Key for Quiz A: 03/18/13

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

Wall Street Journal Questions are on the back of this page.

1) The value of the firm falls

=> less debt to help resolve stockholder-manager conflict

=> cash that had gone to debt service is now more likely to be wasted by management on empire building

=> management wants larger firm since pay, perks, prestige, and power tend to be higher at larger firms

=> management more likely to use cash to pursue costly diversification

=> management will not work as hard without threat of bankruptcy that comes from debt service

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

=> less debt means less monitoring of management

2) Less debt may signal that management is less confident in firm's future

=> value of firm's stocks and bonds fall to reflect this lack of confidence

Scale: 24 = 50
17 = 48
15 = 47
12 = 46
10 = 44
9 = 42
8 = 40
6 = 38

3 = 36
2 = 35
1 = 30
0+ = 20