Part One

Instructor’s Manual

Chapter 1  
Getting Started—Principles of Finance

◼ Chapter Orientation

Finance is the study of how people and businesses evaluate investments and raise capital to fund these investments. Key principles guide the process of evaluating investment decisions. This chapter lays the foundation for understanding the principles that underpin financial decision making. Financial decisions permeate every aspect of the business world and of our personal lives. Understanding basic financial concepts is critical to making informed decisions concerning the use of financial resources.

This chapter describes the three types of business organizations--sole proprietorships, partnerships, and corporations—and compares and contrasts the similarities and differences among these types of business organization. Further, the role of finance is discussed relative to the overall structure of the organization. The overriding goal of finance is to maximize shareholder wealth. Ethical errors in judgment tend to destroy trust in management thereby preventing management from working toward that goal.

Finance encompasses five basic principles: Money has a time value; there is a risk-return tradeoff; cash flows are the source of value; market prices reflect information; and individuals respond to incentives.

◼ Chapter Outline

1.1 Overview of Finance

A. Finance is the study of how people and businesses evaluate investments and raise capital for these investments.

B. Finance concerns the study of the management of money, as well as the interpretation of information.

1.2 Three Types of Business Organization

A. A sole proprietorship is a business owned by a single individual.

B. A general partnership is an association of two or more persons who come together as owners for the purpose of operating a business for profit.

C. A corporation is a business organization that legally functions separately and apart from its owners (shareholders).

1.3 The Goal of the Financial Manager: Maximize Shareholder Wealth

A. Because shareholders are the owners of the firm, the goal of the financial manager is the maximize shareholder wealth.

B. Maximizing shareholders wealth is achieved by maximizing stock price.

C. The Sarbanes-Oxley Act attempts to safeguard the interests of shareholders by providing protection against agency problems related to accounting fraud and financial misconduct.

1.4 Financial concepts can be classified into four general principles.

A. Principle 1: Money has a time value

B. Principle 2: There is a Risk-Return tradeoff

C. Principle 3: Cash flows are the source of value

D. Principle 4: Market prices reflect information

E. Principle 5: Individuals respond to incentives

◼ Learning Objectives

1.1. Understand the importance of finance in your personal and professional lives and Identify the three primary business decisions that financial managers make.

1.2. Identify the key differences between three major legal forms of business.

1.3. Understand the role of the financial manager within the firm and the goal for making financial choices.

1.4. Explain the five principles of finance that form the basis of financial management for both businesses and individuals.

◼ End-of-Chapter Problem Complexity Rating and Spreadsheet Solutions

The end-of-chapter problems are sorted below, according to their level of complexity.

|  |  |  |
| --- | --- | --- |
| **Simple** | **Average** | **Complex** |
|  |  |  |

There are no problems in this chapter.

◼ Lecture Tips

1. Identify various investments that individuals make that require knowledge of finance:

a) going to college

b) purchasing a car

c) buying a home

d) rent versus owning a home

2. Use real-world, non-financial situations to describe the relationship between risk and return; for example, choice of career, travels, etc.

◼ Further Questions for Class Discussion

1. When managers act in an unethical manner, it can have a long-term impact on the value of the firm. Use the example of Enron’s board of directors temporarily suspending its own “code of ethics” to describe how that impact may be negative and permanent.

2. Explain the difference between cash flow and profit.

◼ Internet Resources

None