Chapter 2
Basic Ideas of Finance

Chapter 2, *Basic Ideas of Finance,* introduces the basic financial and accounting categories of revenues, expenses, assets, liabilities, and net worth as tools to understand the relationships between them as a way, in turn, of organizing financial thinking. It also introduces the concepts of opportunity costs and sunk costs as more implicit but no less critical considerations.

Classroom Discussion Activities

1. Individually or in small groups, and without getting into too much personal detail, have students estimate their total monthly budget as a deficit or surplus. That is, usually, do they break even, come out ahead, or fall behind in most months? If they are falling behind or coming out ahead, what happens next, how do they resolve that situation? Do they have a plan, or just wing it? Do they make lifestyle changes or…? This discussion can be a nice lead in to a lecture on the chapter's materials, which present that analysis in a more methodical way.
2. Ask students to come to class with an article or column from a favorite publication or web site that highlights how recent economic conditions have helped or hindered individuals from having a balanced budget. (The recent recession, with its high unemployment and housing market weaknesses should provide plenty of possible material.) They can use a wide range of materials from *The Wall Street Journal's* personal finance columns to clips from the Suze Orman Show, or you can narrow that range for them. Depending on the class size, time, or technology constraints, you may have them each present their topics or discuss them, in smaller groups or as a class.
3. Any of the following exercises may also be used to start a class discussion, with students thinking individually or in small groups.
4. Exploration of any of the web sites cited in the text makes a good starting point for a discussion.

Results of class discussions may be posted on course management sites for reference and as a basis for future classroom discussions.

Online Discussion Activities

All of these discussion ideas should adapt well to an online classroom's discussion board. For each, students can be required to post their own answer and then to comment on at least one from another student.

Lecture Outline from Learning Objectives

2.1 Income and Expenses

1. Identify and compare the sources and uses of income.
2. Define the budget balances that result from the uses of income.
3. Discuss the remedies for budget deficits and surpluses.
4. Spending more, saving, and investing are three ways to deal with budget surpluses.
5. Define opportunity and sunk costs, and discuss their effects of financial decision making.

2.2 Assets

1. Identify the purposes and uses of assets.
2. Identify the types of assets.
3. Explain the role of assets in personal finance.
4. Explain how a capital gain or loss is created.

2.3 Debt and Equity

1. Define equity and debt.
2. Compare and contrast the costs of debt and of equity.
3. Explain the uses of debt and of equity.
4. Describe the costs of debt and of equity.

2.4 Income and Risk

1. Describe how sources of income may be diversified.
2. Describe how investments in assets may be diversified.
3. Explain the use of diversification as a risk management strategy.

Key Takeaways

2.1 Income and Expenses

- It is important to understand the sources (incomes) and uses (expenses) of funds, and the budget deficit or budget surplus that may result.
- Wages or salary is income from employment or self-employment; interest is earned by lending; a dividend is the income from owning corporate stock; a draw is income from a partnership.
- Deficits or surpluses need to be addressed, and that means making decisions about what to do with them.
- Increasing income, reducing expenses, and borrowing are three ways to deal with budget deficits.
- Spending more, saving, and investing are three ways to deal with budget surpluses.

- Opportunity costs and sunk costs are hidden expenses that affect financial decision making.

2.2 Assets

- Assets are items with economic value that can be converted to cash. You use excess liquidity or surplus cash to buy an asset to store wealth until you resell the asset.
- An asset can create income and/or reduce expenses and/or store wealth.
- To have value as an investment, an asset must either store wealth or create income (reduce expenses); ideally, an asset can do both.
- Whatever the choice of asset, investing in assets or selling capital can be more profitable than selling labor.
- Selling an asset results in a capital gain or capital loss.
- Selling capital means trading in the capital markets, which is a sellers' market. You can do this only if you have a budget surplus—an excess of income over expenses.

2.3 Debt and Equity

- Financing assets through equity means sharing ownership and whatever gains or losses that brings.
- Financing assets through borrowing and creating debt means taking on a financial obligation that must be repaid.
- Both equity and debt have costs and value.
- Both equity and debt enable you to use an asset sooner than you otherwise could and therefore to reap more of its rewards.

2.4 Income and Risk

- Diversifying sources of income in both the labor market and the capital markets is the best hedge against risks in any one market.

Exercises

In *Personal Finance*, the exercises are designed to generate interest and enthusiasm for the subject by getting students to think immediately and personally about personal finance. Where there are specific, objective answers for the exercises, they are provided. Many questions ask for personal experience, therefore, answers will vary.

2.1 Income and Expenses

1. Where Does Your Income Come From and Where Does It Go? Analyze your inflows of income from all sources and outflows of income through expenditures in a month, quarter, or year. After analyzing your numbers and converting them to percentages, show your results in two figures, using proportions of a dollar bill to show where your income comes from and proportions of another dollar bill to show how you spend your income. How would you like your income to change? How would you like your distribution of expenses to change? Use your investigation to develop a rough personal

budget.

2. Examine your budget and distinguish between wants and needs. How do you define a financial need? What are your fixed expenses—expenses you must pay regularly each week, month, or year? Which of your budget categories must you provide for first before satisfying others? To what extent is each of your expenses discretionary—under your control in terms of spending more or less for that item or resource? Which of your expenses could you reduce if you had to or wanted to for any reason?

3. If you had a budget deficit, what could you do about it? What would be the best solution for the long term? If you had a budget surplus, what could you do about it? What would be your best choice, and why?

Suggested Answer: The best long-term solutions for a budget deficit are to work more and/or spend less. Borrowing only increases a deficit. The best long-term choice for a budget surplus is to save and/or invest in the capital and/or credit markets to build wealth.

4. You need a jacket, boots, and gloves, but the jacket you want will use up all the money you have available for outerwear. What is your opportunity cost if you buy the jacket? What is your sunk cost if you buy the jacket? How could you modify your consumption to reduce opportunity cost? If you buy the jacket but find that you need the boots and gloves, how could you modify your budget to compensate for your sunk cost?

Suggested Answers: Opportunity cost of buying the jacket is the cost of the boots and gloves. One way to reduce opportunity cost would be to pay less for a second-choice jacket so as to have enough for the other needs. The sunk cost of buying the jacket is the price paid, which cannot be recovered. Money for the boots and gloves would have to be taken from another budget category, which could potentially cause a budget deficit.

2.2 Assets

1. Record your answers to the following questions in your personal finance journal or My Notes. What are your assets? How do your assets store your wealth? How do your assets make income for you? How do your assets help you reduce your expenses?

2. List your assets in the order of their cash or market value. Then list them in terms of their degree of liquidity. Which assets do you think you might sell in the next ten years, why? What new assets do you think you would like to acquire, and why? How could you reorganize your budget to make it possible to invest in new assets?

2.3 Debt and Equity

1. Research the founding of Google online—for example, at http://www.ubergizmo.com/15/archives/2008/09/googles_first_steps.html and http://www.ted.com/index.php/speakers/sergey_brin_and_larry_page.html. How did the young entrepreneurs, Larry Page and Sergey Brin, use equity and debt to make their business successful and increase their personal wealth? Discuss your findings with classmates.
2. Record your answers to the following questions in your personal finance journal or My Notes. What equity do you own? What debt do you owe? In each case, what do your equity and debt finance? What do they cost you? How do they benefit you?
3. Read the article "How to Pay Off Student Loans": http://www.realsimple.com/work-life/money/ how-to-pay-off-student-loans-00100000077561. Students fear going into debt for their education or later have difficulty paying off student loans. This article presents personal financial planning strategies for addressing this issue.

a. What are some practical financial planning tips to take advantage of debt financing for your education?

b. Pick one of the tips mentioned in the article and explain why it may be impractical for you.

2.4 Income and Risk

1. Record your answers to the following questions in your personal finance journal or My Notes. How can you diversify your sources of income to spread the risk of losing income? How can you diversify your investments to spread the risk of losing return on investment?