

Corporate Finance, Module 18: Weighted Average Cost of Capital

*Illustrative Test Questions*

(The attached PDF file has better formatting.)

Question 18.1: WACC

Which of the following statements about weighted average cost of capital (WACC) is true?

- A. The WACC provides a good evaluation measure for a capital budgeting project that is *safer* than other projects of the firm.
- B. One purpose of the WACC is to adjust the cost of *equity* by the appropriate tax rate.
- C. The WACC provides the correct discount rate only for projects with business *risks similar to those of the existing assets* of the firm.
- D. The WACC provides the correct discount rate only for projects whose capital needs are *provided by the same percentage of debt* as the other projects of the firm.
- E. If a company issues additional debt, the increased leverage causes the WACC to *rise*.

Answer 18.1:

*Statement A:* The applies only to projects that are similar to the firm.

*Statement B:* The cost of *debt* capital (not equity capital) is adjusted by the tax rate.

*Statement C:* The WACC is the firm's cost of capital; it applies only to projects that are similar in risk to the existing activities of the firm.

*Statement D:* The *actual borrowing* for each project is *not relevant*. Only the *risk* of the project is relevant, or the optimal debt-equity ratio for the project.

*Statement E:* If the value of the tax shield is greater than the increased cost of bankruptcy, the increased leverage causes the WACC to *decline*.