#1-171A

EASY INTERMEDIATE HARD

CFA® SAMPLE QUESTION – LEVEL I

Corporate Finance

Q: Assume that a company has equal amounts of debt, common stock, and preferred stock. An increase in the corporate tax rate of a firm will cause its weighted average cost of capital (WACC) to:

CORRECT ANSWER:

ⓒ fall.

Recall the WACC equation:

$$WACC = \frac{E}{D+E}(r_e) + \frac{D}{D+E}(r_d)(1-t)$$

Where:
E = market value of equity
D = market value of debt
r_e = cost of equity
r_d = cost of debt
t = corporate tax rate

So the increase in the corporate tax rate will result in a lower cost of debt, resulting in a lower WACC for the company.

** For preferred stock, it won't have any taxation treatment effect in the calculation.*

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