

# Chapter 1 Financial and Economic Concepts

## CHAPTER OUTLINE

Learning Objectives

Basic Financial Concepts

Importance of Finance

Economic Concepts of Finance

    Scarce Resources

    Opportunity Costs

    Savings, Income, Expenditures, and Taxes

    Factors Affecting Interest Rates

        Supply of Money Saved

        Demand for Borrowed Funds

        Federal Reserve Policy

        Inflation

        Risk

Conclusion

Review and Discussion Questions

Exercises and Problems

Case Study: Macy's Housewares Incorporated

## REVIEW AND DISCUSSION QUESTIONS

1. **What is finance?** Finance is essentially any transaction where money or a money-like instrument is exchanged for money or a money-like instrument.
2. **What is a market?** A market consists of any organized effort where buyers and sellers freely exchange goods and services.
  - a) **Name five types of markets in which you participate:** Financial, real estate, retail, wholesale, commodities, stock markets, bond markets, money markets, and flea. Students basically can discuss any market that makes sense to them.
  - b) **What markets trade economic resources?** Labor markets, Capital markets (financial & economic capital markets), land (natural resource markets).
3. **Compare marginal revenue, marginal cost, and marginal revenue product.** Marginal revenue is the additional revenue that a firm obtains by selling one more unit. Marginal cost is the cost of hiring one more unit of labor or the cost of producing one more unit of output. Marginal revenue product is the additional revenue we obtain by hiring one more unit of labor. When we incur a marginal cost our hope it that is will generate marginal revenue product which exceeds the cost. Hence the marginal revenue will exceed our marginal cost.

4. **Distinguish between economic and financial capital.** Economic capital resources include all items that man manufactures by combining natural and human resources like buildings, equipment, roads, and bridges. Financial capital is a dollar value claim on economic capital. Financial capital would include cash, deeds of trust, mortgages, loan papers, stocks, and bonds.
5. **Discuss the value of the entrepreneur. What distinguishes the entrepreneur from the labor resource? Why are entrepreneurs unique?** Entrepreneurial resources consist of the ideas of individuals, who assume risk and begin business enterprises. The entrepreneur combines natural, human, and capital resources to produce a good or service that we value more than the individual components. Without the entrepreneur, the other resources would not normally be combined, except for subsistence (i.e., the resources that are just sufficient to sustain life). The entrepreneur seeks to make a profit when using his ideas. When we look at overall payments, the mental talents of people in the form of the entrepreneur normally exceed the wages that are paid for labor. The owner of a professional sports team, the entrepreneur, will normally make more than any player on that team. Of course, the more brilliant the idea and its ultimate appeal to the buyer of the good or service, the more profit that will accrue to the entrepreneur.
6. **What is opportunity cost?** An opportunity cost is the highest value that is surrendered when a decision is made; it is never the decision, which is made. It is a quantifiable term.
7. **What makes up gross income?** All of the money received from all sources during the year. This includes wages, tips, interest earned on savings and bonds, income from rental property, profits to entrepreneurs, and any other source of income an individual may have.
8. **Compare progressive, regressive, and proportional taxes. Give at least one example of each type of tax.** Progressive taxes are taxes that take a larger percentage of your income as your income increases. Regressive taxes are taxes that take a higher percentage of your income as your income decreases. Proportional taxes are taxes where the percentage paid stays the same, regardless of income. Examples include progressive income taxes, regressive sales taxes, and proportional property taxes.
9. **What is the law of supply?** The law of supply states that as the payment or price of an item increases, *ceteris paribus*, we will supply more of that item.
10. **What is a supply table? How do you obtain a supply curve from a supply table?** A supply table is a listing of the quantities of some variable, which will be supplied at various prices in the market place. The supply curve is obtained by horizontally summing the quantities supplied by different suppliers at each price in the market.
11. **What is the law of demand?** The Law of Demand states that if all other factors are constant, as the price for an item decreases, people will demand more of that item, *ceteris paribus*.
12. **Explain the concept of a surplus of money versus a shortage of money.** When the supply of money saved exceeds the demand for money, there is a surplus of money; then institutions (banks, credit unions, savings and loans, etc.) will pay less for savings, and interest rates will begin to fall. When the demand for money exceeds the supply, there is a shortage of money and interest rates will be bid up in the market as institutions attempt to obtain more money.
13. **What is the Federal Reserve? What are the Fed's three tools for controlling the money supply?** The Federal Reserve is the Central Bank of the United States. The three tools for controlling the money supply are the discount rate, the reserve requirements ratio, and federal open market operations.
14. **What is risk? What is the difference between systematic and unsystematic risk?** Risk involves the probability that the actual return on an investment will be different from the desired return. Systematic risk is that risk which is associated with economic, political, and sociological changes that affect all participants on a near equal basis. Unsystematic risk is that risk that is unique to an individual, firm, or industry.

## EXERCISES AND PROBLEMS

1. **Carry Yoki's Lounge consists of the following. Carry, the owner believed that people would come to hear a band play on Friday, Saturday, and Sunday evening. During the remainder of the week, she believed her customers would watch sporting events on several television sets located throughout the lounge. Carry employed two bartenders, three servers, two assistant servers, two cooks, one dishwasher and a clean-up person. She had a bar, 15 barstools, 4 tables, 40 chairs, 4 television sets, and one satellite dish. She had an oven, stove, grill, refrigerator, sinks, dishes, and glassware. Carry started this business with \$50,000 of her own money, and she borrowed \$150,000 from the bank. From this description, list each of the scarce resources that are used in Carry Yoki's Lounge.**

Entrepreneurial resource: Carry Yoki.

Labor resources: 2 bartenders, 3 servers, 2 assistant servers, 2 cooks, 1 dishwasher, and a clean-up person.

Economic capital resources: 1 bar, 15 bar stools, 4 tables, 40 chairs, 4 television sets, one satellite dish, oven, stove, grill, refrigerator, sinks, dishes, and glassware.

Financial capital resources: \$50,000 of her own money and \$150,000 from the bank.

2. **Joe Fixit has an appliance repair business. He has more business than he can handle and wants to hire another repair person. Joe estimates that three appliances can be repaired each hour by a qualified person. Joe bills out labor at \$45 per hour, but he stipulates that the minimum charge for appliance repair estimates is \$30 plus parts. What is the marginal revenue product of a qualified repair person?**

3 appliance repairs per hour times \$30 = \$90 marginal revenue product.

**What is the maximum hourly wage that he would pay an employee?**

Therefore, since we bring in an additional \$90 per hour by hiring one more repair person, the maximum wage we would pay is \$90.

3. **Sam Smith is currently employed as a mechanical engineer and is paid \$65,000 per year plus benefits that are equal to 30% of his salary. Sam wants to begin a consulting firm and decides to leave his current job. After his first year in business, Sam's accountant informed him that he had made \$45,000 with his consulting business. Sam also notices that he paid \$6,000 for a health insurance policy, which was his total benefit during his first year. What was Sam's opportunity cost?**

Sam gave up \$65,000 in salary plus \$19,500 in benefits or a total of \$84,500.

4. **Sara Lee just graduated from college with a degree in accounting. She had five job offers: Bean Counters CPA, \$35,000; Assets R Us, \$27,000; The Debit Store, \$30,000; J & J's CPA's, \$33,000; and The Double Entry Shop, \$40,000. What was her opportunity cost if she accepted the job with The Double Entry Shop?**

Sara gave up Bean Counters CPA at \$35,000 which was the highest value surrendered.

5. **Sam Club earned \$50,000 and paid taxes of \$10,000. Samantha Heart earned \$60,000 and paid taxes of \$12,000. If these taxes were paid to the same government agency, is the tax on income progressive, regressive, or proportional? Why did you reach this conclusion? As show below these taxes are proportional because they both paid the same percentage of their income in taxes.**

$$\text{Tax Percentage} = \frac{\text{Tax payment in dollars}}{\text{Income in dollars}} \times 100$$

$$\text{Tax Percentage(Sam)} = \frac{\$10,000}{\$50,000} \times 100 = 20\%$$

$$\text{Tax Percentage(Samantha)} = \frac{\$12,000}{\$60,000} \times 100 = 20\%$$

6. **You read an article in this morning's paper that stated inflation was accelerating and would reach six percent this year. If the FED believes this statement and it has set a goal of three percent inflation, what will it likely do at the next meeting of the Federal Open Market Committee?** They would most likely raise the discount rate, the federal funds rate, or both. They could also sell more government securities to decrease the money supply.
7. **A friend came into your office and said that his bank was out to kill small businesses. You asked him what he meant by this remark, and he said that he read an article that said his bank had just loaned \$10 million to a major automobile manufacturer at a rate of 3 percent, which is less than prime. But your friend just borrowed \$50,000 from the same bank and they charged him prime plus four percent, or 7.5 percent. Your friend has been in business for two years, and last year he had a loss of \$2,000. How can you explain this difference in interest rate to your friend?** The bank charges interest based upon risk. The probability of the automobile manufacturer defaulting on the loan is very remote; therefore, they get a favorable interest rate from the bank. Since your friend lost money last year and since over 40 percent of all small businesses fail in the first five years, the bank's risk is much higher and therefore they will charge a higher interest rate.

#### RECOMMENDED TEAM ASSIGNMENT

There are no solutions to the team assignments as they involve research and will vary based on the economic circumstances at the time of the assignment:

1. **Using online resources, describe what measures the Federal Reserve Bank adopted in the past year to make adjustments in the U.S. economy in order to reach the Fed's goals.**
2. **Using two teams, initiate an argument that agrees (Pro) with the Fed action and an argument that opposes (Con) the Fed action.**

#### CASE STUDY QUESTIONS

1. **What effect did changes in government regulations have on the way Macy's had to conduct its business?** When the Fair Trade laws were rescinded Macy's had to compete on service because the discounters could undersell them on price. Phil had to buy directly from manufacturers rather than sales reps. Macy's began offering services that the discounters did not, like replacing individual broken china pieces.
2. **What effect did the economy and current interest rates have on the ability of Macy's to sell their business?** During the 1980's real estate values began to tumble, interest rates on savings reached 15% and the net profit of Macy's was only 10%. Due to these factors Phil and Kayla could find no buyers for their store and had to liquidate the business.

## Chapter 2 Financial Management and Planning

### CHAPTER OUTLINE

#### Learning Objectives

#### Management Functions

- Planning
- Organizing
- Staffing
- Directing
- Controlling

#### Business Organizations and Ownership

- Sole Proprietorship
- Partnership
- Corporation
- Limited Liability Company
- Franchise
- Non-Profit Organizations

#### Starting a Business

#### Development of a Business Plan

- Executive Summary
- General Company Description
- Business Ownership Succession Plans
- Financing a business or raising capital
- Sources of Financing

#### Conclusion

#### Review and discussion questions

#### Exercises and problems

#### Case Study: Introduction to Entrepreneurship

### REVIEW AND DISCUSSION QUESTIONS

1. **What is planning? Compare strategic planning with functional planning.** Planning is a systematic process that takes us from some current state to some future desired state. Strategic planning establishes the overall plan for the business, whereas functional planning is driven by the strategic plan. If McDonalds has a strategic plan to become the number one family restaurant, then its functional plans would involve opening new restaurants in specific communities around the world, financing these restaurants, and developing marketing plans for each area (Germany serves beer, America serves soda, England serves fish and chips, India serves no hamburger meat, etc.).
2. **What role does goal setting play in the planning process?** Goal setting is a precursor to establishing a plan. In order to begin planning, you need goals that are measurable, achievable and can be reached in a specified time period.

3. **Develop a list of at least 10 products that exist today that did not exist 10 years ago.** We recommend dividing the class into teams to do this exercise. Some of the products might include DVD read/write drives, cell phones with picture taking capability, reverse mortgages, iPods, XM and Sirius Satellite Radio, computer cameras, online educational courses, video on demand, GPS for automobiles and hikers, the human genome project, DVD players, hybrid automobiles and hydrogen powered automobiles, etc.
4. **What are the five functions of a manager?** Planning, organizing, staffing, directing, and controlling.
5. **What are the three steps of controlling?** Establish a standard of measurement, measure actual performance against the standard, and take corrective action when actual performance varies from the established standard.
6. **List and briefly explain three forms of business ownership.** The sole proprietorship, which is a business operated by the proprietor for his or her own profit. A partnership is an association of two or more persons who carry out a business as co-owners for a profit. The corporation is a legal entity according to U.S. law that may accomplish all of the tasks that can be accomplished by an individual. A limited liability company (LLC) is a hybrid business entity having features of both partnerships and corporations.
7. **What is meant by unlimited liability?** The owner of a business is personally liable for any debts of the business and is legally liable for any problems that the business may have. This includes the payment of all judgments against the business.
8. **How does a limited partnership differ from a general partnership?** A limited partnership is one in which there is one or more general partners and several limited partners. A limited partner is basically an investor who has liability limited to the amount of the investment in the partnership. All of the partners in a general partnership are general partners. They are in charge of day to day operations and are personally liable for the partnership. General partners have unlimited liability.
9. **What advantages does a corporation have over a sole proprietorship?**  
 Advantages of the corporation primarily include unlimited access to financial capital (stocks and bonds) and limited liability for the owners (can never lose more than investment even if corporation ceases to exist).  
**What are the disadvantages of a corporation?**  
 Disadvantages of the corporation include numerous federal and state legal requirements, double taxation, and owners have little or no control of how the business is run on a daily basis.
10. **What distinct advantage does a private or Subchapter S-corporation have over the public corporation.** Flow through of taxes to individual owners and payment of taxes is at the individual rate. There is no double taxation.

11. **What are the pitfalls of franchising?** You are not truly your own boss and must comply with the legal obligations to the franchiser that you agreed to in the franchise agreement. You have to provide the franchiser with a percentage of gross sales on a monthly basis, and are obligated to conduct business in a manner specified by the franchiser.
12. **List and describe the components of a SWOT analysis.** Strengths are areas of expertise that a business has and for the individual those things that you do well and like doing. Weaknesses are the shortcomings of the business and for the individual items that you really dislike and where you lack expertise. Opportunities are items that exist in the environment that provide your business with expanded sales if taken advantage of and will help your business grow and prosper. Threats are factors that exist in the environment that may impede the growth of your business.
13. **List the major components of a business plan. What components are of primarily concerned to you, and why?** Description of the business which include legal form and name, date of formation, location, product or service, brief history, proposed future operations, financial data and supporting documents. The answers to these last two questions are individually determined by each student or student team.
14. **What is the significance of a business succession plan?** The sole proprietor and partner have personal business and job intertwined. It is extremely important for the entrepreneur to determine who will take over the business if the owner is unable to function because of accident, severe illness, or death. This can be accomplished with a buy-sell agreement or other legal documents such as wills and trusts.
15. **What role does the buy-sell agreement occupy in a business succession plan?** It preserves the continuity of ownership and ensures that everyone is treated fairly. It protects partnership rights and is normally backed by life insurance to insure that the remaining business partners have sufficient funds to purchase a deceased partner's share of the business.
16. **Discuss the federal government's contracting programs.** The federal government's contracting programs are covered in the Federal Acquisition Regulation (FAR). The contracting programs to help small business include set-asides (for underrepresented business groups), Historically Underutilized Business Zone (HUBZone) (urban or rural area that is underutilized and needs development) and set-asides for specific classes of small businesses that include businesses owned by women, veterans, and disabled veterans. In order to qualify for government contract consideration a business must be registered with the Central Contractor Registration (CCR).

### EXERCISES AND PROBLEMS

1. **Carol Jones wanted her business to increase sales by 50 percent over the next five years. To do this, she must hire three more people. She wanted to determine how to evaluate these people, so she lists their job specifications and develops job descriptions. She also listed where these employees would work and what training they would require. What management functions is Carol performing, and how do they apply to this scenario?**  
  
Carol is performing the management function of planning because she wants to increase sales by 50% over the next five years. Specifically she is determining her strategic goals and beginning a long-range plan. She is also performing the management function of staffing because she is about to hire three more people, to evaluate them, and train them. Carol is also performing the management function of control when she develops the standards for evaluating her personnel.
2. **Jerry is a personnel manager for a large retail department store. He just received a memo stating that the company will build three new stores in Phoenix over the next five years, with one store opening in 24 months, one opening in 36 months, and one opening in 60 months. The memo that Jerry received relates to what type of business plan?**  
  
The memo that Jerry received relates to the strategic overall plan for his company.  
  
**If Jerry is directed to develop a personnel plan for Phoenix, what type of planning will Jerry be doing?**

When Jerry develops a personnel plan he will be working on a functional plan (personnel) designed to support the strategic plan.

3. **Joe Doe just started a business. He wants the business income to flow directly to his own personal tax return, but he wants to make sure that he has limited liability. What form(s) of business ownership would you recommend for Joe? Recommend either a Subchapter S corporation or a Limited Liability Company.**
4. **You buy 1,000 shares of ABC Company at \$6 per share. The company is sued for millions of dollars, and ABC Co. is forced into bankruptcy. The newspaper stated that the cost of this suit would amount to \$12 per share of stock. What is the maximum amount of money you can lose with this investment? Why? You can only lose \$6,000 (\$6 per share times the 1,000 shares). Since this is your investment in the corporation it is also your total liability. The price of \$12 reported in the paper is irrelevant in this situation.**
5. **Sam Jones, Mary Adams, and Larry Brown have been talking about starting their own business for several years. Sam is an electronic repairman, Mary is a partner in a large law firm, and Larry is an excellent sales person. Sam and Larry will work in the business on an equal basis. It will cost \$100,000 to start this business. Sam has no money, Mary has \$60,000 and Larry has \$40,000. If they form a partnership, how would you recommend that they organize? You should recommend a limited partnership with Mary as the limited partner. Sam and Larry would be general partners and would each be paid a salary. The profits that accrue to the partnership after all expenses are paid would be divided with sixty percent going to Mary and forty percent going to Larry if share of profits were only based on financial contribution. The actual division of the profits would be based on a partnership agreement because Sam would not want to have unlimited liability and no share of the profits. This business could also be formed as an LLC; then none of them would have unlimited liability, but would Mary agree to this since she is putting up most of the financial capital? This problem was inserted to stimulate discussion.**
6. **Barry McGuire wants to purchase a dry-cleaning establishment. Barry has heard of the SWOT analysis and wants to use this methodology to determine whether he should purchase the business. He found the following information: The dry cleaner is located in a busy shopping center and currently does all the cleaning on the premises. It has three commercial accounts that comprise 20 percent of its business. The population in the local area is growing by approximately 6 percent per year. Located across the street in another shopping center is a price-cutting dry cleaner that advertises heavily in the local area. With the exception of this shopping center and the property across the street, all property in this area is zoned residential. Most of the residents in this area are professional people who wear suits to work. The shop has an assumable lease, and the lease has a fixed rental fee for the next five years. Barry has had five years of experience in the dry-cleaning business, and would run the shop full time. Based on this information, perform a SWOT analysis.**  
  
**Strengths** include the fact that Barry has five years of experience, dry cleaning business is already established, assumable lease, and fixed rent for next five years, commercial accounts for 20% of business.  
  
**Weakness**, none listed.  
  
**Opportunities** include fact that business is located in a busy shopping center, population is growing at 6% a year, residential area with residents being professional and wearing suits to work, no new competition because of favorable zoning.  
  
**Threats** include competition from price cutting business across the street.
7. **Joe Latte wants to open up a coffee and gelato shop. He figures with the popularity of coffee shops and Italian ice cream shops that a combination business will be a clear winner. Write a two page paper describing the following elements of a business plan: description of the business, factors affecting location, and product or service to be offered. This should be graded**



based on the rigor of the class and how much is assigned by the instructor for outside research. We recommend team discussion and specifics with regard to these items.

8. **Joe Latte has completed a business plan and determined that it will take \$120,000 to open the coffee and gelato shop. He has \$30,000 of his own money and will have to obtain \$90,000 in loans or grants. How should Joe go about getting financing? What is the probability that he can obtain a grant to start an Italian ice cream shop?** Joe's first step should be to complete a business plan and contact the local Small Business Association (SBA) and SCORE office to determine what financing is available. He should also check with local and state agencies for small business assistance. Depending on his credit rating and bank standing he can also contact local banks and financial institutions and shop for the best loan and interest rates. Chances of obtaining a grant for this type of business are very slim.

### SUGGESTED GROUP PROJECT

There are really no instructor solutions for this assignment. There are four recommended group projects and the instructor should choose which if any of these would be used in the course.

1. **Determine a business for the group to start. Do a SWOT analysis on the business and the team members.**
2. **Each team member selects two factors that help make up a business plan and explains these factors to their other teammates. Teams determine what is covered and how it relates to the rest of the plan's factors.**
3. **Using the elements from the business plan outline, construct a business plan for one of the following companies:**
  - ♦ Friendly's Ice Cream
  - ♦ Texas Utilities (TXU)
  - ♦ Shopko
  - ♦ In-N-Out Burger
  - ♦ Five Guys
  - ♦ Big Ten Tires
  - ♦ Drug Fair
  - ♦ SC Johnson, a family company
  - ♦ Trader Joe's
4. **Pick a company from the list above. Using resources from the Internet, trace the company through the stages of development from the seed stage through maturity.**

### CASE STUDY QUESTIONS

1. **What were the management functions that Art used in his grandfather's store and at S.E. Nichols? How were these functions carried out by the business?** He did planning, organizing and controlling when managing the inventory and delivering for the butcher shop.
2. **Based on the duties that Art performed in his grandfather's store and at S.E. Nichols, should Art be paid minimum wage? If your answer is yes, why? If your answer is no, why not?** No because he was actually performing management functions. Most managers are paid a salary rather than an hourly wage.

3. **Art's grandfather asks you to advise him on what form of business ownership he should create. Select a form of ownership for Art's grandfather and list and explain its advantages and disadvantages.** We would recommend a Limited Liability Company (LLC). The advantages are that his personal assets are protected and only his investment in the business can be lost. If he brought in his grandmother, he might also consider a subchapter S corporation. In both cases, taxes are paid as individuals, but personal assets are not subject to law suit and loss if the business fails.

