

Hamada's equation, the Sarbanes-Oxley Act of 2002 and the UK Companies Act of 2006: A critique

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Purpose

The purpose of this paper is to show that Hamada's equation, which is used operationally to evaluate changes in capital structure as a result of changes in financial leverage, is subject to a number of non-trivial deficiencies. Each of these deficiencies is of sufficient importance to nullify the fundamental purpose of this equation, render its function impossible, and epistemologically contradict its functioning. Moreover, to the extent that it is dependent on the empirically invalid capital asset pricing model (CAPM), Hamada's equation defies basic requirements of sound research methodology. Since it cannot do what it purports to do and is an operational fiction, it cannot assist directors with capital structure valuations in terms of Section 172 of the UK Companies Act of 2006. Further, if used operationally, is likely to contravene Section 807 §1348 of the Sarbanes-Oxley Act of 2002.

Design/methodology/approach

A secondary survey of Hamada's equation, recent UK and US legislation and the literature of corporate financial management is undertaken in order to examine whether the fundamental purpose, function and functioning of this equation could validly and reliably achieve what it purports to achieve.

Findings

The derivation of Hamada's equation assumes perfect competition, yet to achieve its fundamental purpose and its function it is dependent on financial markets being inefficient and imperfectly competitive. Thus, its functioning requires a state that its mathematical derivation negates. Epistemologically, this equation is unsound, and since it is also dependent on an empirically invalid approach to the calculation of the cost of capital, the CAPM, Hamada's equation is an invalid valuation equation.

Originality/value

Keywords: [Corporate finances](#), [Laws and legislation](#), [United Kingdom](#), [United States of America](#), [Gearing](#), [Risk analysis](#)

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