the rest of the market, which of the following would you expect to observe with the company's borrowing?
    a. It will be able to borrow less than other companies

b. It will have to pay higher interest rates on its loans than otherwise similar companies
c. It will face more “covenants” than otherwise similar companies
d. All of the above
e. None of the above