

17
Key for Quiz B: 10/15/12

Assume that PanditOut Inc. announces plans to issue additional debt and use the proceeds to repurchase shares of common stock. At the announcement, the prices of PanditOut's common shares and its outstanding bonds rose. Excluding tax issues, how would you explain these reactions?

1) The debt will help (raise the value of the firm) as it helps to (resolve stockholder-manager conflicts)

=> cash will be (used for debt service) so that management (can't waste it on empire building)

✓ => management tends to want a larger firm since pay, perks, prestige and power are greater at larger firms

✓ => management may also pursue costly diversification with excess cash

=> the (threat of bankruptcy) will give (management an incentive to work harder)

✓ => problem: management bears the cost of hard work but shares the benefit with stockholders

=> to some extent, the additional creditors may also provide (extra monitoring of management)

2) The debt may send a signal that management is confident in the firm's future

✓ => the value of the firm's stocks and bonds rise to reflect this confidence

Scale

21 = 75	5 = 55
19 = 72	4 = 54
18 = 70	04 = 48
13 = 66	
12 = 63	
11 = 60	
- 10 = 58	
7 = 57	
6 = 56	