Key to Quiz A: 3/21/12

Quiz: Assume that yesterday Firms A and B were identical. However, because of changes made this morning by the management of Firm B, the expected financial distress costs are now far higher for Firm B than for Firm A.

a. Based on the information in chapter 16, what types of changes in firm B might have lead to these higher expected financial distress costs at Firm B?

b. What is the difference between the direct and indirect financial distress costs that Firm B now faces?

c. List, but do not explain, two direct and four indirect financial distress costs that Firm B might now face?

d. Based on the information in chapter 16, how large an impact do financial distress costs have on the value of the average firm?

a. Several things might have occurred:

1) Firm B might have issued additional debt

2) the value of Firm B's assets might have fallen

3) Firm B's cash flows might have become more volatile

4) the value of Firm B's assets might have become more volatile

b. Direct costs occur when the firm goes through bankruptcy while indirect costs occur when the (chance that a firm goes bankrupt increases) to the point that people begin to (change the way they behave towards the firm)

c. Direct (two of): cost to hire accountants, lawyers, or investment bankers

Indirect (four of): loss of customers, loss of suppliers and trade credit, loss of best employees, more difficulty collecting from customers, fire sale of assets, loss of value as management fights fires rather than maximizing value, losses by creditors as we default on what we owe them.

d. Average direct = 3-4% of firm value, average indirect = 10 – 20% of firm value

29 = 50
27 = 48
26 = 46
22 = 44

21 = 42
20 = 40
18 = 39
16 = 38

15 = 37
14 = 36
13 = 35
12 = 34
4 = 30