Corporate Finance, Module 16, “Debt Policy”

Corporate finance module 16: Readings for Eleventh Edition

(The attached PDF file has better formatting.)

The page numbers here are for the *eleventh* edition of Brealey and Myers. You may also use the seventh, eighth, ninth, or tenth 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 eleventh 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 427. The central topic of this module is summarized as “Modigliani and Miller (MM), who showed that dividend policy doesn’t matter in perfect capital markets, also showed that financing decisions don’t matter in perfect markets” (last paragraph in first column).

Read section 17.1, “The Effect of Financial Leverage in a Competitive Tax Free Economy,” on pages 428-433, focusing on the sub-section “Enter Modigliani and Miller” on pages 429-430. Make sure you can replicate Tables 17.1 on page 431, 17.2 on page 432, and Table 17.3 on page 433; the final exam questions are similar to the data in these tables.

Read section 17.2, “Financial Risk and Expected Returns,” on pages 433-437. Focus on the relations for

- R_A and R_E on page 434
- β_A and β_E on page 437

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 437-438.The concepts may seen 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 439-441. Brealey and Myers explain why they disagree with other views. You must understand Brealey and Myers's for the final exam.

Read section 17.4, “A final word on the after-tax weighted average cost of capital,” on pages 441-442. This section restates the intuition. The formula is not new, but the repetition helps you understand the material.

Read the summary on page 442 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, 4, 5, 6, 8, 9, 11, 12, and 13 on pages 443-446; and problems 19, 20, 21, and 22 on pages 446-447. Be sure you can solve problems 19 and 20; the final exam asks similar problems.