

CHAPTER 1

1. What are your main goals in life? How does finance play a part in achieving those goals? What are the major trade-offs you face?

SAMPLE ANSWER:

- Finish school
- Get good paying job which I like
- Get married and have children
- Own my own home
- Provide for family
- Pay for children's education
- Retire

How Finance Plays a Role:

SAMPLE ANSWER:

- Finance helps me pay for undergraduate and graduate education and helps me decide whether spending the money on graduate education will be a good investment decision or not.
- Higher education should enhance my earning power and ability to obtain a job I like.
- Once I am married and have children I will have additional financial responsibilities (dependents) and I will have to learn how to allocate resources among individuals in the household and learn how to set aside enough money to pay for emergencies, education, vacations etc. Finance also helps me understand how to manage risks such as for disability, life and health.
- Finance helps me determine whether the home I want to buy is a good value or not. The study of finance also helps me determine the cheapest source of financing for the purchase of that home.
- Finance helps me determine how much money I will have to save in order to pay for my children's education as well as my own retirement.

Major Trade-Offs:

SAMPLE ANSWER

- Spend money now by going to college (and possibly graduate school) but presumably make more money once I graduate due to my higher education.
- Consume now and have less money saved for future expenditures such as for a house or car OR save more money now but consume less than some of my friends.

2. What is your net worth? What have you included among your assets and your liabilities? What have you excluded that you might have included?

SAMPLE ANSWER:

\$ _____ (very possibly negative at this point)

Assets:

- Checking account balance
- Savings account balance
- Furniture/Jewelry (watch)
- Car (possibly)

Liabilities:

- Student loans
- Credit card balance
- If renting, remainder of rental agreement (unless subletting is a possibility)
- Car payments (possibly)

Students typically exclude the high value of their potential lifetime earning power when calculating their net worth.

3. How are the financial decisions faced by a single person living alone different from those faced by the head of a household with responsibility for several children of school age? Are the tradeoffs they have to make different, or will they evaluate the tradeoffs differently?

A single person needs only to support himself and therefore can make every financial decision on his own. If he does not want health insurance (and is willing to bear the financial risks associated with that decision) then no one will be affected by that decision other than that single person. In addition, this person needs to make no decisions about allocating income among dependents. A single person is very mobile and can choose to live almost anywhere. The tradeoffs this individual makes generally concern issues of consuming (or spending) today versus saving for consumption tomorrow. Since this person is supporting only himself, the need to save now is less important than for the head of household discussed next.

The head of household with several children must share resources (income) among dependents. This individual must be prepared to deal with risk management issues such as how to be prepared for potential financial emergencies (such as a serious health problem experienced by a member of the family or home owners insurance in case of a fire or other mishap). Because there are more people in this household than with a single person, there are greater risks that someone will get sick or injured. And because there are dependents, the wage earner(s) should think carefully about life and disability insurance. In addition, the family is not as mobile as the single individual. Because of the school age children, the family might want to live near "good schools" thinking that a stronger education will eventually help those children's future well being and financial situation. Thus, the tradeoffs for the head of household are more complex: more money is needed to consume today (he or she needs to support more dependents), but a lot more money is also needed to save for future expenses such as education and housing and more money is needed for risk management such as life and disability insurance.

4. Family A and family B both consist of a father, mother and two children of school age. In family A both spouses have jobs outside the home and earn a combined income of \$100,000 per year. In family B, only one spouse works outside the home and earns \$100,000 per year. How do the financial circumstances and decisions faced by the two families differ?

With two wage earners, there is less risk of a total loss of family income due to unemployment or disability than there is in a single wage earning household. The single wage earning family will probably want more disability and life insurance than the two wage earning family. On the flip side, however, the two wage earning family may need to spend extra money on child care expenses if they need to pay someone to watch the children after school.

5. At what age should children be expected to become financially independent?

Students will have differing responses to this question depending upon their specific experiences and opinions. Most will probably say independence should come after finishing their education, and they have a decent paying job.

6. You are thinking of buying a car. Analyze the decision by addressing the following issues:

- a. Are there are other ways to satisfy your transportation requirements besides buying a car? Make a list of all the alternatives and write down the pros and cons.**

<u>Transportation Mode</u>	<u>Pros</u>	<u>Cons</u>
Walking	<ul style="list-style-type: none"> • Takes you directly where you want to go • Free • Convenient 	<ul style="list-style-type: none"> • Takes a long time • Destination may be too far
Bicycle	<ul style="list-style-type: none"> • Takes you directly to where you want to go • Free • Convenient 	<ul style="list-style-type: none"> • Requires physical strength and endurance • Destination may be too far
Bus	<ul style="list-style-type: none"> • Inexpensive • Reaches distant destinations 	<ul style="list-style-type: none"> • May not take you directly where you want to go • Many stops, not efficient
Subway	<ul style="list-style-type: none"> • Inexpensive • Fast 	<ul style="list-style-type: none"> • May not take you directly where you want to go • Local destinations only
Train	<ul style="list-style-type: none"> • Reaches distant destinations 	<ul style="list-style-type: none"> • May not take you directly where you want to go
Airplane	<ul style="list-style-type: none"> • Reaches distant destinations • Fast 	<ul style="list-style-type: none"> • Expensive

b. What are the different ways you can finance the purchase of a car?

Finance through a bank loan or lease, finance through a car dealer with a loan or a lease or finance the car out of your own savings.

c. Obtain information from at least three different providers of automobile financing on the terms they offer.

d. What criteria should you use in making your decision?

Your decision will be to select the financing alternative that has the lowest cost to you.

When analyzing the information, you should consider the following:

- Do you have the cash saved to make an outright purchase? What interest rate would you be giving up to make that purchase? Do you pay a different price for the car if you pay cash rather than finance?
- For differing loan plans, what is the down payment today? What are the monthly payments? For how long? What is the relevant interest rate you will be paying? Does the whole loan get paid through monthly payments or is there a balloon payment at the end? Are taxes and/or insurance payments included in the monthly payments?
- For differing lease plans, what is the down payment today? What are the monthly payments? For how long? Do you own the car at the end of the lease? If not, what does it cost to buy the car? Do you have to buy the car at the end of the lease or is it an option? Is there a charge if you decide not to buy the car? What relevant interest rate will you be paying? Are taxes and/or insurance payments included in the monthly payments? Are there mileage restrictions?

7. You are thinking of starting your own business, but have no money.

a. Think of a business that you could start without having to borrow any money.

Any business which involves a student's own personal service would be cheap to start up. For instance he or she could start a business running errands for others, walking their dogs, shopping etc. Along those same lines they could start some kind of consulting business. Both of these businesses could be run out of their dorm room or their own home and could be started with very little capital. If they wanted to hire additional workers, they would have to be paid on a commission basis to limit upfront expenses.

b. Now think of a business that you would want to start if you could borrow any amount of money at the going market interest rate.

Certainly there are many interesting businesses which could be started if one could finance 100% of the business with borrowed capital and no equity. Since you will be able to borrow 100% of the financing, you will be willing to take a lot greater risk than if you were investing your own money.

c. What are the risks you would face in this business?

[Answer is, of course, dependent on answer to question "b."]

d. Where can you get financing for your new business?

Depending upon the size of the financing needed, students should be looking for both debt and equity financing. The sources of this financing ranges from individuals and credit cards (for very small sums) to banks, venture capitalists, public debt and equity markets, insurance companies and pension funds

8. Choose an organization that is not a firm, such as a club or church group and list the most important financial decisions it has to make. What are the key tradeoffs the organization faces? What role do preferences play in choosing among alternatives? Interview the financial manager of the organization and check to see if he or she agrees with you.

SAMPLE ANSWER:

Local Church group. Most important financial decisions:

- Whether or not to repair damage done to church and grounds during last big hurricane (specifically repairing the leaking roof)
- What project to put off in order to pay for repair damage
- How to pay for renovations to downstairs Sunday school rooms
- How to increase member attendance and contributions
- How to organize and solicit volunteers for the annual Church Sale (largest fund raiser of the year)

Key Tradeoffs and Preferences:

Church group funds are severely limited, so the organization needs to prioritize expenses based upon cost and need. Not all projects that are needed will be undertaken due to the expense involved. An equally large amount of time will be spent trying to raise financing since funds inflow is variable. Since not all projects can be financed, preferences of different important individuals (such as the pastor) take on great significance in the decision-making process.