

## Corporate Finance, Module 16, “Debt Policy”

*Required reading, Eighth Edition:*

(The attached PDF file has better formatting.)

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{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 445. 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 Leverage in a Competitive Tax Free Economy,” on pages 445-451, focusing on the sub-section “Enter Modigliani and Miller” on pages 446-448. Make sure you can replicate Table 17.1 on page 449, Table 17.2 on page 450, and Table 17.3 on page 451; the final exam questions are similar to the data in these tables.

Read section 17.2, “Financial Risk and Expected Returns,” on pages 452-456. Focus on the relations for

- $R_A$  and  $\beta_A$  on page 454-455
- $R_E$  and  $\beta_E$  on page 455

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

Skip section 17.3, “The weighted average cost of capital,” on pages 456-461. You must know the weighted average cost of capital, this relation is discussed in a later module and there is nothing that you must know from this section.

Read the summary on page 462 until the line “... has no effect on firm value” at the top of page 463; skip the rest of the summary.