Key to Quiz D: 3/21/12

Quiz: Assume that Firms A and B are generally similar except that the management of and investors in Firm A have approximately the same information about the firm's operations and prospects while the management and investors of Firm B have vastly different information about the firm's operations and prospects. What differences might you expect to find in the way these two firms are funded? How would you explain these differences?

(Firm B is more likely to have more debt) for a couple of reasons:

1. (If the prospects of Firm B are strong then the management of firm B will issue debt to (signal their confidence))

   Reason this is a believable signal: if the firm's prospects are weak, then issuing debt creates a significant risk of bankruptcy

   => the firm's management is often fired during bankruptcy

2. Firm B's stockholders will rather the firm (raise external capital by issuing debt than by issuing equity)

   Reason: management has an (incentive to issue stock when they know it is overvalued)

   => as a result, a firm's stock price tends to fall when the firm announces that it plans to issue stock

\[
\begin{align*}
10 &= 50 \\
8 &= 47 \\
6 &= 44 \\
4 &= 40 \\
2 &= 35 \\
1 &= 30 \\
0 &= 25
\end{align*}
\]