

33 Lecture - MGT201

Important Subjective

1. **What is the traditional view of capital structure, and how does it differ from the modern view?**

Answer: The traditional view of capital structure assumes that there is an optimal capital structure that maximizes the firm's value by minimizing the cost of capital. The modern view recognizes that there is no single optimal capital structure, but rather a range of acceptable structures, and that a firm's capital structure decisions are influenced by a variety of factors, including market conditions, tax considerations, and the firm's risk profile.

2. **What is the pecking order theory of capital structure, and how does it relate to asymmetric information?**

Answer: The pecking order theory of capital structure suggests that firms prefer to finance their investments using internal funds first, then debt, and finally equity. This preference arises because of the asymmetric information between managers and outside investors, which makes external financing more expensive. By relying on internal funds and debt, firms can avoid the adverse selection problem associated with issuing equity.

3. **What is the trade-off theory of capital structure, and how does it balance the benefits and costs of debt financing?**

Answer: The trade-off theory of capital structure suggests that firms balance the benefits and costs of debt financing to determine their optimal capital structure. The benefits of debt financing include the tax shield from interest payments and the ability to increase the return on equity for the firm's shareholders. The costs of debt financing include bankruptcy costs and agency costs from conflicts between managers and shareholders.

4. **What is the agency cost of debt, and how can it be mitigated?**

Answer: The agency cost of debt arises from the conflict of interest between debtholders and shareholders, where shareholders may pursue actions that increase the value of their equity but harm the interests of debtholders. The agency cost of debt can be mitigated by using covenants in debt contracts, requiring collateral or guarantees, and monitoring by creditors.

5. **How does the presence of financial distress costs affect a firm's capital structure decisions?**

Answer: The presence of financial distress costs, such as bankruptcy costs and the loss of reputation, can influence a firm's capital structure decisions by making it more reluctant to take on additional debt. This may lead the firm to choose a lower debt-to-equity ratio than it would otherwise prefer.

6. **How does the market timing theory of capital structure differ from the pecking order and trade-off theories?**

Answer: The market timing theory of capital structure suggests that firms are opportunistic in their financing decisions and that they time their debt issuances to take advantage of favorable market conditions. This theory differs from the pecking order and trade-off theories in that it assumes that firms have more control over their capital structure decisions and are more strategic in their approach.

7. **How do taxes influence a firm's capital structure decisions, and what is the effect of the tax shield?**

Answer: Taxes can influence a firm's capital structure decisions by providing a tax shield on interest payments that reduces the cost of debt financing relative to equity financing. The tax shield increases the after-tax cash flows available to equity holders and can lead to an increase in the value of the firm.

8. **What is the effect of asymmetric information on a firm's capital structure decisions, and how can the problem be mitigated?**

Answer: Asymmetric information between managers and outside investors can make external financing more expensive and influence a firm's capital structure decisions. The problem can be mitigated by using signaling mechanisms, such as dividend policy, and by providing transparency through disclosure and financial reporting.

9. **What is the role of financial flexibility in a firm's capital structure decisions?**

Answer: Financial flexibility allows a firm to respond to unexpected changes in market conditions or investment opportunities. This flexibility can be enhanced by maintaining a lower debt-to-equity ratio or by using convertible debt, which can be converted