

## Corporate Finance, Module 17, "Optimal Corporate Borrowing"

### *Readings for Ninth Edition*

(The attached PDF file has better formatting.)

Updated: November 19, 2007

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 page 496. As Brealey and Myers say: "We're shooting for a theory combining MM's insights plus the effects of taxes, cost of bankruptcy and financial distress..."

Read section 19.1, "Corporate Taxes," on pages 497-500. Brealey and Myers do an excellent job of removing the complications of corporate taxes and presenting the theory.

Skip section 19.2, "Corporate and Personal Taxes," on pages 501-503. A complete analysis of all taxes, both corporate taxes and personal taxes, with emphasis on the difference between taxes on capital gains and stock dividends, is necessary to analyze capital structure. But the tax analysis detracts from the concepts. If you ever analyze capital structure, you must spend several days examining the tax liabilities caused by debt and stock dividends, but the final exam for this course concentrates on corporate taxes, not personal taxes.

Read section 19.3, "Costs of Financial Distress," on pages 503-507, skipping the sections "Evidence on Bankruptcy Costs" on page 507 and "Direct vs Indirect Costs of Bankruptcy" on pages 507-508. Read the sections "Financial Distress Without Bankruptcy" on pages 508-509, "Debt and Incentives" on page 509, "Risk Shifting: The First Game" on page 510, and "Refusing to Contribute Equity Capital: The Second Game," on pages 510-511. Skip the section "And Three More Games, Briefly," on pages 511-512, and skip the section "What the Games Cost" on pages 512-513.

Read the section "Costs of Distress Vary with Type of Asset" on pages 514-515 and the section "The Trade-off Theory of Capital Structure" on pages 515-517. These are important sections; the trade-off theory is the mainstream view. It is not perfect (that is, it can not explain everything), but it does as well as anything else.

Read section 19.4, “The Pecking Order of Financing Choices” on pages 517-521, but skip the final sub-section, “The Bright Side and the Dark Side of Financial Slack” on pages 521-522. The pecking order is Myers’s theory, given as a presidential address to the financial analysts community many years ago. Read the summary on pages 522-523.