#1-69A

EASY INTERMEDIATE HARD

# CFA® SAMPLE QUESTION – LEVEL I

## Corporate Finance

**Q:** What happens to a company's weighted average cost of capital (WACC) if the firm's corporate tax rate increases and if the Federal Reserve cause an increase in the risk-free rate, respectively?

(Consider the events independently, and assume a beta of less than one.)

The firm's WACC will:

**CORRECT ANSWER:**

| | Tax rate increase | Increase in risk-free rate |
|---|---|---|
| ⓐ | **Decrease** | **Increase** |

First, please remember the corporate after tax cost of debt is equal to kd (1-t). So an increase in the corporate tax rate will reduce the after-tax cost of debt (i.e. the so-called tax shield). As a result, the WACC will fall.

If the risk-free rate were to increase, the cost of debt and equity would both increase, thus causing the firm's cost of capital to increase.

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Date of issue:
1 Jan 2024

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