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 <u>same information</u> about the firm's operations and prospects while the management and investors of Firm B have <u>vastly different</u> 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 would 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

10 = 50
8 = 47
6 = ~~[illegible]~~ 44
4 = 40
2 = 35
1 = ~~[illegible]~~ 30
0+ = 25