Corporate Finance, Module 16, “Debt Policy”

Readings for Ninth Edition

(The attached PDF file has better formatting.)

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The page numbers here are for the *ninth* edition of Brealey and Myers. You may also use the seventh or eighth editions of this text. The page numbers for the seventh and eighth editions are in separate postings.

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Read the introduction on pages 472-473. The central topic of this module is summarized as “Modigliani and Miller, who showed that dividend policy doesn’t matter in perfect capital markets, also showed that financing decisions don’t matter in perfect markets.”

Read section 18.1, “The Effect of Leverage in a Competitive Tax Free Economy,” on pages 473-479, focusing on the sub-section “Enter Modigliani and Miller” on pages 474-475. Make sure you can replicate Tables 18.1 and 18.2 on page 477 and Table 18.3 on page 478; the final exam questions are similar to the data in these tables.

Read section 18.2, “Financial Risk and Expected Returns,” on pages 479-483. Focus on the relations for

- R_A and R_E on pages 480-481
- β_A and β_E on page 482

Know also the CAPM equation relating β to the expected return. You use these equations to solve final exam questions on returns and betas.

Read section 18.3, “The weighted average cost of capital,” on pages 483-484, but don’t be concerned if the concepts are unclear. You must know the weighted average cost of capital, and this relation is discussed in more detail in a later module.

Skip the subsections “The Traditional Position,” “Exotic Securities,” and “Imperfections and Opportunities” on pages 484-488.

Read section 18.4, “A final word on taxes,” on pages 488-489. This section restates the intuition. The formula is not new, but the repetition helps you understand the material.

Read the summary on pages 489-490 until the line “… has no effect on firm value” at the top of page 490; skip the rest of the summary.