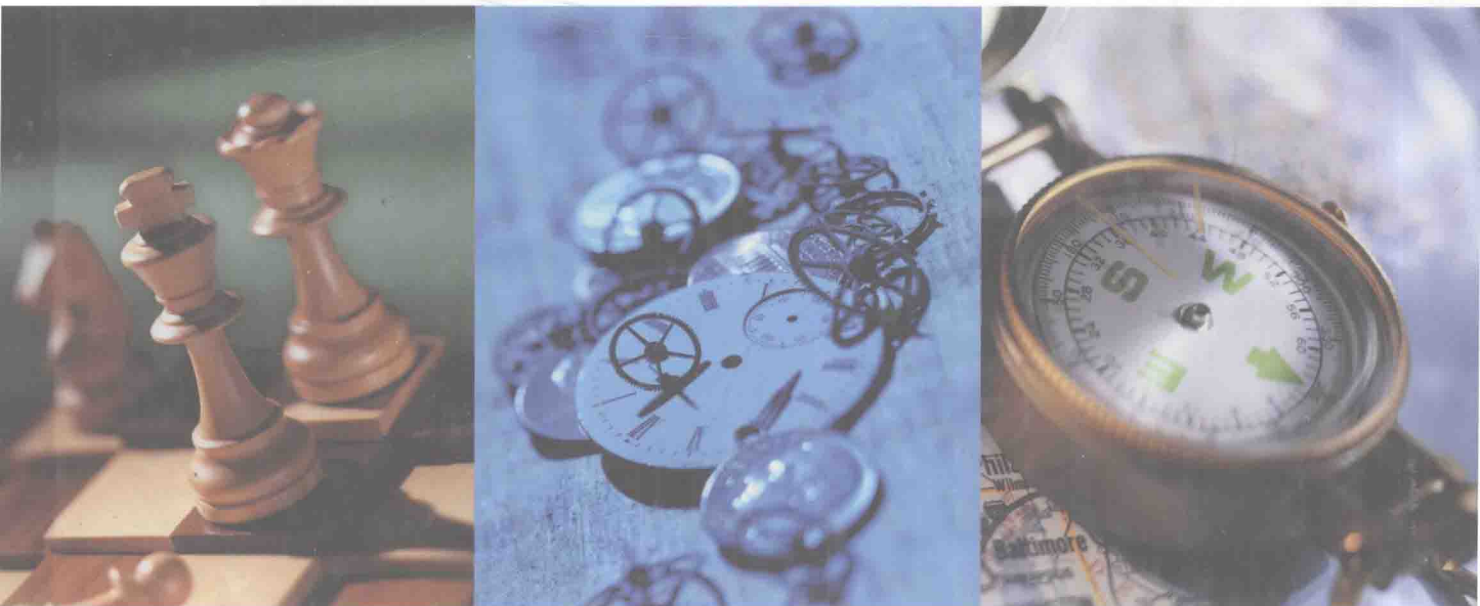


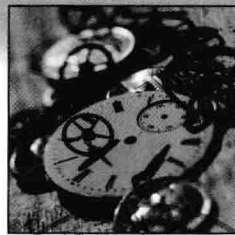
PRINCIPLES OF FINANCE

Second Edition



Scott Besley
Eugene F. Brigham

PRINCIPLES OF FINANCE



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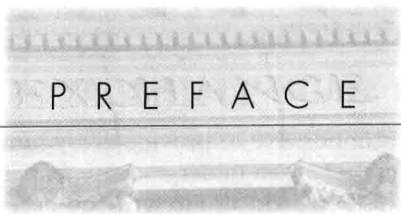
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P R E F A C E

P*principles of Finance* is intended for use in an introductory finance course. The book represents a survey of key concepts by covering the three general areas of study in finance: (1) financial markets and institutions, (2) investments, and (3) managerial finance. The book begins with a discussion of the principles of financial systems—markets, institutions, and assets. This section is followed by a presentation of general business concepts, including discussions of business organizations and goals and an examination of financial health. The next set of chapters covers valuation concepts, which include the time value of money, valuing financial and real assets, and fundamentals of risk and return. Then, corporate decision making, or managerial finance, is presented. The discussions here center on how financial managers can help maximize their firms' values by improving decisions in such areas as capital budgeting, choice of capital structure, and working capital management. Finally, in the last two chapters, investment fundamentals are explained. This organization has three important advantages:

1. Explaining early in the book how financial markets operate and how security prices are determined helps students understand how managerial finance can affect the value of the firm. This background helps when coverage of such key concepts as risk analysis, time value, and valuation techniques are discussed throughout the remainder of the book.
2. Structuring the book around markets and valuation enhances continuity because this organization helps students see how the various topics relate to one another.
3. Most students—even those who do not plan to major in finance—are generally interested in investment concepts, such as stock and bond valuation and selection, how financial markets work, how risk and rates of return affect financial decision making, and the like. Because people's ability to learn a subject is a function of their interest and motivation, and because *Principles* begins by showing the relationships among security markets, valuing financial assets, and managerial finance, this organization works well from a pedagogic standpoint.

Although this book is intended to be a survey of general finance, we could not include discussions of every area associated with the field of finance. Thus, we included those topics considered most relevant to presenting a basic understanding of the diversity of finance as an area of study. Because most students who read this book will probably not become finance majors, this book will be their only exposure to finance, including investment concepts that seemingly are intriguing to all of us. For that reason, we have structured the book so that (1) its content is sufficient to provide students with a good basic understanding of finance and (2) it can be used as a reference, or guide, for answering fundamental questions about finance.

RELATIONSHIP WITH OTHER SOUTH-WESTERN BOOKS

Clearly it is impossible to provide everything one needs to know about finance in one text, especially an undergraduate text. This recognition has led us to limit the scope of this book and also to write other texts to deal with the materials that cannot be included in *Principles*. We have authored a text that emphasizes more detailed material about managerial finance (*Essentials of Managerial Finance*, twelfth edition). Also, Eugene F. Brigham and Philip R. Daves have coauthored an intermediate undergraduate text (*Intermediate Financial Management*, seventh edition), and Eugene F. Brigham and Michael C. Ehrhardt have coauthored a comprehensive book aimed primarily at MBAs (*Financial Management: Theory and Practice*, tenth edition).

The relationship between *Principles* and the more advanced books deserves special comment. First, we recognize that the advanced books are often used by students who have also used *Principles* in the introductory undergraduate course. Thus, we wanted to avoid excessive overlap but wanted to be sure to expose students to alternative points of view on controversial subjects. We should note, though, that our students in advanced courses invariably tell us that they find it helpful to have the more difficult materials repeated—they need the review. Students also say they like the fact that the style and notation used in our upper-level books are consistent with those in the introductory text, as this makes learning easier. Regarding alternative points of view, we have made every effort to take a moderate, middle-of-the-road approach, and where serious controversy exists, we have tried to present the alternative points of view. Reviewers were asked to consider this point, and their comments have helped us eliminate potential biases.

INTENDED MARKET AND USE

As noted earlier, *Principles* is intended for use as an introductory text. The key chapters can be covered in a one-term course, and if supplemented with cases and some outside readings, the book can also be used in a two-term course. If it is used in a one-term course, the instructor might cover only selected chapters, leaving the others for students either to examine on their own or to use as reference in conjunction with work in later courses. Also, we have made every effort to write the chapters in a flexible, modular format, which helps instructors cover the material in a different sequence should they choose to do so.

IMPORTANT FEATURES OF THE BOOK

We must present the material contained in the book in a structured manner to ensure continuity and cogency in the coverage of the topics. To enhance the pedagogy, we have included some important features, which are discussed here.

Cash Flow Time Lines and Solutions Approach to TVM Analysis

In our discussions of time value of money topics (Chapter 9), we begin each major section with a verbal discussion of a time value issue, and then we present a time line to show graphically the cash flows that are involved, after which we give the equation that must be solved to obtain the required answer. Finally, we present

two methods that can be used to solve the equation: (1) a numerical solution and (2) a financial calculator solution. (The use of interest tables is now shown in an appendix to the chapter.) The cash flow time line helps students visualize the problem at hand and see how to set it up for solution, the equation helps them understand the mathematics, and the two-pronged solution approach helps them see that time value problems can be solved in alternative ways. Each student will focus on the particular solution technique he or she will actually use, which generally calls for using a financial calculator. One advantage of our approach is that with it a financial calculator is not considered a “black box”; rather, it is viewed as an efficient way to solve a particular time value problem. The same general approach is used in subsequent chapters, especially in the chapters dealing with stock and bond valuation and capital budgeting.

Globalization

The movement toward the globalization of financial markets and businesses is continuing more rapidly than ever. Foreign corporations and financial institutions, such as banks, are aggressively moving into areas that have traditionally been dominated by U.S. firms. While this situation subjects all U.S. companies, including banks and brokerage firms, to increasing competition, it also gives U.S. companies access to additional markets and sources of funds. Clearly, then, individuals involved in business in the United States, whether it is related to a multinational firm or a purely domestic company, must have some knowledge about foreign firms’ operations and international capital markets and securities and their effects on business conditions in the United States. Thus, because the business arena truly is global, we have incorporated aspects of international finance throughout the text in an effort to make students recognize that success in today’s world requires a multinational perspective. We are not attempting to make multinational finance experts out of introductory finance students, but even introductory students should understand that successful financial decisions must be made within a global context.

Ethical Dilemmas

In the 1990s, ethics became an important buzzword in business education. We felt that it was crucial to introduce students to ethical issues in finance throughout the book. Therefore, in some of the chapters we have included a feature called “Ethical Dilemma,” in which we present an ethical situation based on a true story and ask students to decide what they would do if they were faced with such a situation. These Ethical Dilemmas expose students to the relationship between ethics and business, promote critical thinking and decision-making skills, and provide interesting vehicles for class discussion. The real-world situation upon which the Ethical Dilemma is based is contained in the *Instructor’s Manual*, with information about the situation and key discussion points for the class.

A Managerial Perspective

Each chapter begins with “A Managerial Perspective,” which describes actual events that relate to the material contained in the chapter. These boxes set up interesting and engaging situations that provoke thought about subjects covered in the chapter. The situations come into perspective as the chapters progress and some of the queries are described in greater detail.

Margin Definitions

Throughout the book, we include definitions of important terms and concepts in the margins. This allows students to easily refer to the definitions as they read the book.

End-of-Chapter Problems

We have included a substantial number and variety of questions and problems at the end of each chapter. Exam-Type Problems are included to give students practice with problems similar to some of the more difficult ones in the *Test Bank*. In addition, Integrative Problems appear in each chapter (except Chapter 1) after the regular end-of-chapter problems. The Integrative Problems cover, in a comprehensive manner, the major concepts discussed in the chapters. We use these problems as the basis for our lectures, but other instructors assign them as comprehensive study problems. Finally, in an effort to encourage students to utilize spreadsheets, we have included Computer-Related Problems that must be solved using the predefined models that are contained on the Student CD-ROM. Note, though, that it is not necessary for students using the text to be proficient (or even literate) in computer usage. However, students who do continue their studies in finance and who later use spreadsheets (either to analyze cases or in real-world applications) will benefit from solving these problems.

SUPPLEMENTARY MATERIALS

A number of items are available free of charge to adopting instructors:

1. **Instructor's Kit: *Instructor's Manual* and Instructor's Resource CD-ROM.** This kit contains the *Instructor's Manual* and an Instructor's Resource CD-ROM. The *Instructor's Manual* is a comprehensive manual that contains answers to all text questions and problems, discussion guidelines for the Ethical Dilemmas, and detailed solutions to the Integrative Problems. The Instructor's Resource CD-ROM contains Microsoft *Word* versions of the *Instructor's Manual* and *Test Bank*, as well as Lecture Presentation Software.
2. **Lecture Presentation Software.** To facilitate classroom presentations, a computer graphics slide show written in Microsoft *PowerPoint* is available. The slides feature all the essential topics presented in each chapter. The Lecture Presentation Software is available on the Student CD-ROM, the Instructor's Resource CD-ROM, and on the book's accompanying web site.
3. **Test Bank.** The *Test Bank* contains a substantial number of class-tested questions and problems in an objective format. There is a generous offering of true/false questions, multiple-choice conceptual questions, multiple-choice problems (that can easily be modified to short-answer problems by removing the answer choices), and financial calculator problems. Complete solutions are given for all numerical problems, and explanations for many conceptual questions are also provided. The *Test Bank* is available in computerized format, featuring South-Western's ExamView Testing Software. ExamView is a computerized testing program that contains all of the questions in the printed test bank and is an easy-to-use test creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. For instructors more comfortable

with Microsoft *Word*, we also offer the *Test Bank* in that format on the Instructor's Resource CD-ROM.

4. **Student CD-ROM.** This CD-ROM contains spreadsheet models for the computer-related end-of-chapter problems, as well as the Lecture Presentation Software.

A number of additional items are available for purchase by students:

1. **Study Guide.** This supplement outlines the key sections of each chapter, provides students with self-test questions, and also provides a set of problems and solutions similar to those in the text and in the *Test Bank*. Because many instructors use multiple-choice exams, we include exam-type questions and problems in the *Study Guide*.
2. **Digital Finance Case Library.** More than 100 cases written by Eugene F. Brigham and Linda Klein are now available via the Internet, and new cases are added every year. These cases are in a customized case database that allows instructors to select cases and create their own customized casebooks. Most of the cases have accompanying spreadsheet models that, while not essential for working the case, do reduce number crunching and thus leave more time for students to consider conceptual issues. The models also show students how computers can be used to make better financial decisions.

The cases, case solutions, and spreadsheet models can be previewed by professors from the *Digital Finance Case Library* at <http://www.custom.ThomsonLearning.com> with proper access. For professorial access contact your South-Western sales representative.

3. **Readings Books.** One readings book, *Issues and Readings in Managerial Finance*, fourth edition, edited by Ramon E. Johnson, provides an excellent mix of theoretical and practical articles that can be used to supplement the text. Another supplemental reader is *Advances in Business Financial Management: A Collection of Readings*, second edition, edited by Philip L. Cooley, which provides a broader selection of articles from which to choose.
4. **Spreadsheet Analysis Books.** *Financial Analysis with Microsoft Excel*, second edition, by Timothy Mayes and Todd Shank, fully integrates the teaching of spreadsheet analysis with the basic finance concepts. This book makes a good companion to *Principles* in courses in which computer work is highly emphasized.

South-Western College Publishing will provide complimentary supplements or supplement packages to those adopters qualified under our adoption policy. Please contact your sales representative to learn how you can qualify. If you receive supplements you do not need, please return them to your sales representative.

ACKNOWLEDGMENTS

This book reflects the efforts of a number of people over the years. For the second edition, we are indebted to the professors listed here who provided their input for improving *Principles*:

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ERRORS IN THE TEXT

At this point, most authors make a statement like this: “We appreciate all the help we received from the people listed above, but any remaining errors are, of course, our own responsibility.” And in many books, there are plenty of remaining errors. Having experienced difficulty with errors ourselves, both as students and as instructors, we resolved to avoid this problem in *Principles*. As a result of our error-detection procedures, we are convinced that this text is relatively free of mistakes.

Partly due to our confidence that there are few errors in this book, but primarily because we want to correct any errors that might have slipped by so that we can correct them in future printings of the book, we have decided to offer a reward of \$10 per error to the first person who reports it to us. For purposes of this reward, errors are defined as spelling errors, computational errors not due to rounding, factual errors, and other errors that inhibit comprehension. Typesetting errors, such as spacing, and differences in opinion concerning grammatical or punctuation conventions do not qualify for the reward. Also, given the ever-changing nature of the World Wide Web, changes in Web addresses do not qualify as errors—the Web addresses included in the book are those that existed at the time we wrote it. Finally, any qualifying error that has follow-through effect is counted as two errors only. Please report any errors to Scott Besley at the address given below.

CONCLUSION

Finance is, in a real sense, the cornerstone of the enterprise system—good financial management is vitally important to the economic health of business firms, and hence to the nation and the world. Because of its importance, finance should be widely and thoroughly understood; but this is easier said than done. The field is relatively complex, and it is undergoing constant change in response to shifts in economic conditions. All of this makes finance stimulating and exciting; but also challenging and sometimes perplexing. We sincerely hope that *Principles of Finance*, second edition, will meet its own challenge by contributing to a better understanding of our financial system.


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September 2001



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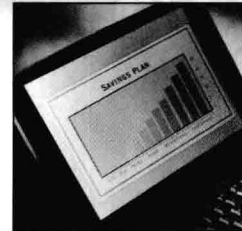
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CHAPTER 5

The Cost of Money (Interest Rates)



An Overview of Finance

Do you like money? Then you should like finance, because finance deals with money. More importantly, you will discover as you read this text that *finance people* like putting the money they have to work so as to make more money. Sound like a good idea? It is if you know what you are doing.

A MANAGERIAL PERSPECTIVE

Businesses must think it's a good idea to understand finance, because, as a recent survey indicates, firms are paying handsome salaries to attract good finance people. The survey, which was conducted by CFO.com, reported that persons in finance-related jobs are well compensated for their services. In 1999, the pay for chief financial officers (CFOs) averaged more than \$500,000 per year, and the average pay for controllers and treasurers exceeded \$400,000. At large companies, the compensation packages of CFOs can amount to millions of dollars. For example, CFOs from Bank of America, Lehman Brothers, Goldman Sachs, and J.P. Morgan & Company received more than \$10 million in compensation. Even CFOs at fairly small companies receive handsome rewards. Reports indicate that some executives in firms with sales of less than \$200 million earned as much as \$1 million in compensation during 1999.

Clearly, finance-related jobs can be highly lucrative. The fact that many CFOs in large companies receive compensation packages valued in the millions of dollars, however, is not the primary reason you should understand finance. Finance is a fundamental part of life, so it is important to have some understanding of how it affects you as a person. When you buy a car or a house or plan for retirement, you must deal with the general concepts of finance. As you read this text, try to relate the topics to future decisions you will face, including investing in stocks, planning for retirement, and financing big-ticket items such as cars and houses. Even if you pursue a career in a nonfinance profession, you will find yourself using finance concepts in both your job and your personal life.

(Continued)