Budgets

by Sophia

WHAT'S COVERED

In this lesson, you will learn how to use a personal budget to track and forecast cash flow to achieve financial goals. You will also examine how having a budget can help you when unexpected expenses occur. Lastly, you will continue to explore the importance of strong technology skills to help you be as productive as possible. Specifically, this lesson will cover:

1. The Personal Budget

You have already learned about time value of money calculations and the balance sheet. We are now going to add another tool to help you along your financial journey: a **budget**. A budget helps you think about how much you will earn (your income) and spend (your expenses) in the future. Budgets are an essential resource management tool because they help you keep your spending in line with your plans. They also help increase your productivity which can help you achieve your goals sooner.

TERM TO KNOW

Budget
A resource management tool that keeps spending in line by tracking how much you will earn and spend in the future.

2. The Five Steps of Resource Management

The following illustration shows the five steps involved in the management of household financial resources. Let's look at each step in more detail.

HINT

These steps, although certainly important in terms of money management, also apply to the management of other resources, including your health, time, skills, and social networks.

2a. Setting Goals

At Step 1, you establish one or more financial goals. A productive way to do this is to use the SMART approach to goal development.

- Taking the time to specifically outline what is important for you today and in the future, based on your attitudes, perceptions, and preferences, is a positive way to shape financial goals.

- Incorporating these types of personal finance factors into the goal-formation process also helps provide a purpose behind managing your money.

2b. Tracking Resources

At Steps 2 and 3, you start tracking where your resources come from and how resources are currently used.

- You need to know where your money for day-to-day expenses and longer-term goal implementation is coming from and where it is going.
- Unless you systematically track your income and expenses, you probably don't know how much you're really earning and spending.

When tracking your income and expenses, it's therefore important that you document what you purchase, not just the amount spent. For example, if you purchase a number of items from a store, it's important to break out these costs into categories of expenses, such as food, clothing, entertainment, and household necessities. Tracking can be done any number of ways, such as using a computer spreadsheet, going old school with pen and paper, or using a smartphone app. There are also companies, such as Mint.com, that will combine your electronic spending from multiple accounts automatically, saving you time and effort. Strong technology skills can ensure you are able to take advantage of tools like these. Simple income- and expense-tracking exercises are incredibly effective in helping you become aware of and identify your own spending habits.

HINT

It is easy to recognize poor spending habits in others, but it is more difficult to see the same issues in ourselves. This isn't because we are being overly judgmental but rather because many of our spending habits are so routine that most of us are not even aware of them.

10 SKILLS

Agility: Skill in Action

Keisha stopped at the coffee shop each morning on her way to work. She grabbed a latte and a bagel sandwich to start her day. She had her budget all worked out to allow for this expense. But last week, on her way to the coffee shop, she got a flat tire. The replacement cost was $200, and it wasn't something she had budgeted for. Keisha used her agility skill to make some quick changes. To make up for the money spent on the tire, she put her coffee shop trips on hold. While she wasn't happy about the change, she was able to recover the tire cost in about a month. But she didn't stop there. Keisha decided to make some long-term financial changes...she committed to only stopping for coffee on Mondays and Fridays going forward. This helped her save $120 per month!

2c. Planning and Using Resources

At this point in the process, you are ready to set up guidelines for how you want your money to be spent (Step 4) and then how you will monitor the actual use of your resources compared to these guidelines (Step 5). This is a budget. A budget is a financial tool that helps you regulate how quickly and in what ways your money is going to be used so that you can stay focused on accomplishing your goals.

3. Format of the Budget

The table below shows the important elements in a budget: income, fixed expenses, and variable expenses. Fixed expenses are difficult to change and must be paid. Variable expenses, on the other hand, fluctuate from month to month and are easier to reduce.

HINT

Variable expenses are usually listed below income and fixed expenses because you may add or delete items over time.

Income	Projection	Actual	Difference
Wages			
Gift income			
Student loan proceeds			
Scholarships			
Other			
Total Income			
Fixed Expenses	Projection	Actual	Difference
Personal savings			
Taxes			
Rent or mortgage			
Utilities			
Credit card payments (for prior balances only)			
Car loan payment			
Student loan			
Other debt payments			
Phone bill			
Insurance			
Other			

Subtotal			
Variable Expenses	**Projection**	**Actual**	**Difference**
Gas for car			
Auto maintenance			
Groceries			
Eating out			
Entertainment			
Charitable donations			
Clothing			
Personal care			
Travel			
Other			
Subotal			
Total Expenses			
Summary	**Projection**	**Actual**	**Difference**
Income			
Expenses			
Surplus (or Deficit)			

BIG IDEA

The main point is that you should create a budget in a format that you find to be useful and easy to maintain. Doing this will also help you be as productive as possible.

You can see in the table above that there are three columns after each item in the budget. The first is how much you *think* you will receive or spend in each category; this is your **projection**. The next column is the amount you actually spent. The third column is the difference between the projected amount and the actual amount. Thus, a complete budget process includes projections, results, and identification of differences.

TERM TO KNOW

Projection

The amount you think you will receive or spend in any given category of a budget.

3a. The Three Sections of a Budget

As shown in the previous table, there are three main sections in a budget.

1. Income
2. Expenses
3. Surplus (deficit) estimate

KEY CONCEPT

Income should include all resources that can be spent or saved, such as wages or salaries, interest earned at a bank or credit union, and allowances.

- Note that the total amount in savings (the amount in the bank) is a balance sheet item, whereas the amount pulled from a savings account is income.
- Student loan proceeds each semester or month can also be a source of income. Keep in mind, however, that the actual student loan amount shows up on the balance sheet as a liability.

KEY CONCEPT

Expenses include everything – really that means everything – you spend money on.

- Make sure your budget includes as many categories of expenses as desired. Detail is important. For example, you may want to separate the Utilities category into Water and Electricity.
- Credit card payments can be a bit tricky. If you have a credit card balance that carries over month-to-month and you are just starting to budget, then it makes sense to track your credit card payment. However, if you pay your credit card balance in full each month, then by tracking all of your expenditures (including those made with your credit card) you will already be accounting for the balance and therefore you should not include the payment in your budget.
- Saving money should become a fixed regular expense in your budget, just like buying food or paying utilities. Ideally, you should strive to save at least 12% of your **gross income** (income before taxes and other deductions) as a long-term savings objective. When viewed this way, savings becomes a regular expense within your budget!

KEY CONCEPT

Finally, your budget should show an ending amount, or the amount your anticipated income exceeds or falls below your estimate of expenses. Hopefully, you'll have a surplus at the end of the planning period.

- A **surplus** means that you have planned well and have your money working for you.
- A **deficit** indicates that your expenses exceed your income.
- As a college student, your budget from month to month may vacillate between surplus and deficit, depending on the timing of tuition payments, loan proceeds, scholarships, and other irregular expenses. However, it is important that over a 12-month period of time, you have a cumulative surplus or you at least break even.

HINT

If you have a deficit over a 12-month period, even after considering student loan proceeds and withdrawals from savings accounts, then you will want to seriously reexamine your budget and see what changes you need to make to balance income and expenses. Strong agility skills can help you make these choices to stay on track.

- Keep in mind that borrowing money to make your budget balance is an easy short-term fix, but that positive income from the loan proceeds will turn into an equally large expense in future years as you have to repay what you have borrowed. So, when possible, it is best to limit or avoid borrowing too much money.

Problem Solving: Skill Tip

If you have an emergency and need to find a way to get some cash, strong problem solving skills can help you consider all of your options and make the best choice.

TERM TO KNOW

Gross Income
Total income before taxes and other deductions.

Surplus
The money left over after all expenses have been paid.

Deficit
When expenses exceed income.

3b. Comparing Estimates with Actual Amounts

As discussed earlier, your budget is an essential financial tool that should be used frequently (most people, for example, track income and expenses on a monthly basis). Recall Step 5 of the resource management process: compare your resource use to your guidelines.

STEP BY STEP

1. At the end of the month, stop and determine what happened. You may have overestimated your income or underestimated expenses.
2. Identify the specific cause and consider whether it was a one-time event or something that is long-term in nature.
3. If it looks like something might be happening on a long-term basis, it's time to revise your budget or change your spending habits.

TRY IT

Hannah has created the following budget:

Item Description	Projection	Actual	+/-
Total Income	$1,100	$1,022	
Savings	$50	$50	
Expenses			
Rent	$400	$400	
Utilities	$220	$248	
Transportation	$200	$188	
Food	$150	$185	
Consumer debt payments	$40	$40	
Entertainment	$40	$35	
Total Expenses			
Surplus (or Deficit)			

Hannah is unsure how to interpret the budget. Answer the following questions to help her analyze it.

Did Hannah have a surplus or deficit for the month? +

Hannah had a deficit this month of $124. She earned $78 less income than expected, and her expenses were $46 more than anticipated.

What should be her next step when managing her resources? +

Hannah can improve her situation next month by either working more and increasing her income or cutting her expenses. She also needs to determine if the cause of her deficit was a one-time event or something that is going to occur again. Over time, she should work to strengthen her financial position by using the financial ratios as benchmarks, to make the changes she needs to achieve her financial goals.

SUMMARY

In this tutorial, you learned how to build and manage a **personal budget** using **the five steps of resource management**. The key steps in this process include **setting financial goals**, **tracking resources** such as income and expenses, and **planning and using your resources**. You were reminded that strong technology skills will allow you to take advantage of the common tools available for this task.

The **format of the budget** should be one that's useful and easy for you to maintain so you can be as productive as possible. Typically there are **three sections to every budget**: fixed expenses, variable expenses, and income. Subtracting expenses from income gives either a surplus or a deficit. A deficit means that your expenses exceeded your income and you need to review your spending habits. If this occurs, you can **compare your monthly estimates with actual amounts** to uncover any discrepancies and to make changes to your budget. Strong agility skills can help you pivot as needed to stay on track. Your problem solving skills can help you examine your options and choose the best path forward.

TERMS TO KNOW

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Deficit
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Gross Income
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Projection
The amount you think you will receive or spend in any given category of a budget.

Surplus
The money left over after all expenses have been paid.