Chapter 2
Measuring Your Financial Health and Making a Plan

Learning Objectives

1. Calculate your level of net worth or wealth using a balance sheet.
2. Analyze where your money comes from and where it goes using an income statement.
3. Use ratios to identify your financial strengths and weaknesses.
4. Set up a record-keeping system to track your income and expenditures.
5. Implement a financial plan or budget that will provide for the level of savings needed to achieve your goals.
6. Decide if a professional financial planner will play a role in your financial affairs.

If you’ve ever seen one of the Sex and the City movies, or one of the TV episodes, you know it revolves around Carrie Bradshaw and her friends living, working, and shopping in New York. One scene finds Carrie Bradshaw taking a break from the pressures of trying to come up with a down payment to buy her apartment by doing what she does best, shoe shopping with her friend Miranda.

“Where did all my money go? I know I made some.”

Holding up a pair of Manolo Blahnik shoes, Miranda replies, “At four hundred bucks a pop how many of these do you have? Fifty? One hundred?”

“Would that be wrong?”

“One hundred times four hundred, that’s your down payment,” Miranda replies.

“Well, that’s only . . . four thousand.”

“No, that’s forty thousand,” corrects Miranda.
"I spent forty thousand dollars on shoes and have no place to live!"

How many of us have thought at one time or another, "Where does all my money go?"

It doesn’t matter how much or how little you make, the key to financial success is control. Today, Sarah Jessica Parker, who played Carrie Bradshaw, leads a relatively frugal life and has financial security well in hand. Perhaps that’s because Ms. Parker wasn’t always wealthy and appreciates her current status, and also because she and her TV counterpart have dramatically different financial personalities, with Carrie being a spender and Ms. Parker being a saver. Ms. Parker has said, "I remember being poor. There was no great way to hide it. We didn’t have electricity sometimes. We didn’t have Christmases sometimes, or we didn’t have birthdays sometimes, or the bill collectors came, or the phone company would call and say, ‘We’re shutting your phones off.’"

While Sarah Jessica Parker is doing well, there are plenty of other celebrities who have proven that making money doesn’t guarantee financial success. For example, rapper M. C. Hammer, who earned $33 million in 1990, declared bankruptcy in 1996 with $13.7 million in debts. In that same decade bankruptcy also bit film stars Kim Basinger and Burt Reynolds, as well as Shannen Doherty of Beverly Hills, 90210 fame. Then, in 2003, former heavyweight champ Mike Tyson filed for bankruptcy. And in 2010, The Real Housewives of New Jersey diva Teresa Giudice and her husband Joe filed for bankruptcy. While the Giudices made about $79,000 a year (plus $120,000 in “assistance” from family members), they owed over $10.8 million. Their credit card debt totaled over $100,000 including $20,000 to Bloomingdale’s, Neiman Marcus, and Nordstrom. How does this all relate to you? Well, you don’t have to be rich to lose control of your money. As we’ve said, it’s easy to avoid thinking about our financial future—dealing with the present is difficult enough. However, don’t forget Principle 2: Nothing Happens Without a Principle.
Plan. If you’re like most people, you can probably spend money without thinking about it, but you can’t save money without thinking about it. For Carrie Bradshaw, that certainly was the case. Saving isn’t a natural event. It must be planned.

Planning and budgeting require control—they don’t come naturally. Without the ability to measure our financial health and develop a plan and budget, we will not achieve our financial goals. Showing financial restraint isn’t as much fun as spending with reckless abandon, but it’s a lot more fun than winding up broke and homeless. Making and sticking with a plan isn’t necessarily easy, and it often involves what some people would consider sacrifices, such as getting a job over spring break instead of going down to Panama City to be on MTV’s *Spring Break*, or just skipping that daily designer coffee. The fact is, though, that the rewards of taking financial control are worth any small sacrifices and more. After all, you don’t want to share Carrie’s fate, who at the end of the *Sex and the City* scene lamented, “I will literally be the old woman who lived in her shoes.”

In this chapter we begin the budgeting and planning process that was first outlined in Figure 1.1, specifically, working on Steps 1 and 3 as shown in Figure 2.1. We begin by measuring our wealth using a personal balance sheet and then a personal income statement to help figure out where our money came from and where it went. With this information in hand, we will use ratios to check into the status of our financial health and look at ways to keep track of all this. Finally, we will set up and implement a cash budget.

**FIGURE 2.1** The Budgeting and Planning Process: Evaluating Your Financial Health and Developing a Plan of Action

**STEP 1**
Evaluate Your Financial Health
- Prepare a personal balance sheet.
- Determine what you’re worth and prepare a personal income statement.
- Use ratios to monitor your financial health.
- Determine where your money comes from and where it goes.

**STEP 2**
Define Your Financial Goals
- Identify what you are saving for and how much you need to save.

**STEP 3**
Develop a Plan of Action
- Make your spending conform with your budget goals.

**STEP 4**
Implement Your Plan
- Just do it!

**STEP 5**
Review Your Progress, Reevaluate, and Revise Your Plan
Using a Balance Sheet to Measure Your Wealth

Before you can decide how much you need to save to reach your goals, you have to measure your financial condition—what you own and what you owe. Corporations use a balance sheet for this purpose, and so can you. A personal balance sheet is a statement of your financial position on a given date—a snapshot of your financial status at a particular point in time. It lists the assets you own, the debt or liabilities you’ve incurred, and your general level of wealth, which is your net worth or equity. Assets represent what you own. Liabilities represent your debt or what you owe. To determine your level of wealth or net worth, you subtract your level of debt or borrowing from your assets. Figure 2.2 is a sample balance sheet worksheet. We will now look at each section.

**Assets: What You Own**

The first section of the balance sheet represents your assets. All your possessions are considered assets whether or not you still owe money on them. When you estimate the value of all your assets, list them using their fair market value, not what they cost or what they will be worth a year from now. The fair market value can be more or less than the price you paid for a given asset, depending on what others are willing to pay for that asset now. Remember, a balance sheet is a snapshot in time, so all values must be current.

**Monetary Assets**  There are a number of different types of assets. The first type of asset listed on the balance sheet is a monetary asset. A monetary asset is basically a liquid asset—one that is either cash or can easily be turned into cash with little or no loss in value. Monetary assets include the cash you hold, your checking and savings account balances, and your money market funds. These are the cash and cash

<table>
<thead>
<tr>
<th>FIGURE 2.2 Personal Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets (What You Own)</strong></td>
</tr>
<tr>
<td>A. Monetary Assets (bank account, etc.) (Chapter 5)</td>
</tr>
<tr>
<td>B. Investments (Chapters 11–15) +</td>
</tr>
<tr>
<td>C. Retirement Plans (Chapter 16) +</td>
</tr>
<tr>
<td>D. Housing (market value) (Chapter 8) +</td>
</tr>
<tr>
<td>E. Automobiles (Chapter 8) +</td>
</tr>
<tr>
<td>F. Personal Property +</td>
</tr>
<tr>
<td>G. Other Assets +</td>
</tr>
<tr>
<td>H. Your Total Assets (add lines A–G) =</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities or Debt (What You Owe)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Current Bills</td>
</tr>
<tr>
<td>J. Credit Card Debt (Chapter 6) +</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-Term Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>K. Housing (Chapter 8) +</td>
</tr>
<tr>
<td>L. Automobile Loans (Chapter 8) +</td>
</tr>
<tr>
<td>M. Other Debt (Chapter 7) +</td>
</tr>
<tr>
<td>N. Your Total Debt (add lines I–M) =</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Your Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>H. Total Assets</td>
</tr>
<tr>
<td>N. Less: Total Debt</td>
</tr>
<tr>
<td>G. Equals: Your Net Worth =</td>
</tr>
</tbody>
</table>
equivalents you use for everyday life. They also provide the necessary liquidity in case of an emergency.

**Investment** The second major category of assets, investments, refers to such financial assets as common stocks, mutual funds, or bonds. In general, the purpose of these assets is to accumulate wealth to satisfy a goal such as buying a house or having sufficient savings for a child’s college tuition or your retirement. You can usually determine the value of your investments by checking their current price on Internet sites such as finance.yahoo.com or in financial newspapers such as the Wall Street Journal. Your insurance policy may also be an investment asset if it has a cash surrender value. This type of insurance policy can be terminated before the insured’s death, at which time the policyholder will receive the cash value of the policy. If you have this type of insurance policy, then its cash surrender value should be included as part of your investment assets. Finally, any real estate purchased for investment purposes should also appear as an asset. The common thread among all these assets is that they are not meant for use, as you would use a car or a house. Instead, they have been purchased for the purpose of generating wealth.

**Retirement Plans** These include investments made by you or your employer aimed directly at achieving your goal of saving for retirement. Retirement plans are usually in the form of IRAs, 401(k) or 403(b) plans, Keogh plans, SEP-IRA plans, and company pension plans, which we will discuss in detail in Chapter 16. Typically, retirement plans issue quarterly statements, which list their current value. The current value of your stake in your company’s pension plan should also be included as a retirement plan asset. If you work for a company that offers a pension plan, the easiest way to value your stake in the plan is to call up your benefits office and ask them how much it’s worth.

**Housing** Your house, if you own it, comprises another asset category. Although a house is an asset that you use—a tangible asset—it usually holds the majority of your savings. The value of your house recorded on the balance sheet should be its fair market value, even though at that price it may take several months for it to sell. You might consult with a real estate agent or look on www.zillow.com for help in valuing your home. Keep in mind that even if you owe money on your home, it’s still yours.

**Automobiles** Your car, truck, motorcycle, or other vehicle also gets its own asset category. Similar to your home, your vehicle is a tangible asset—one you probably use daily. However, unlike your home, your vehicle is likely to be worth less than you paid for it. The fair market value for vehicles almost always goes down, often starting right after you take it home from the showroom. You can find the fair market value for most vehicles in an automotive blue book or try www.edmunds.com. Do not include any cars you lease as assets. If the car is leased, you don’t hold title to it and thus don’t actually own it. Likewise, a company car that you get to use but don’t own wouldn’t count as an asset.

**Personal Property** This category consists of tangible assets. Basically, personal property is all your possessions—furniture, appliances, jewelry, TVs, and so forth. In
general, although you may have spent a good deal of money on these items, their fair market value will be only a fraction of the purchase amount.

**Other Assets**  The “other” category includes anything that has not yet been accounted for. As an example, you might own part of a business or you have a massive collection of semivaluable (or so you think) Pez dispensers, or you might be owed money by a deadbeat friend. All of these count as assets and must appear at their fair market value on your balance sheet. Of course, if your friend is really a deadbeat, the amount owed shouldn’t appear as an asset—since you’ll never see it!

Summed up, these asset categories represent the total value of everything you own.

**Liabilities: What You Owe**

A liability is debt that you have taken on and that you must repay in the future. Most financial planners classify liabilities as current or long-term. Current liabilities are those that must be paid off within the next year, and long-term liabilities come due beyond a year’s time. In listing your liabilities, be sure to include only the **unpaid** balances on those liabilities. Remember, you owe only the unpaid portion of any loan.

**Current Debt**  In general, the current debt category is comprised of the total of your unpaid bills including utility bills, past-due rent, cable TV bills, and insurance premiums that you owe. The unpaid balance on your credit cards represents a current liability because it’s a debt that you should pay off within a year. Even if you have not yet received a bill for a purchase you made on credit, the amount you owe on this purchase should be included as a liability.

**Long-Term Debt**  This category tends to consist of debt on larger assets, such as your home or car or student loan. Because of the nature of the assets it finances, long-term debt almost always involves larger amounts than does current debt. If you think about it, the very reason long-term debt covers the long term is that it involves sums too large for the average individual to be able to pay off within 1 year. The largest debt you ever take on, and thus the longest-term debt you ever take on, will probably be the mortgage on your home. Car loans are another major category of long-term debt. Just as a leased car is not considered an asset, the remaining lease obligation should not be considered a liability, or something that you owe. In effect, you are “renting” your car when you lease it. However, it’s a very fine line between a debt obligation and a lease contract—if the lease simply can’t be broken, no matter what, it may be considered debt. Keep in mind that future lease payments, future insurance payments, and future rent payments are something you may owe in the future, but they are not something you owe right now.

Finally, any other loans that you have outstanding should be included. For example, student loans, loans on your life insurance policy, bank loans, and installment loans are liabilities. Together, long-term debt and current liabilities represent what you owe.
Net Worth: A Measure of Your Wealth

To calculate your net worth, subtract your total debt from your total assets. This represents the level of wealth you have accumulated. If your liabilities are greater than the value of your assets, then your net worth has a negative value, and you’re considered insolvent. Insolvency results from consuming more than you take in financially, and in some instances it can lead to bankruptcy.

What is a “good” level of net worth? That depends upon your goals and your place in the financial life cycle. You would expect a 25-year-old to have a considerably lower net worth than a 45-year-old. Likewise, a 45-year-old who has saved for college for three children may have a higher net worth than a 45-year-old with no children. Which one is in better financial shape? The answer doesn’t necessarily rest on who has the larger net worth, but on who has done a better job of achieving financial goals. Just to give you an idea of where most people stand, Table 2.1 presents the average annual salary and net worth for individuals along with some other financial data.

Your goal in financial planning is to manage your net worth or wealth in such a way that your goals are met in a timely fashion. The balance sheet enables you to measure your progress toward these goals, and to monitor your financial well-being. It also allows you to detect changes in your financial well-being that might otherwise go unnoticed and correct them early on.

### Table 2.1 How Do You Compare?

<table>
<thead>
<tr>
<th>Family Net Worth and Income</th>
<th>Average Net Worth</th>
<th>Median Net Worth</th>
<th>Head of Household Education Status</th>
<th>Average Net Worth</th>
<th>Median Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 35</td>
<td>$106,000</td>
<td>$11,800</td>
<td>No high school diploma</td>
<td>$142,900</td>
<td>$33,200</td>
</tr>
<tr>
<td>35 to 44</td>
<td>$325,600</td>
<td>$86,600</td>
<td>High school diploma</td>
<td>$251,600</td>
<td>$80,300</td>
</tr>
<tr>
<td>45 to 54</td>
<td>$661,200</td>
<td>$182,500</td>
<td>Some college</td>
<td>$365,900</td>
<td>$84,700</td>
</tr>
<tr>
<td>55 to 64</td>
<td>$935,800</td>
<td>$253,700</td>
<td>College degree</td>
<td>$1,097,800</td>
<td>$280,800</td>
</tr>
<tr>
<td>65 to 74</td>
<td>$1,015,200</td>
<td>$239,400</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75 or more</td>
<td>$638,200</td>
<td>$213,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All families</td>
<td>$120,300</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average annual amount spent by full-time college students on beer and pizza . . .</td>
<td>$1,900</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average annual cost of college—tuition, room, and board at an in-state university . . .</td>
<td>$19,388</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Projected cost in 18 years . . .</td>
<td>$54,779</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sample Balance Sheet for Larry and Louise Tate

To illustrate the construction and use of a balance sheet, we have a sample from Larry and Louise Tate shown in Figure 2.3. Remember, a balance sheet provides a snapshot of an individual’s or a family’s financial worth at a given point in time. As investment values fluctuate daily with the movements in the stock market, so does net worth. The balance sheet in Figure 2.3 was constructed on December 31, 2011, and reflects the value of the Tates’ assets, liabilities, and net worth on that specific date.

Using an Income Statement to Trace Your Money

The second step in creating a personal financial plan is to trace your money. A balance sheet is like a financial snapshot: It tells you how much wealth you have accumulated as of a certain date. An income statement is more like a financial motion picture: It tells you where your money has come from and where it has gone over some period of time. Actually, although it’s generally called an income statement, it’s really an income and expenditure, or net income, statement because it looks at both what you take in and subtracts from that, or “nets out,” what you spend, with what is left over being the amount available for savings or investment.

An income statement can help you stay solvent by telling you whether or not you’re earning more than you spend. If you’re spending too much, your income statement shows exactly where your money is going so that you can spot problem areas quickly. Of course, if you don’t have a spending problem, your income statement tells you how much of your income is available for savings and for meeting financial goals. With a good income statement, you’ll never end another month wondering where all of your money went.

Personal income statements are prepared on a cash basis, meaning they’re based entirely on actual cash flows. You record income only when you actually receive money, and you record expenditures only when you actually pay money out. Giving someone an IOU wouldn’t appear on an income statement, but receiving a paycheck would. Buying a stereo on credit wouldn’t appear on your income statement, but making a payment to the credit card company would. As a result, a personal income statement truly reflects the pattern of cash flows that the individual or family experiences.

To construct an income statement, you need to record your income only for the given time period and subtract from it the expenses you incurred during that period. The result tells you the amount you have available for savings. Figure 2.4 shows a general outline for an income statement.

Income: Where Your Money Comes From

For your income statement, income, or cash inflows, will include such items as wages, salary, bonuses, tips, royalties, and commissions, in addition to any other sources of income you may have. Additional sources of income might include family income, payments from the government (e.g., veterans’ benefits or welfare income), retirement income, investment income, and those yearly checks you get for winning the Publishers’ Clearinghouse Sweepstakes.

Some of your income may not ever reach your pocketbook. Instead, it may be automatically invested in a voluntary retirement plan, used to pay for insurance you buy through work, or be sent to the government to cover taxes. For example, if your total earnings are $50,000 and you automatically have $4,000 deducted for insurance
### FIGURE 2.3 A Balance Sheet for Louise and Larry Tate, December 31, 2011

<table>
<thead>
<tr>
<th>Assets (What They Own)</th>
<th>Liabilities or Debt (What You Owe)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MONETARY ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>A. Total Monetary Assets</td>
<td>3,590</td>
</tr>
<tr>
<td><strong>INVESTMENTS</strong></td>
<td></td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>5,600</td>
</tr>
<tr>
<td>Individual Stocks and Bonds</td>
<td>+ 9,500</td>
</tr>
<tr>
<td>Investment Real Estate (REITs, partnerships)</td>
<td>+ 0</td>
</tr>
<tr>
<td>Other (life insurance—cash value, REITs, other)</td>
<td>+ 0</td>
</tr>
<tr>
<td>B. Total Investments</td>
<td>15,100</td>
</tr>
<tr>
<td><strong>RETIREDMENT PLANS</strong></td>
<td></td>
</tr>
<tr>
<td>401(k) and 403(b), Keough Plan</td>
<td>2,500</td>
</tr>
<tr>
<td>Company Pension</td>
<td>+ 8,000</td>
</tr>
<tr>
<td>IRA</td>
<td>+ 8,000</td>
</tr>
<tr>
<td>C. Total Retirement Plans</td>
<td>18,500</td>
</tr>
<tr>
<td><strong>HOUSING</strong></td>
<td></td>
</tr>
<tr>
<td>Primary Residence</td>
<td>170,000</td>
</tr>
<tr>
<td>Time-Shares/Condominiums, and Second Home</td>
<td>+ 70,000</td>
</tr>
<tr>
<td>D. Total Housing (market value)</td>
<td>240,000</td>
</tr>
<tr>
<td><strong>AUTOMOBILES</strong></td>
<td></td>
</tr>
<tr>
<td>E. Total Automobiles</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>PERSONAL PROPERTY</strong></td>
<td></td>
</tr>
<tr>
<td>F. Total Personal Property</td>
<td>11,000</td>
</tr>
<tr>
<td><strong>OTHER ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>G. Total Other Assets</td>
<td>0</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>H. Total Assets (add lines A-G)</td>
<td>300,190</td>
</tr>
<tr>
<td><strong>CURRENT BILLS</strong></td>
<td></td>
</tr>
<tr>
<td>I. Current Bills (unpaid balance)</td>
<td>350</td>
</tr>
<tr>
<td><strong>CREDIT CARD DEBT</strong></td>
<td></td>
</tr>
<tr>
<td>J. Total Credit Card Debt</td>
<td>1,150</td>
</tr>
<tr>
<td><strong>HOUSING LOANS</strong></td>
<td></td>
</tr>
<tr>
<td>First Mortgage</td>
<td>105,000</td>
</tr>
<tr>
<td>Second-Home Mortgage</td>
<td>+ 52,000</td>
</tr>
<tr>
<td>Home Equity Loan</td>
<td>+ 9,000</td>
</tr>
<tr>
<td>K. Total Housing Loans</td>
<td>166,000</td>
</tr>
<tr>
<td><strong>AUTOMOBILE LOANS</strong></td>
<td></td>
</tr>
<tr>
<td>L. Total Automobile Loans</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>OTHER DEBT</strong></td>
<td></td>
</tr>
<tr>
<td>College Loans</td>
<td>4,000</td>
</tr>
<tr>
<td>Other Loans (installment, bank, other)</td>
<td>+ 1,000</td>
</tr>
<tr>
<td>M. Total Other Debt</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>TOTAL DEBT</strong></td>
<td></td>
</tr>
<tr>
<td>N. Total Debt (add lines I-M)</td>
<td>$175,500</td>
</tr>
<tr>
<td><strong>Your Net Worth</strong></td>
<td></td>
</tr>
<tr>
<td>H. Total Assets</td>
<td>$300,190</td>
</tr>
<tr>
<td>N. Less: Total Debt</td>
<td>$175,500</td>
</tr>
<tr>
<td>O. Equals: Net Worth</td>
<td>$124,690</td>
</tr>
</tbody>
</table>

**Assets:** This includes everything they own.

**Liabilities:** This includes everything they owe.

**Net Worth:** This is the difference between assets and liabilities and is a measure of your wealth.

Adding all the assets together shows that the Tates own or have total assets of $300,190.

The Tates’ total liabilities, or what they owe, equals $175,500.

If the Tates sold off all their assets and paid off all their debts, they would have $124,690 in cash—that is their net worth.

We use net worth to gauge financial progress. If in future balance sheets the Tates’ net worth is higher, the Tates are accumulating more wealth.

Just as the Tates’ homes make up their primary assets, their mortgages on these homes make up their primary liabilities. Their mortgage loans total $166,000.

The Tates’ primary investments are their home and their vacation condominium in Vail, which have market values of $170,000 and $70,000, respectively.
and a retirement fund, and $8,000 deducted in taxes, then your income would be $50,000 even though your take-home pay is only $38,000. You must make sure to record the full amount of what you earned—your full earnings and taxes paid, not just the dollar value of your paycheck. Any money you receive, even if you automatically spend it (even for taxes), is considered income at the point in time when it is received.

Next, include the total amount of money you pay in federal, state, and Social Security income taxes. Then, subtract your taxes from your earnings. This is your take-home pay, or the money you have available for expenditures.

**Expenditures: Where Your Money Goes**

Although income is usually very easy to calculate, expenditures usually are not. Why? Because many expenditures are cash transactions and do not leave a paper trail. It’s hard to keep track of all the little things you spend your money on. But to create a valuable personal financial plan, you must understand where your money goes. Look at the categories of expenditures in Figure 2.4 to get an idea of the ways living expenses can be categorized and tracked.

Some financial planners also classify living expenses as variable or fixed expenditures, depending on whether you have control over the expenditure. These classifications are appealing, but not all expenses fit neatly into them. For example, it’s difficult to categorize car or home repairs as being either variable (you have a choice in spending this money) or fixed (you have no choice in spending this money). They may be postponable but probably not for too long.

Where does all our money go? Turns out that what the average American household spends its money on depends on how much it earns. The more we earn, the more we spend on such things as education and entertainment. Figure 2.5 provides a breakdown of spending for the average U.S. household or, as the government calls it, consumer unit. It shows that housing is the major expenditure, accounting for 34.4 percent of all expenditures. Under the heading of housing, shelter is the main item, with utilities, fuels, and public services following next in importance. The category that comes

---

**Figure 2.4 A Simplified Income Statement**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Total Income</td>
<td>A.</td>
</tr>
<tr>
<td>B. Total Income Taxes</td>
<td>B.</td>
</tr>
<tr>
<td>C. After-Tax Income Available for Living Expenditures or Take-Home Pay</td>
<td>C.</td>
</tr>
<tr>
<td>(line A minus line B)</td>
<td></td>
</tr>
<tr>
<td>D. Total Housing Expenditures</td>
<td>D.</td>
</tr>
<tr>
<td>E. Total Food Expenditures</td>
<td>E.</td>
</tr>
<tr>
<td>F. Total Clothing and Personal Care Expenditures</td>
<td>F.</td>
</tr>
<tr>
<td>G. Total Transportation Expenditures</td>
<td>G.</td>
</tr>
<tr>
<td>H. Total Recreation Expenditures</td>
<td>H.</td>
</tr>
<tr>
<td>I. Total Medical Expenditures</td>
<td>I.</td>
</tr>
<tr>
<td>J. Total Insurance Expenditures</td>
<td>J.</td>
</tr>
<tr>
<td>K. Total Other Expenditures</td>
<td>K.</td>
</tr>
<tr>
<td>L. Total Living Expenditures (add lines D–K)</td>
<td>L.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>C. After-Tax Income Available for Living Expenditures or Take-Home Pay</td>
<td>C.</td>
</tr>
<tr>
<td>L. Total Living Expenditures (add lines D–K)</td>
<td>L.</td>
</tr>
<tr>
<td>M. Income Available for Savings and Investment (line C minus line L)</td>
<td>M.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Variable Expenditure**

An expenditure over which you have control. That is, you are not obligated to make that expenditure, and it may vary from month to month.

**Fixed Expenditure**

An expenditure over which you have no control. You are obligated to make this expenditure, and it is generally at a constant level each month.
in second in terms of money spent is transportation, which accounts for 15.6 percent
of all expenditures, followed by food, which accounts for 13 percent of all expendi-
tures. Interestingly, but probably not a surprise, 41.1 percent of food expenditures, or
an average of $2,619 per year, is spent away from home at restaurants.

Why the difference between income before taxes and average annual expenditures
shown in Figure 2.5? One big reason is that neither taxes nor savings are included. How
much are taxes on average? Federal, state, and local income taxes consumed 9.2 percent
of all personal income in 2009. On top of that, it’s also possible to spend even more
by borrowing money—just by putting it on your credit card. One thing to keep in
mind with these figures is that they represent the averages, not median or middle
income. Why is that important? If you calculate the average income for 100 people,

you add up the income for all 100, then divide that by 100. However, if there are some people like Warren Buffett who make a ton of money in that population of 100, they would raise the average income of the entire population above what the 50th ranked person earned. What that 50th ranked person earned is the median of the population. You can think of that as what the “Average Joe” earns. For the United States, the median household income is less than the $62,857 shown in Figure 2.5; it’s actually only about $49,777. If you look at what is considered “family households,” it is pretty close to $61,265, and for “non-family households” (someone living alone or unrelated people living together), it is only $30,444. Still, this figure gives you a good idea of what some of the typical expenditures are for a typical household unit.

Also, keep in mind that the amounts in Figure 2.5 are spending averages, and that they vary across the country. For example, people living in San Francisco spend quite a bit more on food because they tend to eat out more often than those who live elsewhere (better restaurants, I guess). In addition, remember that when you buy something, it actually costs more than you may think—at least in terms of how much money you must earn to buy it. For example, if you pay 28 percent of your income in taxes, and you want to buy a new stereo for $720, you have to earn $1,000 to pay for it. The first $280 of your $1,000 earnings went to Uncle Sam, leaving you $720 for your stereo.

**Preparing an Income Statement: Louise and Larry Tate**

To get a better understanding of the preparation of an income statement, take a look at the one for Louise and Larry Tate in Figure 2.6. The income statement and balance sheet can and should be used together. The balance sheet lets you judge your financial standing by showing your net worth, and the income statement tells you exactly how your spending and saving habits affect that net worth. If your balance sheet shows you that you’re not building your net worth as much or as quickly as you’d like, or if you’re overspending and actually decreasing your net worth, your income statement can help by showing you where your money is going.

By reviewing all your expenses and spending patterns, you can decide on specific ways to cut back on purchases and increase savings. This process of setting spending goals is referred to as setting a **budget**. As you will see later in this chapter, a smart budget includes estimates of all future expenses and helps you manage your money to meet specific financial goals.

But before you can design and implement a budget plan, you first need to analyze your balance sheet and income statement using ratios to better understand any financial shortcomings or deficiencies you discover.

**Using Ratios: Financial Thermometers**

The next step in creating your personal financial plan is to take the temperature of your finances. By themselves the numbers in your balance sheet and income statement are helpful and informative, but they don’t tell you everything you need to know about your financial well-being. You need a tool to help you glean all the meaning you can from these numbers. That tool is ratios.

Financial ratios allow you to analyze the raw data in your balance sheet and income statement and to compare them with a preset target or your own previous performance. In general, you use ratios to better understand how you’re managing your financial resources. Specifically, you want answers to these questions:

1. Do I have enough liquidity to meet emergencies?
2. Can I meet my debt obligations?
3. Am I saving as much as I think I am?
Your take-home pay is your after-tax income—it is what you have available to spend or save. Your income statement only makes sense if you know where your money goes. To determine your living expenses, keep a small notebook or some notepaper in your purse or wallet, and write down all your cash expenditures—do this for a month. You’ll probably be surprised to see where your money went. In addition, make use of your credit card bills and cancelled checks to help keep track.

### FIGURE 2.6 Louise and Larry Tate’s Personal Income Statement

<table>
<thead>
<tr>
<th>Income</th>
<th>Wages and Salaries</th>
<th>Wage Earner 1</th>
<th>$57,500</th>
<th>Wage Earner 2</th>
<th>12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Wages and Salaries</td>
<td>69,500</td>
<td>+ Interest, Dividends, Royalties, Other</td>
<td>730</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>A. Total Income</strong></td>
<td><strong>$70,220</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>Federal Income and Social Security</td>
<td>11,830</td>
<td>+ State Income</td>
<td>1,880</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>B. Total Income Taxes</strong></td>
<td><strong>$13,710</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>C. After-Tax Income Available for Living Expenditures or Take-Home Pay (line A minus line B)</strong></td>
<td><strong>$56,510</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>D. Total Housing Expenditures</strong></td>
<td><strong>$30,476</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Food</td>
<td><strong>E. Total Food Expenditures</strong></td>
<td><strong>$7,200</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rent</td>
<td>0</td>
<td>+ Restaurant Expenses</td>
<td>1,400</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Utilities, Maintenance, Taxes, Furniture, Other</td>
<td>19,656</td>
<td>10,820</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>F. Total Clothing and Personal Care Expenditures</strong></td>
<td>2,590</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>G. Total Transportation Expenditures</strong></td>
<td><strong>$4,138</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Vacation</td>
<td>2,000</td>
<td>+ Gas, Tolls, Parking, Repairs, Other</td>
<td>1,550</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other Recreation</td>
<td>1,700</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>H. Total Recreation Expenditures</strong></td>
<td><strong>$3,700</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>I. Total Medical Expenditures</strong></td>
<td><strong>$410</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>J. Total Insurance Expenditures</strong></td>
<td><strong>$1,940</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>K. Total Other Expenditures</strong></td>
<td><strong>$1,780</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>L. Total Living Expenditures (add lines D-K)</strong></td>
<td><strong>$52,234</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>M. Income Available for Savings and Investment (line C minus line L)</strong></td>
<td><strong>$4,276</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If your take-home pay is greater than your living expenses, you can save and invest—but if your take-home pay is less than your living expenses, you’ve got some changes to make.
Question 1: Do I Have Enough Liquidity to Meet Emergencies?

If your TV died in the middle of the playoffs or that miniseries you’ve been watch-
ing, would you have enough cash on hand to buy another one immediately? To judge your liquidity, you need to compare the amount of your cash and other liquid assets with the amount of debt you have currently coming due. In other words, you need to look at your balance sheet and divide your monetary assets by your current liabilities. The resultant measure of your liquidity is called the current ratio:

\[
\text{current ratio} = \frac{\text{monetary assets}}{\text{current liabilities}}
\]

We can see from Larry and Louise Tates’ balance sheet that their monetary assets total $3,590 and their current liabilities (current bills and credit card debt) total $1,500. Thus, the Tates’ current ratio is:

\[
\text{current ratio} = \frac{3,590}{1,500} = 2.39
\]

Although there’s no set rule for how large the current ratio should be, it certainly should be greater than 1.0. Most financial advisors look for a current ratio above 2.0. More important than the level of the current ratio is its trend—is it going up, or of more concern, is it going down? If it is going down, you have to try to find the cause. To do this you have to see what changes have caused the ratio to decrease.

One problem with the current ratio is that people generally have a number of monthly expenses that are not considered current liabilities. For example, long-term debt payments such as mortgage payments, auto loan payments, and so forth may not be considered current liabilities but still must be paid on a monthly basis. Therefore, it’s also helpful to calculate the ratio of monetary assets to monthly living expenses, called the month’s living expenses covered ratio.

\[
\text{month’s living expenses covered ratio} = \frac{\text{monetary assets}}{\text{annual living expenditures}/12}
\]

As the name suggests, this ratio tells you how many months of living expenses you can cover with your present level of monetary assets. Again, the numerator is the level of monetary assets, and the denominator is the annual living expenditures (as on line L of the income statement in Fig. 2.6) divided by 12. For the Tates, this ratio would be:

\[
\frac{3,590}{52,234/12} = \frac{3,590}{4,353} = 0.825 \text{ months}
\]

This means the Tates currently have enough cash and liquid assets on hand to cover 0.825 months of expenditures.
The traditional rule of thumb in personal finance is that an individual or family should have enough liquid assets to cover 3 to 6 months of expenditures in order to cover the untimely death of a television, a major car repair, or some other unexpected event. The Tates fall well short of this amount. However, this rule was set up long before credit cards and home equity lines of credit were as common as they are today. You set up emergency funds so that you don’t need to tap into money for long-term goals. However, sufficient credit from your credit cards or a home equity line of credit to cover emergency expenses will serve the same purpose. Of course, you may have to pay high interest on any credit you use, but the return you get from having to keep less in emergency funds may be enough to compensate. Most emergency funds earn very little return, because as you gain liquidity you give up expected return. Liquid investments are low risk and low return because the money is always safe and readily available—that’s the risk–return relationship we looked at in Principle 8: Risk and Return Go Hand in Hand.

The bottom line is that the Tates, and most people, may be better off investing most of their emergency funds in higher yielding, less liquid investments. For example, if the Tates invest their emergency funds in a money market fund paying 3 percent, those funds will grow 34 percent over the next 10 years. If they invested them in a stock fund that grew at an annual rate of 9 percent, their investment would have grown 137 percent over that same period. Thus, if you have enough credit and insurance protection to provide income in the face of an emergency, you can safely reduce the number of months of living expenses you keep in your emergency fund to three or below.

Regardless of what you do with your emergency funds, the month’s living expenses covered ratio still provides a sound, easy-to-understand indication of the relative level of cash on hand. It’s a better personal liquidity measure than the current ratio. You should track this ratio over time to make sure that it does not drop unexpectedly.

**Question 2: Can I Meet My Debt Obligations?**

A second question ratios can answer is, “Do you have the ability to meet your debt obligations?” In other words, you saw it, you borrowed money and bought it, now can you pay for it? To answer this question you need to look at the debt ratio and the debt coverage ratio. The debt ratio answer tells you what percentage of your assets has been financed by borrowing. This ratio can be expressed as follows:

\[
\text{debt ratio} = \frac{\text{total debt or liabilities}}{\text{total assets}}
\]

Looking at the Tates’ balance sheet, we see that the level of their total debt or liabilities is $175,500, (line N of Figure 2.3), while their total assets or what they own is $300,190 (line H of Figure 2.3). Thus, their debt ratio becomes $175,500 / $300,190 = 0.5846. This figure means that just over half of their assets are financed with borrowing. If you are managing your finances well, this ratio should go down as you get older.

The long-term debt coverage ratio relates the amount of funds available for debt repayment to the size of the debt payments. In effect, this ratio is the number of
times you could make your debt payments with your current income. It focuses on long-term obligations such as home mortgage payments, auto loan payments, and any other long-term credit obligations. If credit card debt has gotten large enough, it, too, represents a long-term obligation. The denominator of this ratio represents your total outstanding long-term debt payments (excluding short-term borrowing such as credit cards and bills coming due). The numerator represents the funds available to make these payments.

\[
\text{long-term debt coverage ratio} = \frac{\text{total income available for living expenses}}{\text{total long-term debt payments}}
\]

For the Tates, total income available for living expenses is found on line C of their income statement and is $56,510. The only long-term debt obligations they have are their mortgage payments of $19,656 (under Housing in Figure 2.6, the income statement), their automobile loan payments of $2,588 (under Transportation in Figure 2.6, the income statement), and college loan payments of $1,600 (under Other Expenditures in Figure 2.6, the income statement). Thus, their debt coverage ratio is \([\frac{56,510}{19,656 + 2,588 + 1,600}] = 2.37\) times. In general, a debt coverage ratio of less than approximately 2.5 should raise a caution flag.

You should also keep track of your long-term debt coverage ratio to make sure it does not creep downward. The Tates are at their limit in terms of the level of debt that they can manage comfortably. Such a low debt coverage ratio, though, is not surprising, because most of their assets are tied up in housing.

Another way of looking at the debt coverage ratio is to take its inverse; that is, divide the total debt payments by the total income available for living expenses. In this case, the inverse of the Tates’ debt coverage ratio is 0.43, or 43 percent, indicating that 43 percent of the Tates’ total income available for living expenses goes to cover debt payments.

**Question 3: Am I Saving as Much as I Think I Am?**

The final question you can answer using ratios is, “How much of your income are you really saving?” The answer to this question lies in the *savings ratio*, which is simply the ratio of income available for savings and investment (line M of Figure 2.6) to income available for living expenditures (line C of Figure 2.6). This ratio tells you the proportion of your after-tax income that you are saving.

\[
\text{savings ratio} = \frac{\text{income available for savings and investment}}{\text{income available for living expenditures}}
\]

For the Tates, this ratio is \((4,276/56,510) = 0.076\) or 7.6 percent. This figure is in the range of what is typical in this country. Actually, for families saving for their first house it tends to be higher, and for families that have just purchased their first house and now are experiencing large mortgage payments, it tends to be lower. Again, as with the other ratios, this ratio should be compared with past savings ratios and target savings ratios to determine whether or not the Tates’ savings efforts are enough.

If you’re not presently saving, then you’re living above your means. The only effective way to make saving work is to pay yourself first. That is, you first set aside your savings, and what is left becomes the amount you can spend.

**Record Keeping**

The fourth step in creating a personal financial plan is to keep and maintain records, for three reasons. First, without adequate records it’s extremely difficult
# Checklist 2.1

## Storing Financial Files

### Home File
- Tax Records (may be discarded after 6 years) (Chapter 4)
  - Tax returns
  - Paychecks
  - W-2 forms
  - 1099 forms
  - Charitable contributions
  - Alimony payments
  - Medical bills
  - Property taxes
  - Any other documentation

### Tax Records (Chapters 4)
- Tax returns
- Paychecks
- W-2 forms
- 1099 forms
- Charitable contributions
- Alimony payments
- Medical bills
- Property taxes
- Any other documentation

### Investment Records (Chapters 11–15)
- Bank records and non-tax-related checks less than a year old
- Safety deposit box information
- Stock, bond, and mutual fund transactions
- Brokerage statements
- Dividend records
- Any additional investment documentation

### Investment Records (Chapters 5, 13, 14)
- Certificates of deposit
- Listing of bank accounts
- Stock and bond certificates
- Collectibles

### Retirement and Estate Planning (Chapters 16, 17)
- Copy of will
- Nondeductible IRA records

### Retirement and Estate Planning (Chapters 16–17)
- Copy of will
- Pension plan documentation
- IRA documentation
- Keogh plan transactions
- Social Security information
- Any additional retirement documentation

### Personal Planning (Chapters 2, 8–10, 17)
- Personal balance sheet
- Personal income statement
- Personal budget
- Insurance policies and documentation
- Warranties
- Receipts for major purchases
- Home improvement receipts
- Credit card information (account numbers and telephone numbers)
- Birth certificates

### Personal Planning (Chapters 6–10, 17)
- Personal balance sheet
- Personal income statement
- Personal budget
- Insurance policies and documentation
- Warranties
- Receipts for major purchases
- Home improvement receipts
- Credit card information (account numbers and telephone numbers)
- Birth certificates

### Throw Out
- Non-tax-related checks over a year old
- Records from cars and boats you no longer own
- Expired insurance policies on which there will be no future claims
- Expired warranties
- Non-tax-related credit card slips over a year old

---

### Safety Deposit Box Storage
- Investment Records (Chapters 5, 13, 14)
  - Certificates of deposit
  - Listing of bank accounts
  - Stock and bond certificates
  - Collectibles

- Retirement and Estate Planning (Chapters 16, 17)
  - Copy of will
  - Nondeductible IRA records

- Personal Planning (Chapters 6–10, 17)
  - Copy of will
  - Deed for home
  - Mortgage
  - Title insurance policy
  - Personal papers (birth and death certificates, alimony, adoption/custody, divorce, military, immigration, etc.)
  - Documentation of valuables (video-tape or photos)
  - Home repair/improvement receipts
  - Auto title and new car sticker
  - Listing of insurance policies
  - Credit card information (account numbers and telephone numbers)
to prepare taxes. Second, a strong record-keeping system allows you to track expenses and know exactly how much you’re spending and where you’re spending it. In short, if you don’t know where and how much you’re spending, you don’t have control of your finances. Third, organized record keeping makes it easier for someone else to step in during an emergency and understand your financial situation.

Record keeping really involves two steps: tracking your personal financial dealings, and filing and storing your financial records in such a way that they are readily accessible. Very simply, if you don’t know where financial records are, you won’t be in control of your affairs.

In determining how best to track your personal financial dealings, you must keep in mind that the best system is one that you will use. This may sound silly, but because of the tedious nature of record keeping, anything too complex just won’t be used. Do yourself a favor and keep your system simple.

In general, credit card and check expenditures are easy to track because they leave an obvious paper trail. It’s the cash expenditures that cause the most concern. Cash expenditures must be tracked as they occur; if not, they will be lost and forgotten. The simplest way to keep track of all cash expenditures is by recording them in a notebook or your checkbook register as they are made, and then using these records, in addition to check and credit card transactions, to generate a monthly income statement. You then compare this monthly income statement with your annual and target income statements to determine whether or not you have any problems. Sure, the process may be tedious, but it’s necessary. Remember, your budget is your best friend, because the key to controlling expenditures is to keep track of them.

Once you’ve tracked your expenditures, you need to record them in an organized way. How should you do this? A relatively easy way is to set up a budget book similar to the income statement shown in Figure 2.4 and manually enter your expenditures. Alternatively, a number of personal finance computer programs can track your monthly and yearly expenses and your financial position once you’ve entered your daily expenditures. This approach is ideal. The two most popular personal financial management programs for the personal computer (PC) are Intuit’s Quicken and Microsoft’s Money. However, for those without a PC, the money for such a software program, or the time to set up such a system, the manual approach works just as well.

When recording your transactions, you should have a section in your ledger for each month broken down by the major types of expenditures. In addition, each month should be broken down by day. The more detailed your records are, the easier it is to track your money. For example, when you spend $200 on new clothes, you should enter the expense in the new clothes subsection of the clothes and personal care section of the proper month on the day on which the expenditure occurred (it sounds more complicated than it is). At the end of the month you should add up your expenditures and compile your monthly income statement.

After you’ve been keeping records for a while, you’ll notice that they really start to pile up. How long do you have to hang on to these records? This, of course, depends upon the item. In general, items dealing with taxes must be kept for at least 6 years after the transaction takes place; some items should be kept for life. Checklist 2.1 provides a summary of where and for how long financial records should be kept.
Putting It All Together: Budgeting

Now we are ready to put our financial plan together. Chapter 1 introduced the planning cycle as a five-step process. Now that you have a better understanding of the tools involved in that process, how about a little review? Let’s see how the balance sheet and income statement fit into the planning process.

The planning process begins by evaluating your financial health, which is exactly what the balance sheet and income statement are all about. Your balance sheet sums up everything you own or owe and lets you know your net worth, the basic element of financial health. Your income statement furthers your understanding by showing you where your money comes from, where it goes, and what your spending patterns are. Once you understand how much money you have coming in and how you tend to spend it, you can figure out how much you can realistically afford to save. If you don’t know how much you can actually save, you can’t come up with realistic financial goals, the second step of the planning process.

By providing you with information on how far you need to go to achieve a certain level of wealth and how you might realistically balance spending and saving to get there, your balance sheet and income statement not only help you set goals, but they also help you achieve them. Developing a plan of action to achieve your goals is the third step in the planning process, and for this your income statement is the key.
Your income statement helps you set up a cash budget (which we examine in more detail in the next section) that allows you to manage your savings while considering flexibility, liquidity, protection, and minimization of taxes. Once your plan is in place, you’ll need to monitor your progress. Because this last step is really the same as the first, you’re right back to using your balance sheet and income statement again. As you can see, without these documents, the planning process isn’t nearly as effective.

**Developing a Cash Budget**

A budget is really nothing more than a plan for controlling cash inflows and outflows. The purpose of the cash budget is to keep income in line with expenditures plus savings. Your cash budget should allocate certain dollar amounts for different spending categories, based on your goals and financial obligations.

To prepare a cash budget, you begin with your most recent annual personal income statement. First, examine last year’s total income, making any adjustments to it you expect for the coming year. Perhaps you expect to receive a raise, plan to take a second job, or anticipate an increase in royalty payments. Based on your income level, estimate what your taxes will be. This figure provides you with an estimate of your anticipated after-tax income available for living expenditures, which is commonly called take-home pay.

Just as your estimate of anticipated take-home pay flows from your most recent annual personal income statement, so does your estimate of living expenses. Using last year’s personal income statement, identify expenditures over which you have no control—fixed expenditures. Then determine your variable expenses. These are the expenses over which you have complete control, and you can increase or decrease them as you see fit.

This is the category in which you have to start looking for ways to reduce your spending and increase your saving. For example, you can generate savings just by reducing the amount you spend on food—substitute bean dip for those exotic fresh fruits as your evening snack (of course, any savings there will probably be offset in an increase in exercise equipment this year). You must also keep in mind that when you buy on credit, you obligate yourself to future expenditures to pay off your debt. When you borrow you are spending your future income, which limits your ability to save.

Finally, subtract your anticipated living expenditures from your anticipated take-home pay to determine income available for savings and investment. Then compare your anticipated monthly savings with your target savings level, which is, as we mentioned earlier, based on a quantification of your goals. If it doesn’t look as if you’ll be able to fund all your goals, then you must earn more, spend less, or downsize your goals. The choice is, of course, personal; however, keep in mind that regardless of your level of income, many people live on less than what you’re earning.
How do Louise and Larry Tate develop a cash budget? First, assume that the only change in income they expect for the coming year is a $5,000 increase in wages and salaries from $69,500 to $74,500. Last year, the Tates paid approximately 20 percent in federal and state income taxes. If they pay the same percentage this year, their $5,000 raise will result in an increase in take-home pay of $4,000, with 20 percent of the raise, or $1,000, going to pay increased taxes.

The Tates’ personal income statement is shown in Figure 2.6. If there are any anticipated changes in different expenditure categories, they must adjust their personal income statement—and the changes can involve increases in planned spending. A cash budget, then, does not necessarily curb spending in all areas. Instead, it allows you to decide ahead of time how much to spend where.

Assume that the Tates’ target level of savings for the entire year is $6,400. If the Tates stick to this cash budget, they will exceed their target. Were this not the case, they would have been forced to adjust their budget so that it covered their target savings. To make your annual cash budget easier to control, you should break it down into monthly budgets by simply dividing by 12.

A key point to remember when budgeting is that no budget is set in stone. As Principle 5 says, Stuff Happens. A TV, a car, a washer—unexpected expenditures are just that—unexpected. Conversely, you may be pleasantly surprised that you wound up spending less than you planned. Then again, you may change your goals—you don’t want that new house, your apartment’s fine for the moment, but you do want to buy a llama farm in Peru. Basically, the budgeting process is a dynamic one: You must continuously monitor the financial impact of change on your spending and saving habits.

**Implementing the Cash Budget**

Now that you’ve put together a cash budget and have your plan, how do you make it work? Essentially, you just put it in place and try to make a go of it for a month. At the end of the month, compare your actual expenditures in each category with your budgeted amounts. If you spent more than you budgeted, you may want to pay closer attention to expenditures in that category or you may want to change the budgeted amount. If you do need to increase one budgeted amount, you might try to reduce spending in another area. Keep in mind that responsibility for sticking to the budget remains with you, but by examining deviations from desired spending patterns on a monthly basis, you can focus on where you need to exert additional self-control.

If you need help, see Worksheet 7, which is downloadable from the MyFinanceLab Web site (www.myfinancelab.com). Figure 2.7 shows a budget tracker in the form of an Excel spreadsheet. It not only does the calculations for you, but also allows you to track how close you came to your budgeted amount in each category.

If sticking to a desired budget remains a problem, one possible control method is using what’s generally called the envelope system. At the beginning of each month the dollar amount of each major expenditure category is put into an envelope. To spend money in that area, simply take it out of the envelope. When the envelope is empty, you’re done spending in that area.

If you are having trouble controlling spending only in certain areas, envelopes could be used just for those areas. For example, if you budgeted $120 per month for restaurant expenditures, put $120 in an envelope each month. When it is exhausted, trips to the restaurant are over for the month. This includes pizza home delivery, so no cheating!
If spreadsheets make you cringe and you like working online, take a look at Mint.com, which is a free Web-based personal financial planning Web site that allows you keep an eye on your financial moves and track all bank accounts, credit cards, investments, and loans together. In addition to aggregating all your financial information it creates a simple budget for you and then gently lets you know when you’re stepping out of line—keeping you from spending too much on entertainment or meals out—and it does this in real time, right when you’re spending your money. You’ll even get a weekly summary e-mail that looks like a bank statement for all of your accounts. What happens if your checking account balance is getting low or if there is unusual spending taking place on one of your accounts? You’ll receive an alert message, and you have control of how, for what, and when you receive alerts. Not only that, but it also provides a list of possible goals—retirement, travel, a wedding, education, and so forth—then lets you work toward the goals you select by entering them directly into your budget. There’s even an app for smartphones and other electronic devices so you don’t have to leave your financial plan at home. And what’s the price of this app? Just like Mint.com, the app is free. Figure 2.8 provides a short description of Mint.com along with its features, and it also gives you an idea of what Mint.com looks like, with a screenshot of your income and expenses over several months.

**Hiring a Professional**

The goal of this course and text is to give you the understanding, tools, and motivation to manage your own financial affairs. Sometimes, though, smart management means knowing when to ask for help. When it comes to personal financial management, there’s good help to be found. You have three options available regarding working with professionals: (1) Go it alone, make your own plan, and have it checked...
FIGURE 2.8 Web-Based Financial Planning with Mint.com

Web site: Mint — “the best free way to manage your money”
Address: http://www.mint.com/
Features:
◆ Free.
◆ Recommended by the Wall Street Journal and Businessweek.
◆ Award-winning, top-rated online finance service by PC World.
◆ Extremely easy to use.
◆ Connects securely with more than 16,000 U.S. financial institutions and automatically updates all transactions.
◆ Spending is automatically categorized to make it easy to see how much you’re spending on food, gas, groceries, entertainment, and more.
◆ Has a free app available for smartphones and other electronic devices.

What can you do with Mint.com?
◆ See all your accounts together at the same time — from checking and savings to credit cards, retirement, and more.
◆ Mint automatically pulls in and categorizes your transactions daily. You only need to enter your cash transactions. All other transactions are automatically entered.
◆ Mint can create a budget based on your actual spending, or you can create your own. Your budget works in real time allowing you to know how much you can spend while you’re out.
◆ Avoid late fees and monitor cash flow. Mint allows you to stay up-to-date with e-mail or text alerts (your choice) for budgets, fees, due dates, low balances, unusual activity, and more.
◆ Mint allows you to track all your expenses at a particular merchant — for example, Starbucks — to see if you are spending more or less than usual there.
◆ Mint tracks all of your investments, including your brokerage and bank accounts, 401(k)s, and IRAs, keeping you up-to-date on the performance of your investments.
◆ Mint helps you plan for your goals — like buying a car, retirement, and buying a house — and works those goals into your budget.

by a professional; (2) work with a professional to come up with a plan; or (3) leave it all in the hands of a pro (though preferably not one with a bad toupee, leisure suit, and beat-up Ford Pinto). Although this decision need not be made until you have finished this course and have a better grasp of the process, let’s take a moment to look further at the options.

What Planners Do

For relatively simple personal financial matters, computerized financial planning programs provide basic budgeting tools and advice. However, as with most standardized advice, they simply may not fit your particular situation. The more unique your situation, the greater the need for professional help.

Even if you turn over the development of your plan to a professional, however, you must understand the basics of personal financial planning in order to judge the merits of the plan and to monitor your game plan. Remember, even if you use a financial planner
to put together the entire plan, you are merely receiving advice. You still bear the ultimate responsibility. This brings us back to Principle 1: The Best Protection Is Knowledge.

It is extremely important that you find a financial planner who is competent and trustworthy. Although the overwhelming majority of financial planners are dedicated, responsible, and competent, and despite the fact that there are regulations in place meant to protect consumers, these regulations don’t mean that all planners are equally qualified. Remember, financial planners may receive commissions on certain products, and they may talk up those more than others in order to receive this commission. Also be wary of those who promise you quick riches, and walk away from anyone using high-pressure tactics. Building wealth takes time and consistent attention.

Choosing a Professional Planner

Many financial planners are excellent at what they do. Some, however, are not so excellent. How do you choose a financial planner? The title “financial planner” is not legally defined—it just means that the individual offers comprehensive financial planning services and says nothing about competence. It is wise to limit your search to those who have received accreditation from a professional organization:

- A personal financial specialist (PFS) is a certified public accountant who has passed certification tests in personal financial planning administered by the American
Part 1 • Financial Planning

Institute of Certified Public Accountants, and has 3 years of personal financial planning experience.

- A certified financial planner (CFP) has satisfactorily completed a 10-hour, 2-day exam and a minimum of 3 years of experience in the field.
- A chartered financial consultant, or ChFC, has completed coursework and ten exams administered by the American College.

After you’ve ascertained a planner’s credentials, consider how much experience they have had. Experience can teach a planner a lot about what’s best for you. Also be aware of whether the planner will give you advice tailored to your specific circumstances. And don’t forget about referrals. Can the planner provide the names of people they’ve worked for? Do you have friends or relatives who have had good experiences with this financial planner in the past?

How Are Financial Planners Paid? Actually, there are four common ways that planners are paid:

1. Fee-only planners earn income only through the fees they charge, generally running from $75 to $200 per hour. They tend to work with bigger, more involved, and specialized situations. You will personally have total control of the products purchased to complete your plan, and therefore you control commission costs. However, you have to sort through a sometimes overwhelming array of options and deal with several different vendors.

2. Fee-and-commission planners charge fees and also collect commissions on products they recommend. Fees may be less if you do choose to use some of their commissioned products, but if you’re dealing with a less-than-ethical person, you could be directed toward higher-commission products. Be aware of what you’re paying for.

3. Fee offset planners charge a fee, but then reduce this fee by any commissions they earn.

4. Commission-based planners work on a commission basis. They can provide an analysis of your personal financial situation, offer solutions to problems, and assist you in implementing the plan. You want to make sure your planner has a wide range of financial products to choose from.

If you have trouble getting recommendations, try calling the Financial Planning Association (www.fpanet.org) at 800-322-4237 or the CFP Board of Standards (www.cfp.net/search) at 800-487-1497 or 888-237-6275 for help. Remember, you bear all the consequences of bad decisions, so you must take responsibility for doing it right.

### Checklist 2.2

**What to Ask a Financial Planner**

- How long have you been a financial planner?
- What are your credentials and professional designations?
- How do you keep up with the latest financial changes?
- Can you provide references?
- Will you show me a copy of a financial plan you made for someone with a somewhat similar financial situation? (With names removed to preserve confidentiality, of course.)
- Who will I work with on a regular basis? You, or another member of your staff?
- Who will actually create my plan? You, a junior staffer, or a software program?
- How many financial companies do you represent?
- How are you paid—by fee or commission? How will that fee be calculated?
- Can you provide a written estimate of the services I can expect and the cost of those services?
Summary

1. Calculate your level of net worth or wealth using a balance sheet.
   A personal balance sheet is a statement of your financial position on a given date. It includes the assets you own; the debt, or liabilities, you have incurred; and your level of wealth. The difference between the value of your assets (what you own) and your liabilities (what you owe) is your net worth, the level of wealth that you or your family has accumulated.

2. Analyze where your money comes from and where it goes using an income statement.
   Whereas a balance sheet tells you how much wealth you have accumulated as of a certain date, an income statement tells you where your money has come from and where it has gone over some period of time. Actually, an income statement is really an income and expenditure, or net income, statement, because it looks at both cash inflows and outflows. Once you understand where your money comes from and where it goes, you’ll be able to determine whether you’re saving enough to meet your goals and how you might change your expenditure patterns to meet those goals. Then you’ll be able to construct a budget.

3. Use ratios to identify your financial strengths and weaknesses.
   Financial ratios help you to identify your financial standing. These ratios are analyzed over time to determine trends and are also compared with standards or target ratios. The purpose of using ratios is to gain a better understanding of how you are managing your financial resources.

4. Set up a record-keeping system to track your income and expenditures.
   To keep track of your income and expenditures and to calculate your net worth, you need a sound system of record keeping. Such a system not only helps with tax preparation, but also allows you to identify how much you are spending and where you are spending it.

5. Implement a financial plan or budget that will provide for the level of savings needed to achieve your goals.
   Developing a plan of action involves setting up a cash budget. The starting point for the cash budget, which is the center point of the plan of action, flows directly from the personal income statement. By comparing the income available for savings and investments with the level of savings needed to achieve your goals, you can determine whether you need to alter your current spending patterns and by how much. Once you have established a plan, it’s your responsibility to stick to your budget.

6. Decide if a professional financial planner will play a role in your financial affairs.
   If you need help in financial planning, there are professional planners out there who can provide such help. You can use professional planners simply to validate the plan you have developed, or you can hire them to put the entire plan together, from start to finish.
Review Questions

1. What are the steps of the budgeting and planning process? Describe what happens in each step.
2. Why is net worth a measure of financial health? What is the purpose of a personal balance sheet?
3. What information must you gather to develop an accurate balance sheet? What can you learn by annually updating the balance sheet?
4. Define and give examples of the seven categories of assets. How do you determine the current value of your assets?
5. What is a financial liability? How do you determine the amount owed on current and long-term liabilities? Give examples of each.
6. Why is net worth a relative and not an absolute measure? For example, why might insolvency be of less concern for a college student than for the student’s parents?
7. Why might an income statement more accurately be called an income and expenditure statement or a “net” income statement? What is the purpose of an income statement?
8. What information do you need to calculate an accurate income statement? What are likely to be the four largest expenses?
9. Explain the practical difference between a fixed and a variable expense. Over which type of expense does a household have greater control?
10. Why are financial ratios important diagnostic tools? What three potential problem areas do they highlight?
11. If Larry and Louise Tate were trying to determine how long they would be able to continue paying their bills if they both lost their jobs, which financial ratio would be most useful?
12. Why are both the current measures and the trends of the ratios over time important measures of financial well-being?
13. Explain the debt coverage ratio and the inverse of the ratio. Why is the inverse ratio intuitively more informative?
14. List the three most important reasons for keeping accurate financial records.
15. Where should you keep the following records: non-tax-related checks or credit card slips, a listing of all bank accounts, your investment earnings statements, and copies of your will?
16. Summarize the steps to establish a cash budget.
17. If there is no legal requirement to be a financial planner, how might Principle 1: The Best Protection Is Knowledge affect your decision to seek professional assistance? What accreditations might you look for when shopping for a planner?

Develop Your Skills—Problems and Activities

These problems are available in MyFinanceLab.

1. Mike and Mary Jane Lee have a yearly income of $65,000 and own a house worth $90,000, two cars worth a total of $20,000, and furniture worth $10,000. The house has a mortgage of $50,000 and the cars have outstanding loans of $2,000 each. Utility bills, totaling $150 for this month, have not been paid. Calculate or use Worksheet 4 to determine their net worth and explain what it means. How would the Lees’ age affect your assessment of their net worth?
2. Using the preceding information, calculate the debt ratio for the Lee household.
3. Ed and Marta are paid $3,250 after taxes every month. Monthly expenses include $1,200 on housing and utilities, $550 for auto loans, $300 on food, and an average of $1,000 on clothing and other variable expenses. Calculate and interpret their savings ratio. Hint: Prepare an income statement or use Worksheet 5 and then compute the ratio.

4. A rumor of “right sizing” at Ojai’s engineering firm has him and his wife Kaya concerned about their preparation for meeting financial emergencies. Help them calculate their net worth or complete Worksheet 4 and calculate and interpret the current ratio given the following assets and liabilities:

- Checking account $2,000
- Savings account $4,000
- Stocks $8,000
- Utility bills $500
- Credit card bills $1,000
- Auto loan $2,600

5. Faith Brooks, a 28-year-old college graduate, never took a personal finance class. She pays her bills on time, has managed to save a little in a mutual fund, and with the help of an inheritance managed a down payment on a condominium. But Faith worries about her financial situation. Given the following information, prepare Worksheet 4 and Worksheet 5. Using information from these statements, calculate the current ratio, savings ratio, monthly living expenses covered ratio, debt ratio, and long-term debt coverage ratio. Interpret these financial statements and ratios for Faith. Based on your assessment, what advice would you give Faith? In addition to the following list, Faith offers these explanations:
   - All short-term and long-term liabilities are unpaid.
   - “Other expenses, monthly” represents cash spent without a record.
   - She charges all incidentals on her credit cards and pays the balances off monthly. The balances shown below represent her average monthly balances.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Visa bill</td>
<td>$355</td>
</tr>
<tr>
<td>Stocks</td>
<td>$5,500</td>
</tr>
<tr>
<td>MasterCard bill</td>
<td>$245</td>
</tr>
<tr>
<td>Monthly paycheck, net</td>
<td>$2,400</td>
</tr>
<tr>
<td>Annual medical expenses</td>
<td>$264</td>
</tr>
<tr>
<td>Mortgage payment, monthly</td>
<td>$530</td>
</tr>
<tr>
<td>Temple Mutual Fund</td>
<td>$2,100</td>
</tr>
<tr>
<td>401(k) retirement account</td>
<td>$4,500</td>
</tr>
<tr>
<td>Car payment, monthly</td>
<td>$265</td>
</tr>
<tr>
<td>Total monthly utilities</td>
<td>$275</td>
</tr>
<tr>
<td>Savings account</td>
<td>$2,300</td>
</tr>
<tr>
<td>Clothing expense, monthly</td>
<td>$45</td>
</tr>
<tr>
<td>Checking account</td>
<td>$825</td>
</tr>
<tr>
<td>Quarterly auto insurance (not due)</td>
<td>$450</td>
</tr>
<tr>
<td>Inherited coin collection</td>
<td>$3,250</td>
</tr>
<tr>
<td>Condominium</td>
<td>$65,000</td>
</tr>
<tr>
<td>Food, monthly</td>
<td>$225</td>
</tr>
<tr>
<td>Auto</td>
<td>$9,000</td>
</tr>
<tr>
<td>Furnishings</td>
<td>$5,500</td>
</tr>
<tr>
<td>Mortgage outstanding</td>
<td>$50,000</td>
</tr>
<tr>
<td>Auto loan outstanding</td>
<td>$4,225</td>
</tr>
<tr>
<td>Other personal property</td>
<td>$8,000</td>
</tr>
<tr>
<td>Other expenses, monthly</td>
<td>$150</td>
</tr>
</tbody>
</table>

6. Your friend Dario heard about your personal finance class and asked for your help. Explain to Dario why he should establish a budget and what information he needs.

7. If the Potinsky household spends $39,000 annually on all living expenses and long-term debt, calculate the amount recommended for an emergency fund. How might household circumstances (e.g., wage earners in the household, available credit, type and stability of employment) affect this decision?

8. Based on your projected salary, estimate and subtract 20 percent for taxes and benefits and another 10 percent for retirement. From the remainder, estimate and subtract the amount you plan to save annually for short-, intermediate-, and long-term goals. What you have left represents your income available for meeting all expenses. Now, estimate your needed emergency fund of 3 to 6 months of expenses. Realistically, how long will it take you to save the needed amount?
Learn by Doing—Suggested Projects

1. Using Worksheet 6 as a guide, talk to your parents about their record-keeping system. Offer to assist with organizing the household financial records. Do they have a balance sheet, income statement, or budget to track financial well-being? If not, offer the worksheets from the text as a starting point. Do they handle all financial matters alone or with the help of professionals? What assistance have they received and from whom?

2. Use Worksheet 7 to track your actual income and expenses for 1 month and then to develop a budget or spending plan for future months. Analyze your income and expenses to determine your spending patterns and any needed changes. (If you don’t actually earn an income, consider your monthly college allowance or periodic withdrawals from summer savings.) See how long you can follow the budget. Should you consider an envelope system for some expenses? (Also, consider using the worksheet to project your finances when moving off campus, accepting a job after graduation, or changing jobs.)

3. According to this chapter, “planning and budgeting require control.” Talk to several friends, family, or acquaintances about the strategies they routinely or occasionally use to control spending and saving. What’s the best advice they could give to a novice financial manager? Have they automated spending or saving decisions? Share your findings as an oral or written report.

4. Locate at least three different Web sites with net worth calculators. Compare and contrast the listings of assets and liabilities. Do any of the calculators offer guidelines for interpreting results? Comment on the ease of use. Share your findings in an oral or written report.

5. The acronym GIGO—“garbage in, garbage out”—is commonly associated with computer-automated analysis. How does GIGO apply to the calculation of a balance sheet, income statement, or the ratios that are derived from both documents? Explain how an individual preparing these documents guards against GIGO.

6. To learn more about financial planners, profile a typical client, summarize the services offered by the planner, and explain the method(s) of payment for the services. Planners often include this information on their Web page, or you could call and explain that you are a student doing research for a class. How do you find a planner? Are there planners in your college community or hometown? Ask friends and family or use the “find a planner” link on the Web sites of professional groups such as the Financial Planning Association (www.fpanet.org), National Association of Personal Financial Advisors (NAPFA) (www.napfa.org), or the International Association of Registered Financial Consultants (IARFC) (www.iarfc.org). What does it mean to be a fee-only planner? Report your findings to the class.

7. Watch a short video on the Mint.com Web site on how to set up a Mint account. Explore the Web site to determine who funds the program. Read one or more of the personal finance blogs and write a one-page essay on what your learned from the Web site and blog(s).

8. Write a one-page essay that explains at least four reasons why you believe that people do not budget or develop even a simple plan for balancing income and expenses, including saving for goals. Review Worksheet 1 or Worksheet 2 for examples of financial objectives and goals for which households are most or least prepared.

Be a Financial Planner—Discussion Case 1

This case is available in MyFinanceLab

Sami, 34, and Ronald, 31, want to buy their first home. Their current combined net income is $65,000 and they have two auto loans totaling $32,000. They have saved approximately $12,000
for the purchase of their home and have total assets worth $55,000, which are mostly savings for retirement. Ronald has always been cautious about spending large amounts of money, but Sami really likes the idea of owning their own home. They do not have a budget but they do keep track of their expenses, which amounted to $55,000 last year including taxes. They pay off all credit card bills on a monthly basis and do not have any other debt or loans outstanding. Other than that, they do not spend a great deal of time tracking their finances.

Questions

1. What financial statements should Sami and Ronald prepare to begin realizing their home purchase goal? What records should they use to compile these statements?
2. Use the worksheets or simply calculate their net worth and income surplus. How does their net worth compare to other “thirty-somethings”?
3. Calculate and interpret their month’s living expenses covered ratio and their debt ratio.
4. What other information would be necessary or helpful to develop more complete statements? Give as much detail as possible.
5. What six- to eight-step process should Sami and Ronald undertake to develop a budget?
6. Why might adopting Principle 6: Waste Not, Want Not—Smart Spending Matters be important to Sami and Ronald, given their goal of home ownership?

Be a Financial Planner—Discussion Case 2

This case is available in MyFinanceLab

Tim and Jill Taylor are retiring this year! Tim has worked for a utility company since his co-op job in college and has participated in all of the company’s retirement savings plans. Jill has worked since the kids were in high school. Although they never consulted a financial planner, they have been careful to keep their insurance policies updated, to keep debt to a minimum, and to save regularly. As a result, the Taylors have a very large retirement portfolio—and now, without the restrictions of their companies’ plans, lots of other investment options. Jill would like to live “the good life” for a while, but also is concerned about “outliving” their money. Tim says, “I earned it, I’ll spend it.” Now Tim and Jill think that consulting a professional might be a good idea to keep them on track through retirement. They haven’t made too many plans, but know they want to help pay for college costs for their grandchildren.

Questions

1. What assessments of their financial situation should Tim and Jill expect when working with a financial planner? Given their past efforts to plan their finances and control spending, will these assessments be necessary?
2. The Taylors just received statements from their companies outlining the total value of their retirement savings. How can they use this information?
3. How might a budget ensure that they will have the necessary amount to help their grandchildren?
4. Since both their income and expenses will change, how would you suggest that they not “go overboard in living the good life,” yet at the same time know that they can afford some retirement luxuries?
5. Should they manage the investment portfolio themselves or should they find a planner to manage their retirement assets and help them develop a plan for what could be 30 years in retirement? What kind of relationship with the planner and method of payment might work best for them?
6. Do the Taylors need to track their expenses more or less closely once they retire? Are their big expenses likely to remain the five reported by the average household?