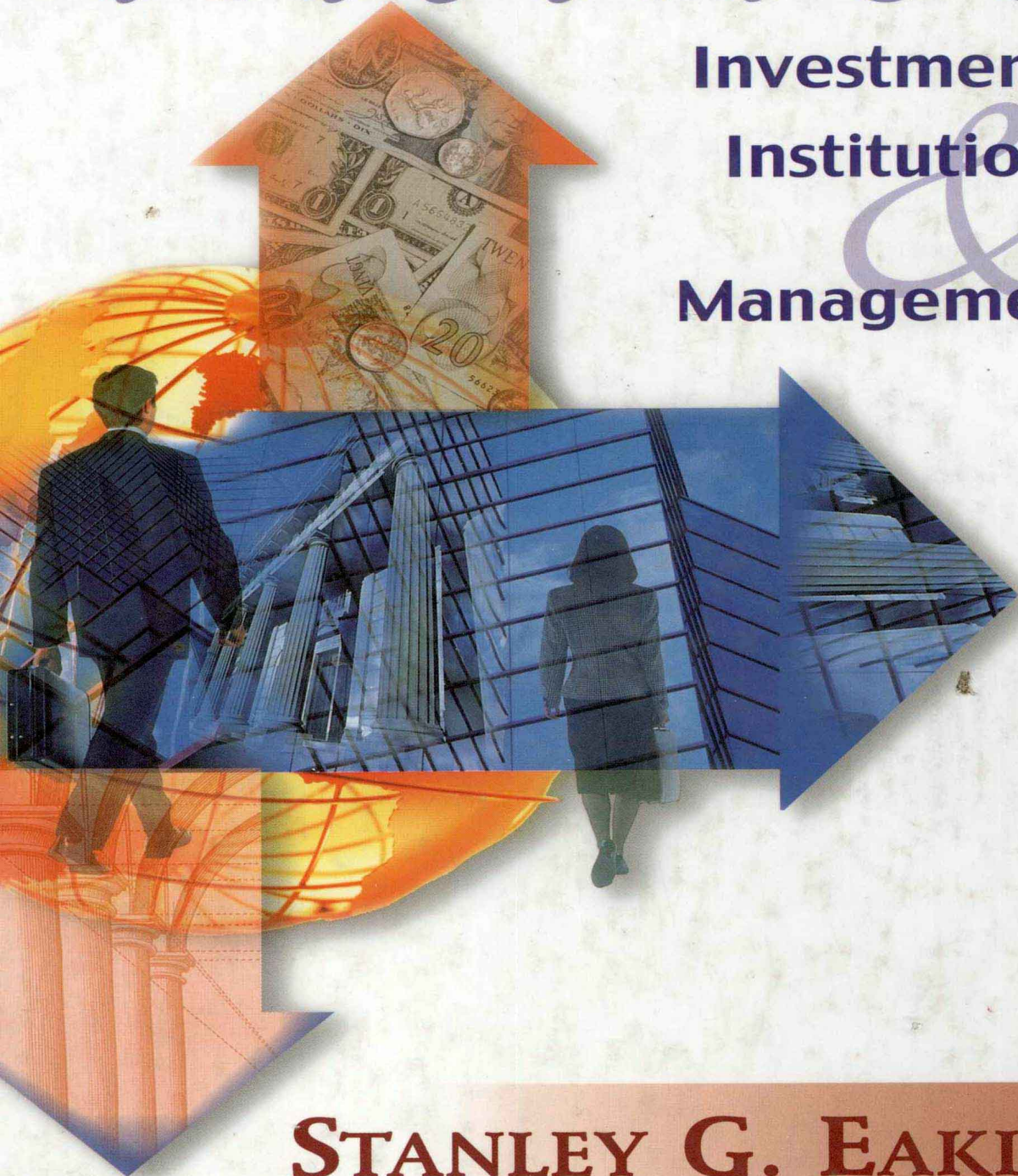


Finance

Investments,
Institutions,
&
Management



STANLEY G. EAKINS

FINANCE

Investments, Institutions, and Management

Stanley G. Eakins
East Carolina University

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Preface

Purpose of This Text

In the mid 1990s, the number of students in the school of business at East Carolina University dropped, as did the number of declared finance majors. The same was true in schools across the nation. Decreasing class sizes prompted us to rethink how we were teaching the introductory course in finance. Surveys told us that they regarded it as one of the most difficult courses they would take during their college careers. Talking with students we learned that they were not getting what they expected or wanted out of the finance course. They wanted to learn about all areas of finance, not just how large corporations practice finance. For example, they were very interested in investments and wanted to better understand popular business publications.

The revelations gleaned from our student survey inspired me to write this book. Most students in the introductory finance class will not take any other course in finance before they graduate. However, some find the subject so interesting that they will choose finance as their major field of study. Both of these groups can be better served by a course that introduces all the major areas of study in finance. Just as introductory biology does not focus exclusively on plants and introductory accounting does not simply cover taxes, introductory finance should not be limited to corporate applications.

The Benefits of a Broader Approach

This text includes coverage of the three main areas of finance: markets and institutions, investments, and managerial finance. The greatest emphasis continues to be given to corporate topics, since we are educating business majors and most will go on to be employed by corporations. However, by limiting some of the corporate finance detail and expanding areas that are of interest to a greater number of students, two benefits are achieved. First, the class becomes more interesting, relevant, and valuable to a wide range of students. A broader exposure to finance allows the nonfinance major to better comprehend financial information and make business and personal finance decisions.

A second benefit of a broader approach to finance is that some students may find one of the three areas of study particularly interesting and choose to become finance majors. This text makes it clear that not all finance majors have to work for large corporations. There are also jobs in financial planning, stock and security sales, and insurance, to name just a few. Students interested in these topics may be discouraged by courses that follow the traditional corporate finance approach.

Customizing the Level of Difficulty

In writing this text I tried to address students' fear of this course. To this end, every topic is explained in clear terms to which students can easily relate. To further enhance the text's appeal, it has been classroom tested extensively, with bonus points given to students who identified any section that was the least bit difficult to understand or follow. These suggestions have helped make this a highly readable and student-friendly finance text.

Another unique feature of this text is the use of "Extension" sections within each chapter. These sections "extend" coverage of certain topics, allowing professors to customize the text's level of difficulty. During the manuscript review process, we learned that the survey approach to introductory finance differs widely from school to school: some instructors want more depth while others want less. Even within departments, we suspect there are different opinions on how far each topic should be taken. My approach satisfies both sides. For example, the modified internal rate of return is included in an Extensions section: professors who want to skip this topic can advise students not to read Extension 1. Unlike end-of-chapter appendices, Extensions allow topics to be placed where they naturally fall in the development of the chapter. End-of-chapter problems that relate to Extension topics are clearly identified for those who choose to skip the material.

Unique Chapter Brings Closure to the Course

We all are guilty of running out of time before we have been able to properly tie together the subjects covered during the semester. With this in mind, the concluding chapter is both short and entertaining. Chapter 18 introduces an entrepreneur who has started a small business. As the entrepreneur's firm grows, she applies the lessons she has learned in her finance course to the various problems she faces. Besides introducing a number of useful topics, such as lease versus purchase analysis and the valuation of a private firm, this chapter demonstrates how the tools that students have learned can be used to solve a wide range of real-life problems. This chapter is a perfect capstone for the last week of classes.

Organization of the Text

There are many ways to organize a text to include the three main areas of finance. We chose the current organization because it best allows the topics to build naturally on each other, while presenting the most critical material within the first 13 chapters.

Part I provides an introduction to markets and institutions. By beginning here, students quickly become familiar with the terminology of finance, the major institutions that are involved, and the different financial securities available. Students learn how the actions of the intermediaries that participate in the different markets facilitate the flow of funds from those with a surplus to those with a need for the funds and how accurate prices are established along the way. Part I also introduces the role of interest rates and how they are established. It concludes with the role of the Federal Reserve in the creation of money and in establishing the level of interest rates.

Part II introduces the major topics in the study of investments. To capture their interest, students first learn the concept of the time value of money and its applications to

personal finance issues. They then learn about the relationship between risk and return. Finally, they learn how various securities are priced. Chapter 9 also provides a discussion of whether the markets are efficient and whether the CAPM accurately measures the required return.

Part III covers traditional corporate finance topics. The topics have been divided into discrete chapters enabling instructors to cover only those topics that meet their needs. We begin with two chapters on capital budgeting, one which introduces the models and methods and another that shows how to evaluate cash flows and refine the capital budgeting models. Chapter 12 develops the cost of capital by reexamining the models used to value securities in Chapters 8 and 9. Chapter 13, which develops the theory of capital structure, is organized carefully around many extension sections so that professors can give this topic as much or as little attention as they deem appropriate. Financial statement and ratio analysis is placed immediately before the chapter on financial planning and forecasting. These two chapters naturally complement each other. We conclude our corporate coverage with a chapter on the management of networking capital.

Part IV concludes the text with a chapter introducing the major topics included in international finance and Chapter 18 is devoted to a case study that involves a small business owner making decisions that require the application of many of the finance topics discussed earlier in the text.

Target Audience

This book can be used effectively by any university or college interested in providing a broad coverage of financial topics in the introductory course. The length of the text has been kept to a minimum so that most of it can be reasonably covered in a typical one-semester course. The text assumes that students have a basic understanding of accounting and a limited understanding of statistics, though statistical concepts are reviewed as needed. The lucid writing style will make the text particularly valuable to schools that expect their students to grasp the material with limited guidance from the instructor.

This text is appropriate for introductory courses that include both finance and non-finance majors. Finance majors will find it provides an excellent foundation for their other finance classes. Nonfinance majors will appreciate its clear, comprehensive coverage of the full scope of finance. Both will come away from the course able to read and understand popular business publications and communicate effectively with finance professionals.

Pedagogical Features

We have incorporated a variety of features to make this text as accessible as possible to students.

- Study tips are included in each chapter to highlight or clarify issues that frequently cause students trouble. These tips reflect my years of experience teaching introductory finance to thousands of students.
- Self-test problems conclude each section enabling students to pause and reflect on what they have learned, before moving forward. To encourage students to

answer the questions and test their comprehension, the answers are provided, upside down, at the bottom of the page.

- Step-by-step calculator solutions are provided for many of the in-text examples, along with equation and factor solutions. This approach exposes students to all of the solution methods and also allows you, the instructor, to emphasize your method of choice.
- Key terms that reinforce the most important concepts are highlighted and listed at the end of each chapter.
- Each chapter contains numerous discussion questions and problems. The time value of money chapter includes an additional section of self-test questions with answers.
- In addition to the many examples integrated throughout chapter discussions, labeled examples often focus on real-life and familiar companies. These examples make the material more interesting and relevant to students.
- “Finance in Practice” boxes discuss real-world applications of the chapter material that students will find both relevant and interesting. These boxes focus on global, ethical, and practical applications of the material.
- “Extension” features identify material that goes into more depth, so that faculty can customize the course to suit their students.

Supplemental Materials

This text is accompanied by a full range of supplementary materials to support teaching and learning. These include an instructor’s manual, test bank, computerized test bank, transparency masters, PowerPoint lecture software, and a study guide. The instructor’s manual includes detailed answers to all end-of-chapter questions and problems, as well as sample lecture outlines, suggested class quizzes, and additional examples. The study guide includes chapter summaries and sample tests. Powerpoint slides of all text figures facilitate class presentation.

Although this text is the result of many years of my own hard work and creative thinking, I also have received a great deal of generous assistance along the way. The following group of colleagues devoted a great deal of their own time and energy to this project as it took shape, poring over early drafts and providing invaluable feedback. To these individuals, then, I would like to extend a heartfelt and most sincere word of thanks:

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