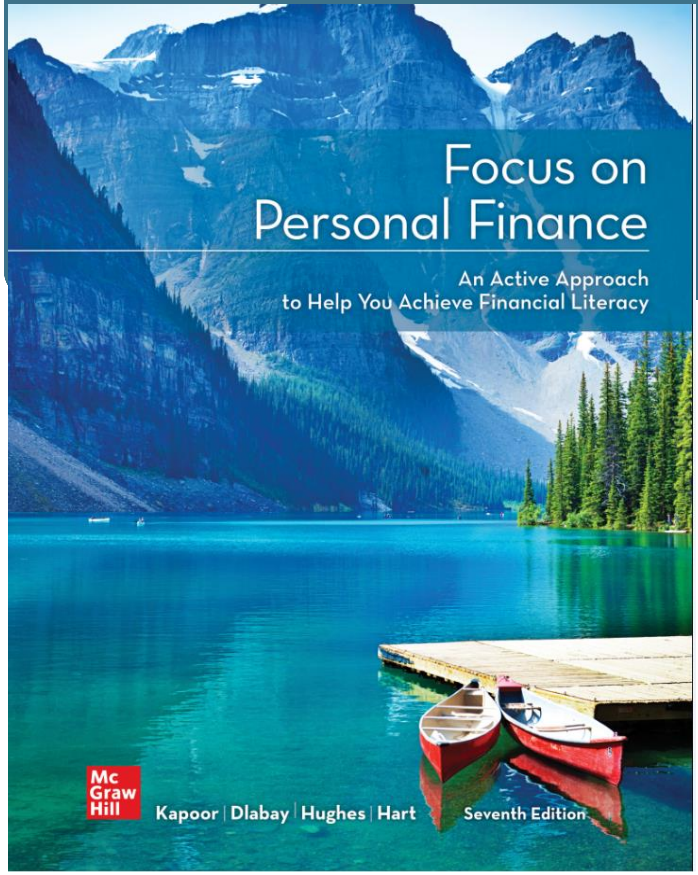

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Chapter 2

Money Management Skills

Money Management Skills
Chapter Learning Objectives

LO2.1 Identify the main components of wise money management.

LO2.2 Create a personal balance sheet and cash flow statement.

LO2.3 Develop and implement a personal budget.

LO2.4 Connect money management activities with saving for personal financial goals.

A Successful Money Management Plan
LO2.1

- Daily spending and saving decisions are the focus of financial planning
  - Must be coordinated with needs, goals, and personal situations

- **Money management** refers to the day-to-day financial activities necessary to manage current personal economic resources while working toward long-term financial security

Components of Money Management

- Three main money management activities re interrelated:
  - *Personal financial records and documents* help you plan the use of your resources
  - *Personal financial statements* measure and guide your financial position and progress
  - Your spending plan, or *budget*, is the basis for effective money management

A System for Personal Financial Records

- Purchase receipts, credit card statements, insurance policies, and tax forms are the basis of financial recordkeeping and personal economic choices
- Organized system of records provides a basis for:
    1. Handling daily business affairs, such as bill paying
    2. Planning and measuring financial progress
    3. Completing required tax reports
    4. Making effective investment decisions
    5. Determining available resources for current and future spending

A System for Personal Financial Records (Continued)

- Most financial records are kept in one of three places:
  - *Home files* should be used to keep records for current needs and documents with limit value
    - Examples would be a series of folders, a cabinet with several drawers, or even a box
  - **Safe deposit box** is a private storage area at a financial institution with maximum security for valuables
    - Important financial records and valuable articles should be kept in a safe deposit box because it provides better security than a home file
  - Computer, or online, system, such as “the cloud”
    - Download copies and back up files, secure data with passwords and encryption, and permanently erase files when deleting

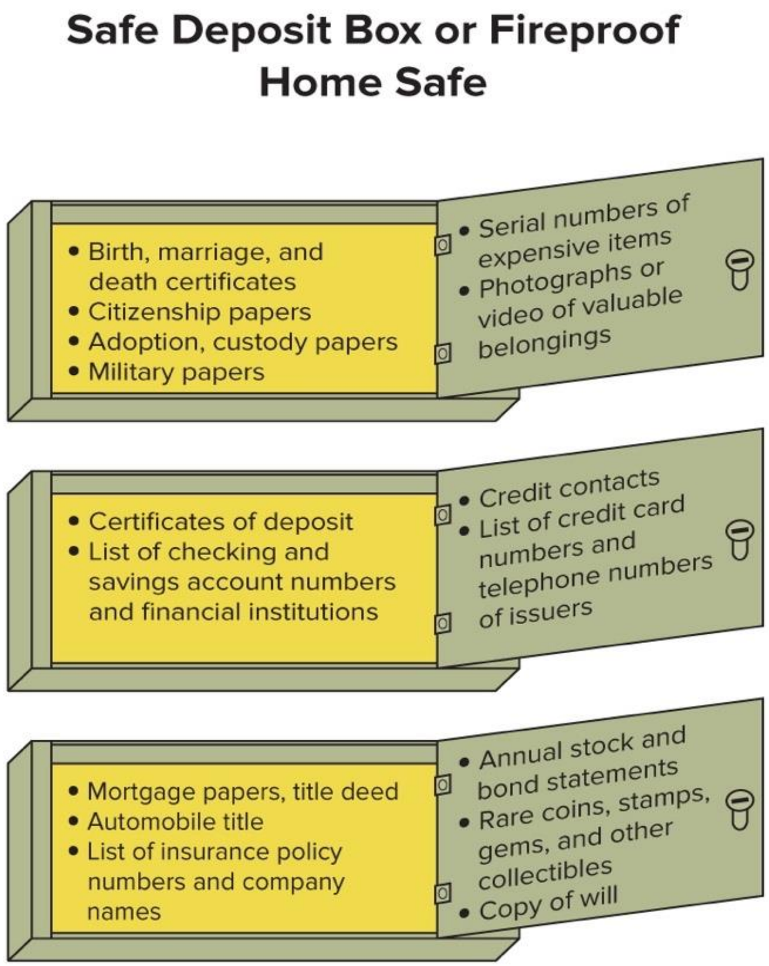
Categories of Financial Records

- Personal and employment records
- Money management records
- Tax records
- Financial services records
- Credit records
- Consumer purchase and automobile records
- Housing records
- Insurance records
- Investment records
- Estate planning and retirement records

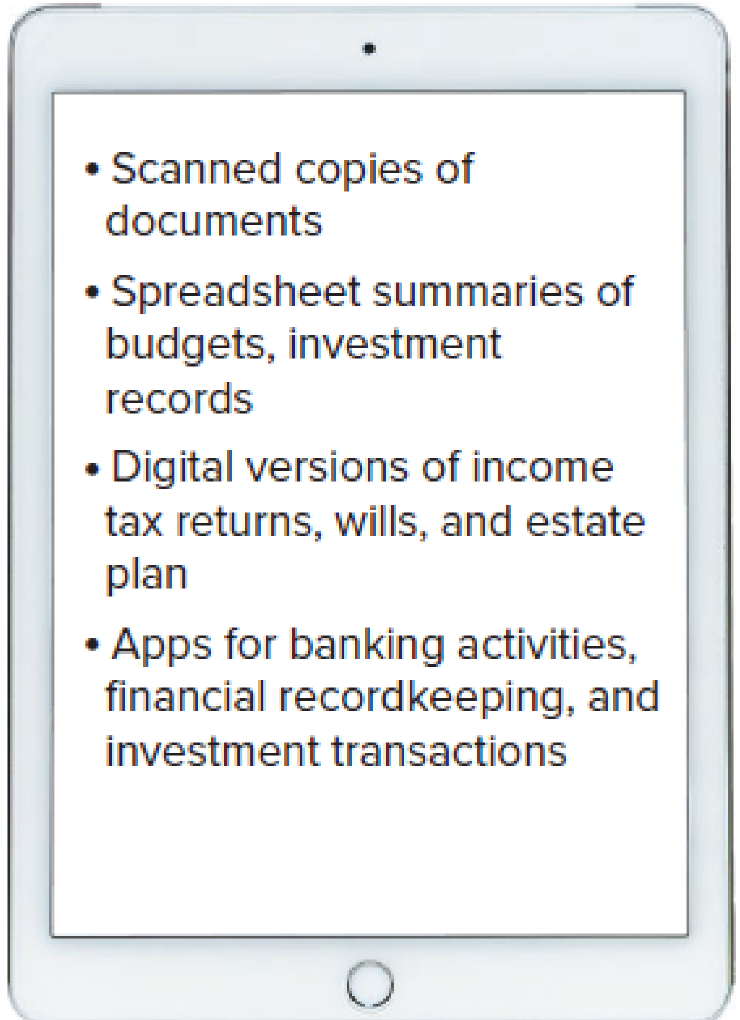
How Long Should Records be Kept?

- Birth certificates, wills, and Social Security data should be kept permanently
- Records for investments should be kept as long as you own the items
- Federal tax documents should be kept for three years from the date you file your return
  - Consider keeping tax records for six years
- Keep documents related to the purchase and sale of real estate indefinitely

What to Keep in a Safe Deposit Box or Fireproof Home Safe



Records on Your Computer. Tablet, or Phone



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What Not to Keep

PinnacleAnimates/Shutterstock

Personal Financial Statements
LO2.2

- Personal financial statements tell you the starting point of your financial journey
- Most financial documents come from financial institutions, businesses, or the government
  - Two documents you create yourself are the personal balance sheet and the cash flow statement
- Main purpose of personal financial statements are to:
  1. Report your current financial position
  2. Measure your progress toward financial goals
  3. Maintain information about your financial activities
  4. Provide data for preparing tax forms or applying for credit

Your Personal Balance Sheet:
The Starting Point

- A **balance sheet** (i.e., **net worth statement** or **statement of financial position**) is a financial statement that reports what an individual or family owns and owes

Items of value (what you own) − Amounts owed (what you owe) = Net worth (your wealth)

Creating a Personal Balance Sheet

- Step 1 – List items of value
  - **Liquid assets** are cash and items of value that can easily be converted to cash
  - Real estate
  - Personal possessions
  - Investment assets
- Step 2 – Determine amounts owed
  - **Current liabilities** are debts that must be paid within a short time, usually less than a year
  - **Long-term liabilities** are debts that you do not have to pay in full until more than a year from now
- Step 3 - Compute your net worth
  - **Net worth** is the difference between total assets and total liabilities

Creating a Personal Balance Sheet

Exhibit 2-2

Exhibit 2–2 Creating a Personal Balance Sheet

Step 1

Total all items of value (assets). Include amounts in bank accounts, investments, and the cost (or estimated current value) of your possessions.

Step 2

List and total the amounts owed to others (liabilities). This list will include current debts, charge account/credit card balances, and amounts due on loans and mortgages.

Step 3

Subtract total liabilities from total assets to determine net worth. This amount indicates the current financial position of an individual or a household.

Sandra and Mark Scott
Personal Balance Sheet as of October 31, 2022

Assets		
Liquid Assets		
Checking account balance (Chap. 4)	$ 1,450	
Savings/money market accounts (Chap. 4)	5,235	
Cash value of life insurance (Chap. 10)	3,685	
Total liquid assets		$ 10,370
Real Estate		
Current market value of home (Chap. 7)		$ 189,900
Personal Possessions		
Market value of automobile	8,000	
Furniture and appliances	5,900	
Home entertainment system	2,600	
Home computer	1,400	
Jewelry	2,200	
Total household assets		$ 20,100
Investment Assets (Chaps. 11–13)		
Retirement accounts (Chap. 14)	26,780	
Mutual funds (Chap. 12)	11,890	
Total investment assets		38,670
Total assets		$ 259,040
Liabilities		
Current Liabilities		
Medical bills (Chap. 9)	$ 150	
Charge account and credit card balances (Chap. 5)	3,340	
Balance due on auto loan	1,750	
Total current liabilities		$ 5,240
Long-Term Liabilities		
Mortgage (Chap. 7)	91,600	
Home improvement loan (Chap. 5)	1,760	
Student loan	1,200	
Total long-term liabilities		94,560
Total liabilities		$ 99,800
Net worth (assets minus liabilities)		$ 159,240

Computing Net Worth

Assets - Liabilities = Net Worth

Assets = Liabilities + Net worth

- **Example:** If a household has $193,000 of assets and liabilities of $88,000, the net worth would be $105,000 ($193,000 minus $88,000)
- **Insolvency** is the inability to pay debts when they are due because liabilities exceed the value of assets

Methods to Increase Net Worth

- Individuals and families can increase their net worth by any one of the following:
  - Increasing their savings;
  - Reducing spending;
  - Increasing the value of investments and other possessions;
  - Reducing amounts owed
- Remember, your net worth is *not* money available to use but an indication of your financial position on a given date

Your Cash Flow Statement

- **Cash flow** is the actual inflow and outflow of cash during a given time period
- **Cash flow statement** (i.e., **personal income and expenditure statement**) summarizes cash receipts and payments for a given period

Total cash received during the time period − Cash outflows during the time period = Cash surplus or deficit

Your Cash Flow Statement:
Inflows and Outflows

- **Inflows** are deposits made into your account and include the following:
  - Income from employment
  - Interest earned on a savings account
- Checks written, cash withdrawals, and debit card payments are your **outflows**, such as the following:
  - Rent
  - Food
  - Loans

Preparing a Cash Flow Statement

- **Step 1 – Record income**
  - **Income** is the inflow of cash to an individual or household
    - **Take-home pay**, or *net pay*, is earnings after deductions for taxes and other items; also called *disposable income*
    - **Discretionary income** is money left over after paying for housing, food, and other necessities
  - Main source of income is usually money received from a job
    - Other income sources include commissions, self-employment income, interest, dividends, gifts, grants, scholarships, government payments, pensions, retirement income, alimony, and child support
- **Step 2 – Record cash outflows**
  - *Fixed expenses* and *variable expenses*
- **Step 3 – Determine new cash flow**
  - Use this statement as a foundation for preparing and implementing a spending, saving, and investment plan

Creating a Cash Flow Statement

Exhibit 2-3

Step 1

For a set time period (such as a month), record your income from various sources, such as wages, salary, interest, and payments from the government.

Step 2

Develop categories and record cash payments for the time period covered by the cash flow statement.

Step 3

Subtract the total outflows from the total inflows. A positive number (surplus) represents the amount available for saving and investing. A negative number (deficit) represents the amount that must be taken out of savings or borrowed.

Kim Walker
Cash Flow Statement for the Month Ended September 30, 2022

Income (cash inflows)				
Salary (gross)		$4,350		
Less deductions				
Federal income tax	$810			
State income tax	108			
Social Security	332			
Total deductions		$1,250		
				$3,100
Interest earned on savings				34
Earnings from investments				62
Total income				$3,196
Cash Outflows				
Fixed Expenses				
Rent		$1,150		
Loan payment		216		
Cable/Internet		52		
Monthly train ticket		196		
Life insurance		32		
Apartment insurance		23		
Total fixed outflows			$1,669	
Variable Expenses				
Food at home		260		
Food away from home		168		
Clothing		150		
Telephone		52		
Electricity		48		
Personal care (dry cleaning, laundry, cosmetics)		66		
Medical expenses		85		
Recreation/entertainment		100		
Gifts		70		
Donations		80		
Total variable outflows			1,079	
Total outflows				$2,748
Cash surplus + (or deficit –)				+$448
Allocation of Surplus				
Emergency fund savings				168
Savings for short-term/intermediate financial goals				80
Savings/investing for long-term financial security				200
Total surplus				$448

A Plan for Effective Budgeting
LO2.3

- A **budget**, or *spending plan*, is necessary for successful financial planning

- Budgeting will help you do the following:
  - Live within your income
  - Spend your money wisely
  - Reach your financial goals
  - Prepare for financial emergencies
  - Develop wise financial management habits

Common Financial Goals

Exhibit 2-4

Personal Situation	Short-Term Goals (less than 2 years)	Intermediate Goals (2–5 years)	Long-Term Goals (over 5 years)
Single person	• Complete college • Pay off auto loan	• Take a vacation to Europe • Pay off education loan • Attend graduate school	• Buy a vacation home in the mountains • Provide for retirement income
Married couple (no children)	• Take an annual vacation • Buy a new car	• Remodel home • Build a stock portfolio	• Buy a retirement home • Provide for retirement income
Parent (young children)	• Increase life insurance • Increase savings	• Increase investments • Buy a new car	• Accumulate a college fund for children • Move to a larger home

7-Step Process to Budgeting Activities

1. Set financial goals
   - Goals should take a SMART approach
2. Estimate income
3. Budget an emergency fund and savings
4. Budget fixed expenses
5. Budget variable expenses
6. Record spending amounts
   - **Budget variance** is the difference between the amount budgeted and the actual amount received or spent
7. Review spending and saving patterns

Review Spending and Saving Patterns

- Budgeting is an ongoing process, and you will need to review and perhaps revise your spending plan on a regular basis
  - *Review your financial progress*
  - *Revise your goals and budget allocations*
  - *Successful budgeting* are well planned, realistic, flexible, and clearly communicated
  - *Selecting a budgeting system*
    - Mental budgets exist in a person’s mind
    - Physical budgets involve envelopes, folders, or containers
    - Written budget can be kept in a notebook
    - Digital budget may involve spreadsheets or software

Developing a Monthly Budget

Exhibit 2-5

Step 1
Set financial goals.

Step 2
Estimate expected income from all sources; this amount is to be allocated among various outflow categories.

Step 3
Budget amount for an emergency fund, periodic expenses, and financial goals.

Step 4
Budget set amounts that you are obligated to pay.

Step 5
Budget estimated amounts to be spent for various household and living expenses.

Step 6
Record actual amounts for inflows and outflows. Compare actual amounts with budgeted amounts to determine variances.

Step 7
Evaluate whether revisions are needed in your spending and savings plan.

Monthly Budget for the Robinson Family

Financial goals
- reduce credit card debt
- increase amount in emergency fund

	Budgeted Amounts (dollars)	(percent)	Actual Amounts	Variance
Projected Inflows (income)				
Salary	2874	100	2874	–
Projected Outflows (disbursements)				
Emergency Fund and Savings:				
Emergency fund savings	115	4	115	–
Savings for auto insurance	29	1	29	–
Savings for vacation	57	2	57	–
Savings for investments	57	2	57	–
Total savings	258	9	258	–
Fixed Expenses				
Mortgage payment	518	18	518	–
Property taxes	115	4	115	–
Auto loan payment	144	5	144	–
Life insurance	29	1	29	–
Total fixed expenses	806	28	806	–
Variable expenses				
Food	402	14	417	–15
Utilities (telephone, heat, electric, water)	172	6	164	+8
Clothing	116	4	93	+23
Transportation (automobile operation, repairs, public transportation)	460	16	471	–11
Personal and health care	172	6	163	+9
Entertainment	172	6	201	–29
Reading, education	86	3	78	+8
Gifts, donations	144	5	150	–6
Personal allowances, miscellaneous expenses	86	3	90	–4
Total variable expenses	1,810	63	1,827	–17
Total outflow	2,874	100	2,891	–17

Typical After-Tax Budget Allocations
Exhibit 2-6

Budget Category	Student	Working Single (no dependents)	Couple (children under 18)	Single Parent (young children)	Parents (children over 18 in college)	Couple (over 55, no dependent children)
Housing (rent or mortgage payment; utilities; furnishings and appliances)	0–25%	30–35%	25–35%	20–30%	25–30%	25–35%
Transportation	5–10	15–20	15–20	10–18	12–18	10–18
Food (at home and away from home)	15–20	15–25	15–25	13–20	15–20	18–25
Clothing	5–12	5–15	5–10	5–10	4–8	4–8
Personal and health care (including child care)	3–5	3–5	4–10	8–12	4–6	6–12
Entertainment and recreation	5–10	5–10	4–8	4–8	6–10	5–8
Reading and education	10–30	2–4	3–5	3–5	6–12	2–4
Personal insurance and pension payments	0–5	4–8	5–9	5–9	4–7	6–8
Gifts, donations, and contributions	4–6	5–8	3–5	3–5	4–8	3–5
Savings	0–10	4–15	5–10	5–8	2–4	3–5

Sources: Bureau of Labor Statistics (http://stats.bls.gov); Money; The Wall Street Journal.

A Money Management SWOT Analysis
Financial Literacy in Practice

- SWOT (**s**trengths, **w**eaknesses, **o**pportunities, **t**hreats) analysis, a planning tool used by companies, can also help with money management and budgeting activities

Internal (personal) Factors	External (economic, social) Influences
Strengths	**Opportunities**
• Saving 5–10 percent of income • Informed on personal finance topics • No credit card debt • Flexible job skills *Your strengths:* ______________________________ ______________________________	• Phone apps for monitoring finances • Part-time work to supplement income • Availability of no-fee bank account • Low-interest-rate education loan *Potential opportunities:* ______________________________ ______________________________
Weaknesses	**Threats**
• High level of credit card debt • No emergency fund • Automobile in need of repairs • Low current cash inflow *Your weaknesses:* ______________________________ ______________________________	• Lower market value of retirement fund • Possible reduced hours at part-time job • Reduced home market value • Increased living costs (inflation) *Potential threats:* ______________________________ ______________________________

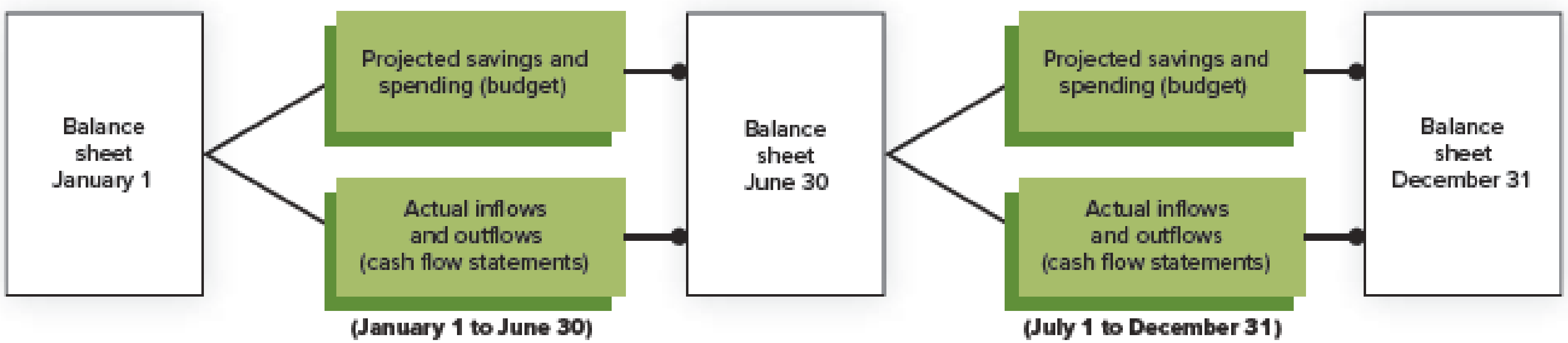
Money Management and Achieving Financial Goals
LO2.4

- Personal financial statements and a budget help you achieve financial goals with the following:

1. Your balance sheet: reporting your financial position – where you are now
2. Your cash flow statement: telling you what you received and spent over the past month
3. Your budget: planning spending and saving to achieve financial goals

Changes in Net Worth

- Changes in net worth result from cash inflows and outflows
  - In periods where outflows exceed inflows, you must draw on savings or borrow
  - When inflows exceed outflows, putting money into savings or paying off debts results in a higher net worth



Selecting a Saving Technique

- Traditionally, the U.S. ranks low among industrial nations in savings rate, but these methods can help make saving easier:

1. On each payday, deposit an amount in a separate savings account
2. Payroll deduction, under a direct deposit system, will automatically deduct an amount from your salary to deposit in savings
3. Save coins or spend less on certain items
   - Examples: bring lunch to work and avoid expensive coffee/snacks

Using Savings to Achieve Financial Goals

Exhibit 2-7

- To achieve your financial objectives, convert savings goals into specific amounts

Financial Goal	Saving Method	Annual Interest Rate	Savings Balance after: 2 years	5 years	10 years
Set aside $6,000 for unexpected expenses and financial emergencies	A single deposit from past savings	7%	$6,870*	$8,418	$11,802
Save for retirement living expenses	Deposit $2,000 a year	8%	$4,160**	$11,734	$28,974☆
Save for a down payment to purchase a home	Deposit $200 every three months	12%	$1,778†	$5,374	$15,080

Chapter Summary

LO2.1: Identify the main components of wise money management.

- Successful money management requires coordination of personal financial records, personal financial statements, and budgeting activities.

- An organized system of financial records and documents should provide ease of access as well as security for financial documents.

Chapter Summary

LO2.2: Create a personal balance sheet and cash flow statement.

- A personal **balance sheet**, also known as a *net worth statement,* is prepared by listing all items of value (**assets**) and amounts owed to others (**liabilities**).
  - The difference between your total assets and your total liabilities is your **net worth**.
- A **cash flow statement**, also called a *personal income and expenditure statement,* is a summary of cash receipts and payments for a given period, such as a month or a year.

Chapter Summary

LO2.3: Develop and implement a personal budget.

- The budgeting process consists of seven steps:
    1. Set financial goals;
    2. Estimate income;
    3. Budget an emergency fund and savings;
    4. Budget fixed expenses;
    5. Budget variable expenses;
    6. Record spending amounts;
    7. Review spending and saving patterns

Chapter Summary

LO2.4: Connect money management activities with saving for personal financial goals.

- The relationship among the personal balance sheet, cash flow statement, and budget provides the basis for achieving long-term financial security.
- Future value and present value calculations may be used to compute the increased value of savings for achieving financial goals.