

Corporate Finance, Module 16, "Debt Policy"

Corporate finance module 16: Readings for Tenth Edition

(The attached PDF file has better formatting.)

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The page numbers here are for the *tenth* edition of Brealey and Myers. You may also use the seventh, eighth, or ninth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the tenth edition.

{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 418. 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 17.1, "The Effect of Financial Leverage in a Competitive Tax Free Economy," on pages 419-424, focusing on the sub-section "Enter Modigliani and Miller" on pages 420-421. Make sure you can replicate Tables 17.1 on page 422, 17.2 on page 423, and Table 17.3 on page 424; the final exam questions are similar to the data in these tables.

Read section 17.2, "Financial Risk and Expected Returns," on pages 424-428. Focus on the relations for

- R_A and R_E on page 425-427
- β_A and β_E on page 427-428

Know the CAPM equation relating β to expected return. You use the equations to solve final exam questions on returns and betas. The end of chapter problems in the textbook and the practice problems on the discussion forum help you with these relations.

Read section 17.3, "The weighted average cost of capital," on pages 428-429. The concepts may seem difficult at first, but you must understand the weighted average cost of capital. The relations are discussed in more detail in a later module.

Skip the subsections "The Traditional Position," "Exotic Securities," and "Imperfections and Opportunities" on pages 430-433. Brealey and Myers explain why they disagree with certain other views. You must understand Brealey and Myers's for the final exam.

Read section 17.4, "A final word on taxes," on page 433. This section restates the intuition. The formula is not new, but the repetition helps you understand the material.

Read the summary on pages 434 until the line "... has no effect on firm value" in the middle of the page; skip the rest of the summary.

Review problems 1, 2, 3, and 4 on page 435; problems 5, 6, and 8 on page 436; problems 11 and 12 on page 437; and problems 18, 19, 21, and 22 on page 438.