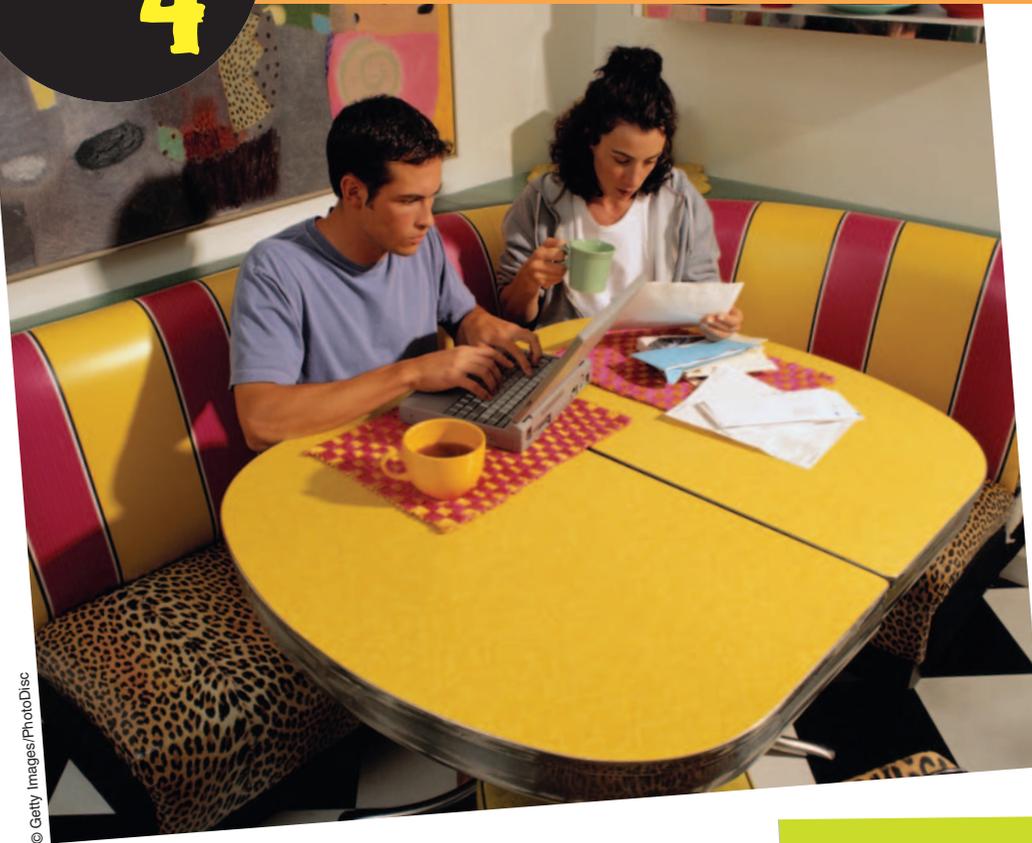


CHAPTER

4

FINANCIAL DECISIONS AND PLANNING



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Chapter 4 focuses on the starting point of good money management—assessing your needs and wants. In this chapter, you will learn how your financial resources impact your choices. You will look at where you are now (financially) and prepare a personal balance sheet. You will study strategies you can use to make better financial choices. You will then explore budgeting and create a simple budget. You will learn about budget variances and how to keep good financial records. Finally, you will examine a five-step financial planning process, which begins with setting your personal and financial goals.

ONLINE RESOURCES

Personal Financial Literacy
Web site:

Vocabulary Flashcards

Beat the Clock: Financial
Planning

Chapter 4 Supplemental
Activity

Search terms:

- assets
- financial planning
- fixed expenses
- identity theft
- liabilities
- variable expenses

Resources and Choices

OUTCOMES

- Explain how basic needs, other needs, and wants differ.
- Describe how limited resources affect consumer choices.
- Prepare a personal income and expense statement.
- Prepare a personal balance sheet.
- Apply a decision-making process to personal financial choices.

MEETING NEEDS AND WANTS

Basic needs include food, clothing, shelter, and medical care. People need these items to survive. People who do not have their basic needs met are not able to provide for other needs or wants. Other needs include things such as more than one pair of shoes, clothing for different purposes,



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A fast, expensive car is a luxury item.

education, or furniture to make life more comfortable. Items to fill some of these needs can be rented instead of purchased. For example, a person can go to a library to borrow books rather than buy them. Other items, such as a washer and dryer, save the owner both time and money as compared to renting their use. While these items are not basic to survival, they are needed to have a comfortable lifestyle.

The term **wants** refers to things people desire for reasons beyond survival and basic comfort. These items allow people to enjoy life more. Examples of wants are new cars, vacation trips, a large wardrobe, dozens of pairs of shoes, and so on. Luxury items, which are very costly, often fill emotional wants rather than physical needs.

Resources Limit Choices

The term **financial resources** refers to money or other items of value that people can use to acquire goods and services. Although their financial resources are limited, wants and needs for many people are unlimited and growing. Every day, new products and services appear to tempt consumers. Because most people do not have enough resources to meet all their needs and wants, people must make choices. For a person who has few resources, the choices available will also be few. This person may need to spend all resources to cover basic and other needs. For a person with more resources, more choices will be available. The amount of money a person has to spend after needs are met is called **discretionary income**. A person who has high discretionary income can consider buying a larger number or higher quality of goods.

Financial Resources

Income is the inflow of money you receive from working, investments, or other sources. You can spend this amount of money without using savings or other assets. **Assets** are money and items of value that you own. Their value is the price you could get if you sold them (for goods, such as a car) or the monetary value (for cash or savings).

Expenses are items for which you must spend money. An income and expense statement lists income received and money spent for expenses for a certain period of time, such as a month or a year. If you have more income than expenses, you have a net income for the period. If you have more expenses than income, you have a net loss for the period. Comparing monthly income and expense statements can help you see whether you are meeting your financial goals. The income and expense statement in Figure 4-1.1 on page 94 shows a net income of \$50.00.



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Having high discretionary income allows consumers to consider buying expensive products they want.

ANDREA MCCALL			
PERSONAL INCOME AND EXPENSE STATEMENT			
April 1-30, 20--			
Income			
Work (part-time)	\$150.00		
Allowance for doing household chores	40.00		
Lunch money allowance	60.00		
Total Income			\$250.00
Expenses			
Gifts	\$20.00		
Clothes and shoes	60.00		
Spending money (miscellaneous)	20.00		
Lunches	60.00		
Entertainment	40.00		
Total Expenses			200.00
Net Income			<u><u>\$50.00</u></u>

A personal balance sheet lists assets you own and their current value on a certain date. The balance sheet also lists debts you owe, called liabilities. A **liability** is any debt that you must repay. The difference between your assets (what you own) and your liabilities (what you owe) is called **net worth**. In the balance sheet shown in Figure 4-1.2, the net worth is \$3,351.58.

JERRY PEREZ			
PERSONAL BALANCE SHEET			
May 1, 20--			
Assets		Liabilities	
Cash and checking account	\$452.56	Car loan	\$1,100.00
Savings account	500.00	Credit card debt	200.98
Savings bonds	300.00	Total Liabilities	1,300.98
Movie collection	100.00		
Computer, iPod, games	300.00	Net Worth	
Car, current book value	3,000.00	Assets minus Liabilities	3,351.58
Total Assets	<u><u>\$4,652.56</u></u>	Total Liabilities and Net Worth	<u><u>\$4,652.56</u></u>

Net Worth



© Comstock Images

Houses may grow in value over time.

Assets that are growing in value are said to be appreciating. Savings bonds and other types of savings will grow over time and will increase in value. The value of land or a house may also increase over time. Other assets, such as cars and electronic items, may be depreciating, or going down in value. These items have temporary value that will be used up over time.

MAKING GOOD FINANCIAL CHOICES

Buying decisions play an important part in managing your money. When you give up a particular benefit or item to get another that you think is more desirable, you are making a **trade-off**. For example, you may choose to buy a music player such as an iPod®. To have enough money to buy the iPod, you must not buy something else that you want. The benefit or item you give up (do not buy) is called the **opportunity cost**. For example, instead of the iPod, you might have bought a bicycle. In this situation, the bicycle is the opportunity cost.

To help you make good financial decisions, use a step-by-step decision-making process.

1. Define the need or problem to be resolved by buying the item or service. For example, you might need access to a computer to use in doing homework and surfing the Internet. Think about all the ways in which the item or service could be used and features it should have to meet your needs.
2. List options for filling the need or solving the problem. For example, you could buy a new computer. You could rent a computer. You could use a computer at a local library. List the cost of each option. Research the features of any items you consider buying.

3. Compare the options you have identified. List the advantages and disadvantages of each one. For example, renting a computer may be more costly in the long term than buying one. Using a computer at the library will be less costly than buying a computer. However, you will have to travel to the library each time you want to use the computer. You can only use the computer during hours the library is open. Think about the opportunity cost of each option.
4. Make a decision based on your research and evaluation of the information you have gathered.
5. Take action based on your decision. For example, buy a computer or plan times to use one at the library.
6. Reevaluate your choices. After some time has passed, think about your decision again. Did the option you chose resolve the problem, or is it filling the need for which it was selected? If the answer is no, or if your needs have changed, follow the process again to make a new decision.

Financial choices you make today will affect your finances tomorrow. If you plan ahead, you will be better prepared to use your resources to fill your needs and wants. Making good financial choices will help prevent worry over financial matters. Follow these strategies to help you make good financial choices:

- Financial choices should be forward-looking. Ask yourself how a choice will affect your future.
- Consider the opportunity cost of each item or service you purchase. Doing so will help you decide whether the item or service selected is the best choice for you.
- When in doubt about whether to buy a particular item or service, do not make the purchase. If you are not sure of a choice, keep asking questions or doing research until you know enough to make a good decision.
- Do not make snap decisions about financial matters. Buyer's remorse occurs when you make a purchase and then later regret it.
- Spend less than your income each month. Set aside money for unexpected expenses.
- Be realistic when deciding which wants you can fill. Learn to enjoy items you have rather than always wanting more items.
- Take enough time to read all financial agreements. Ask lots of questions; be sure you understand what you are agreeing to before you sign a financial document.
- Learn from mistakes that others have made. Listen to the experiences of others to learn about possible financial problems. This will help you avoid the same situations.

Building Communications Skills

Reading is a basic communications skill. Much of the information people need comes in written form. People read for many reasons. They read to learn new ideas related to school, work, or personal activities. They read directions for doing a task or following a particular route. Many people also read stories, novels, or poems for pleasure.

Your vocabulary is the words you know and understand how to use. Whatever your purpose in reading, improving your vocabulary will help you better understand the material you read. For example, key terms are listed in each chapter of this textbook. Learning these words will help you understand the concepts presented. Use the following strategies to add new words to your vocabulary:

- Try to learn the meaning of a word from the way it is used in a sentence. Then

check a dictionary to see if that meaning is correct.

- Divide a long word into parts. If you know the meaning of one part, you may be able to guess the meaning of the entire word. Again, check a dictionary to see if that meaning is correct.
- When you are reading and see a word you do not know, find the meaning in a dictionary at that time, if possible. If you cannot check the dictionary right away, make a note of the word and find it in a dictionary later.
- If you find a word you do not know when reading a textbook, see if the word is defined in a glossary at the end of the book.
- Use new words that you learn in conversation or writing to help you remember the meanings.

READING VOCABULARY

4-1 REVIEW

4-1 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. How are other needs different from basic needs? Besides food, clothing, shelter, and medical care, what are some other needs?
2. How are wants different from needs? What are some wants that you have?
3. How do financial resources limit a person's spending choices?
4. What are assets? What are liabilities?
5. How is a person's net worth calculated?
6. What is a trade-off? What is an opportunity cost?
7. Briefly list five steps to follow when making a financial decision.
8. You have given careful thought to buying either a new book bag or a music CD. You decide to buy the music CD. What is your opportunity cost?
9. List some strategies you can use to make good financial choices.

4-1 Activity 1 Personal Financial Statements

Identifying the income, expenses, assets, and liabilities you have now is a good place to begin planning for your financial future. In this activity, you will create a personal income and expense statement and find your net worth or net loss for one month. You will also create a personal balance sheet and determine your net worth.

1. Review the personal income and expense statement shown in Figure 4-1.1 on page 94. Create a similar document using your information. Use spreadsheet software, if available, to create the statement.
2. List all your income—money you receive from any source during one month.
3. List all your expenses—money you pay for goods and services during the same month.

4. Find the total of your income and the total of your expenses. Subtract the two total amounts to find your net income or net loss.
5. Review the personal balance sheet shown in Figure 4-1.2 on page 94. Create a similar document using your information. Use spreadsheet software, if available, to create the balance sheet.
6. List all your assets—money you have or things of value you own.
7. List all your liabilities—money you owe that must be repaid.
8. Subtract your liabilities from your assets to find your net worth. Note that if your liabilities are larger than your assets, you will have a negative net worth.



Budgeting

OUTCOMES

- Identify the purpose of a budget.
- Prepare a personal budget using the "pay-yourself-first" philosophy.
- Describe recordkeeping methods used in the budgeting process.

THE PURPOSE OF BUDGETING

Budgeting is a critical part of managing your money. The purpose of a budget is to plan how you will spend or save money. A **budget** is a spending and saving plan based on expected income and expenses. It lists expenses and the source of income to pay those expenses. Using a budget allows you to compare your financial resources with your financial needs.

You may need to adjust amounts in a budget several times. Your goal is to create a plan that meets your spending and saving needs with your expected income. Using spreadsheet software, such as *Microsoft® Excel®*, makes adjusting amounts and recalculating totals easy. Using *Excel*, you can record your financial goals and then prepare the budgets that will help you achieve them. A sample budget is shown in Figure 4-2.1 on page 101.

Spreadsheets allow you to insert numbers and then change them later. You can use formulas to compute the amounts of budget variances and the percentage of variances.

Excel also makes changing a budget or a financial plan easy. For example, what if your expenses go up by 8 percent? How will the budget be affected? What if the price of a car you are saving to buy goes up by 10 percent during the time you are saving for it? How much money will you need for the car? Allowing you to answer "what if" questions easily is one of the strengths of a spreadsheet program. When you change a number in *Excel* that is part of a calculation, the result is automatically updated. When you enter a new expense amount, for example, the total expense amount will be updated. Because amounts are calculated using formulas, math errors are eliminated.

BUILDING A BUDGET

A budget should be designed to help meet financial goals such as paying for current expenses and saving for the future. To create a budget, begin by looking at the amount you have available to spend or save. Then

	A	B	C
1	ALICE CHIN		
2	BUDGET FOR SEPTEMBER 20--		
3			
4	Income		
5	Work (part-time)	\$300.00	
6	Allowance for doing household chores	15.00	
7	Lunch money allowance	40.00	
8	Total Income	\$355.00	
9			
10	Savings		
11	Deposit to savings account	\$110.00	
12			
13	Expenses		
14	Daily lunches	\$80.00	
15	Supplies	20.00	
16	Snacks	25.00	
17	Entertainment (movies and bowling)	120.00	
18	Total Expenses	\$245.00	
19			
20	Total Expenses and Savings	\$355.00	
21			
22			

FIGURE 4-2.1

Using a spreadsheet will make creating a budget easier.

decide how much of that amount you will save and how much you will spend. You must also choose the items or services for which you plan to spend. Remember that a budget is a plan. Your actual income, saving, and spending may not be exactly as planned. You can compare your actual spending and saving to the budget to see how well you planned. This process will help you create better budgets in the future.

Figure 4-2.2 on page 102 shows a sample budget. Look at each part of the budget as you read the steps for creating a budget in the following sections.

Step 1 Estimate Income

You may have many different sources of income. Whether the money is earned or unearned, you should keep track of where it comes from and how often it is received. Because most budgets are prepared once a year, you should calculate income for an entire year. Locate the total estimated yearly income amount, \$2,640.00, in the budget in Figure 4-2.2.

Money you will receive during the year is estimated in a budget. You may receive the money weekly, monthly, yearly, or on some other schedule. No matter when the money is received, it can be accounted for in terms of a monthly budget.

If you receive money weekly, multiply the weekly amount by 4 to see how much that is per month. For example, \$10 received per week would be \$40 a month. (Rounding is okay as long as your total yearly amount is accurate.) If you get money once a month, you can multiply by 12 to get yearly income. When you look at the big picture—how much money comes in and goes out during an entire year—it may change the way you think about money.



ANDREA MCCALL BUDGET FOR 20--			
	Weekly	Monthly	Yearly
Income			
Work (part-time)	\$30.00	\$120.00	\$1,440.00
Allowance for doing household chores	10.00	40.00	480.00
Lunch money allowance	15.00	60.00	720.00
Total Income	\$55.00	\$220.00	\$2,640.00
Savings			
Deposit to savings account	\$5.00	\$20.00	\$240.00
Expenses			
Gifts	\$5.00	\$20.00	\$240.00
Clothes and shoes	15.00	60.00	720.00
Spending money (miscellaneous)	5.00	20.00	240.00
Lunches	15.00	60.00	720.00
Entertainment	10.00	40.00	480.00
Total Expenses	\$50.00	\$200.00	\$2,400.00
Total Expenses and Savings	\$55.00	\$220.00	\$2,640.00

Step 2 Plan Savings

Pay yourself first—put money into savings before you consider other expenses. If you plan what you want to spend first, you may have no money left for savings. Enter an amount that you would like to save. After entering expenses, you may need to adjust this amount. You might not be able to save as much as you want and still pay for all expenses. Plan to save some money, however, if at all possible. Savings allow you to plan for the future. You can identify items you would like to purchase at a future time with savings. Savings can also be used to pay for unexpected expenses that you may have in the future. Locate the yearly savings amount, \$240.00, in the budget in Figure 4-2.2.

Step 3 Estimate Expenses

Expenses are items for which you spend money. Clothes, lunches at school, and bus fares are examples of expenses. You may make payments on an asset you purchase, such as a car. Other expenses are related to living costs and entertainment. Keeping track of what you spend will help you estimate expenses for the future. If you are trying to control



expenses, seeing exactly how much you spend for each expense can be helpful. Locate the expense amounts in the budget in Figure 4-2.2.

VARIABLE EXPENSES

Expenses that can go up and down each month are called **variable expenses**.

Examples of variable expenses are food, entertainment, and clothing. These expenses go up or down as you need more or fewer items. For example, when the weather is cold, the heating expense may go up. Expenses can also vary due to changing prices. For example, as the price of gasoline rises, the transportation expense will also rise.

Some variable expenses can be decreased when you have less income or higher expenses than expected. For example, you could spend less than planned on entertainment. You can spend more on variable expenses, such as clothes, if you have more income or fewer expenses than expected. For example, if you receive a gift of cash for your birthday, you can use the money to make an unplanned purchase.

FIXED EXPENSES

Expenses that do not change each month are called **fixed expenses**.

Examples of fixed costs are rent, insurance, and car payments. Renters typically have a contract that states a monthly rent amount. The rent does not change each month. Although rent and insurance expenses do go up periodically, these increases typically occur on a yearly basis. Monthly car payments are usually fixed for the term of the car loan. Fixed expenses remain constant each month and must be paid even when income is less than expected. If income continues to be less than planned, a fixed expense may have to be eliminated. For example, suppose Terry's income goes down because he loses his job. Terry may have to sell his car and pay off his car loan to eliminate this fixed expense that he can no longer afford.

Step: 4 Balance the Budget

Find the total of each category in the budget—income, savings, and expenses. Find the total of savings and expenses. This amount should be the same as the total income amount. When these amounts are the same, the budget is in balance. Locate the total income, total savings, and total expenses amounts in the budget in Figure 4-2.2.



Eating at a fancy restaurant is entertainment, a variable expense.

PREPARING A BUDGET ANALYSIS

A budget is a plan for saving and spending. You should not expect income, savings, and expenses to be exactly as you planned in a budget. Looking at differences between planned income or spending and actual income or spending, called **variances**, can help you plan better when creating budgets in the future.

Technology Corner

Many people use the Internet to do all types of research, from reading about a new medical breakthrough to finding a plumber. One valuable type of research is product and price comparisons. You can look at products for sale and compare their features. You can visit several sellers' Web sites and compare their prices and services offered. This saves you both time and money. You will save time by not driving from one business to another. That saves on gasoline as well.

Internet search engines, such as Google and Yahoo!, allow you to enter keywords and

INTERNET RESEARCH

find all types of information. This includes historical facts and data, as well as what's happening in the world today. Keywords should be nouns—persons, places, or things—that are likely to be found on the Web pages you want to view. When the search is complete, a list of links, also called hits, will appear. Clicking a link will take you to a Web page with information related to the search keywords.

Try using keywords, such as *Mall of America*. Look at some of the sites in the hits list and the information that is available to you.

Sometimes you will earn or save more than you estimated. This is a favorable variance. If you earn or save less than you estimated, it's an unfavorable variance. The same is true with expenses. If you spend less money than you planned to spend, this is a favorable variance, but if you spend more than you planned to spend, it is an unfavorable variance. Figure 4-2.3 on page 105 shows budget variances—both in dollar amounts and in percents. To compute the percents for income and savings, subtract the budgeted amount from the actual amount; then divide the difference by the budgeted amount. To compute the percents for expenses, subtract the actual amount from the budgeted amount; then divide the difference by the budgeted amount.

By looking carefully at variances, you can see where you spent more or less than the estimated amounts. Any variance that is more or less than 10 percent of what you had planned should be looked at carefully. For example, Andrea had planned to spend \$60 on clothes and shoes for the month, but she actually spent \$70. That is \$10 more than budgeted, or a 17 percent difference. Andrea should think about why this happened. She may decide that she needs to revise the budget or change her spending habits. Analyzing variances will help you understand and better estimate your income and expenses.

RECORDKEEPING METHODS

Keeping good records will help you prepare a better budget. Good information will also help you do a better job analyzing your budget. There are several methods you can use as you keep track of what you are earning, spending, saving, and investing.

**ANDREA MCCALL
BUDGET VARIANCES FOR AUGUST**

	Budgeted Amount	Actual Amount	Dollar Variance	Percent Variance
Income				
Work (part-time)	\$120.00	\$110.00	-\$10.00	-8% U
Allowance for doing household chores	40.00	50.00	10.00	25% F
Lunch money allowance	60.00	60.00	0.00	0%
Total Income	<u>\$220.00</u>	<u>\$220.00</u>	<u>\$0.00</u>	0%
Savings				
Deposit to savings account	\$20.00	\$20.00	\$0.00	0%
Expenses				
Gifts	\$20.00	\$18.00	\$2.00	10% F
Clothes and shoes	60.00	70.00	-10.00	-17% U
Spending money (miscellaneous)	20.00	22.00	-2.00	-10% U
Lunches	60.00	55.00	5.00	8% F
Entertainment	40.00	35.00	5.00	13% F
Total Expenses	<u>\$200.00</u>	<u>\$200.00</u>	<u>\$0.00</u>	0%
Total Expenses and Savings	<u>\$220.00</u>	<u>\$220.00</u>	<u>\$0.00</u>	0%

Percents are rounded to the nearest whole number.

Manual Records

You can keep logs or journals on paper that list types and amounts of income, savings, and expenses. You can manually compute your variances and make notations about what to change. You will want to keep these journals over time so you can compare them. For example, you can look at the previous year’s budget and see how your income has grown. You can also see how your spending habits have changed.

Computerized Records

Software packages such as *Quicken*[®] or *Microsoft Money* allow you to keep financial records using a computer. The software will retain the data and will allow you to print reports, such as a personal balance sheet. It will also allow you to quickly reference expense information. Versions of programs such as *Microsoft Money*, shown in Figure 4-2.4 on page 106, are available for use on handheld computers. Using such a program on a handheld computer makes recording data quick and easy at any location.



FIGURE 4-2.4

Keeping good records is essential to good financial planning.

Account Register		Checking	
1/2/2007	Paycheck	320.63	820.63
1/3/2007	Pizza Pan Pizza Shop	(24.50)	796.13

Balance: 796.13

You can also use spreadsheet programs, such as *Microsoft Excel*, for data entry and budget analysis. The program will allow you to compute variances in dollar amounts as well as percentages. You can set up worksheets and link them together. This will allow you to make estimates and change amounts easily.

Success Skills

DEALING WITH CONFLICT

Conflicts are bound to happen sooner or later. People you know will not be able to get along with each other. Maybe you will have a hard time working out a problem with another person. The ability to deal with conflict is an important personal skill—it will help you both in your personal life and in your work life.

When faced with a conflict, stop and take a ten-second time out. For those ten seconds, ask yourself, "What is happening here?" Listen rather than talk. Think about who is speaking and why that person is upset. Repeat a short summary of the problem or complaint to acknowledge that you understand the issue and confirm what you have heard.

If the person is upset or angry and not speaking rationally, suggest that you continue your talk later. This will give you and the other person time to think about the issue. Resume talking when you are both calm and can speak in a courteous manner.

Focus on the problem, not on the person. Be objective. Do not let your personal feelings—whether you like or dislike the person—cloud your judgment. Look for positive ways to address the issue. Be willing to compromise, when appropriate, to reach a solution that will be acceptable to all parties.

The next time you must deal with conflict, practice these skills. Reflect on a past situation—how could you have handled it differently?

4-2 REVIEW

4-1 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. What is the purpose of a budget?
2. What three types of amounts are included in a "pay-yourself-first" budget?
3. How are variable expenses different from fixed expenses?
4. Why is it important that a budget be balanced? If your budget does not balance, what can you do to bring it into balance?
5. What is an unfavorable variance?
6. Describe ways to keep financial records manually.
7. Name three software programs that can be used to keep financial records.
8. List steps you can take to help resolve a conflict in a positive manner.

4-1 Activity 1 Personal Budget

In this activity, you will create a personal budget. You will keep track of your finances for one month and then compute budget variances. In 4-1 Activity 2, you created a personal income and expense statement. Refer to that document to see income and expense items you have already identified.

1. Review the personal budget shown in Figure 4-2.2 on page 102.
2. Create a similar budget for yourself for the coming month. Use spreadsheet software to prepare the document, if it is available.
 - Enter your expected income from all sources during the month.
 - Enter an amount you want to save for the month.
 - List all your estimated expenses for the month.
 - Total the sections of the budget to see if the budget is in balance. If it is not, change the savings or expense amounts to make the budget balance.
3. Keep track of the amount of money you receive, the amount you save, and the amount you spend during the coming month. Continue this exercise after one month has passed.
4. Review the personal budget variance examples shown in Figure 4-2.3 on page 105.
5. Create a similar monthly budget variance report for yourself. Use the budget you created for the month and the actual amounts of your income, savings, and expenses.

Personal Financial Planning



- Explain the purpose of a financial plan.
- List the steps of the financial planning process.
- Describe how financial goals help make achieving personal goals possible.
- Prepare a personal financial plan.

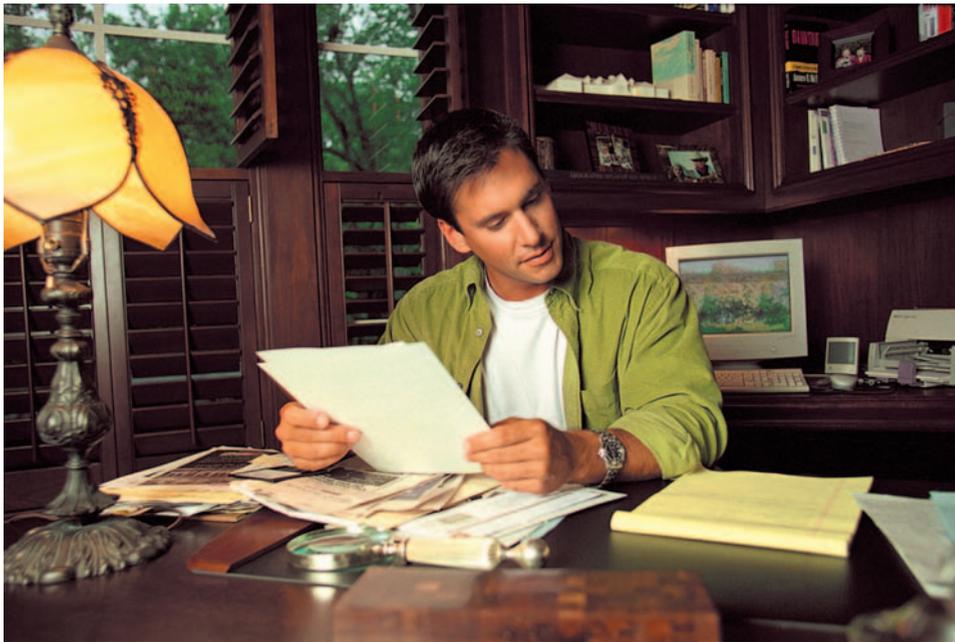
FINANCIAL PLANNING

A **financial plan** contains personal goals you want to accomplish. It also contains a timeline for reaching these goals and methods you will use to finance them. Getting a college education, owning a car, and owning a home are examples of personal goals. For each personal goal, you will have a related financial goal. Paying for living expenses, tuition, books, and other related expenses while in college is a financial goal. Saving for a down payment and having a job that provides enough income to make monthly car payments are financial goals. Saving for a down payment and having a job that provides enough income to make monthly house payments are financial goals. A financial plan is more than a budget. Its purpose is to plan for earning, spending, saving, and investing that will allow you to achieve your personal goals in the present and the future.

A FIVE-STEP FINANCIAL PLANNING PROCESS

Financial planning is a formal process. It involves looking carefully at your current situation and thinking about your future. It also requires a long-term commitment. You must put your plan into action and monitor it periodically. At least once a year, you should review and update the plan. Your plan should contain details, but it should not be too complicated to review and follow.

Some people create a plan by themselves. They may think they do not need help, or they may want to keep their financial information and goals private. Other people hire a financial planner. A financial planner is trained to help people with advice about how to invest earnings, plan for retirement, and manage other financial matters. Whether you do planning by yourself or with help from others, you will need to complete five steps.



© Digital Vision

Financial planning begins with getting organized.

Step 1 Gather Information

The first step in financial planning is gathering information. Everything related to your finances should be considered. The purpose of gathering information is to look at the state of your finances now—your starting point. The following list shows examples of items you may need to gather. You may not have all the items listed at this time in your life. However, you can gather or prepare the first three items. Other items may become part of your plan in later life.

- Personal income and expense statement
- Personal balance sheet
- Personal budget
- Checkbooks
- Current bank account statements
- Investment account statements
- Insurance policies
- Current paycheck stub
- Tax returns
- Will
- Trusts
- Financial contracts for items purchased on credit
- Other legal documents related to your finances

At some point when you review your plan, you will need to think about how to finance your retirement. You may want to gather data about your medical history and the medical history of family members. This data may help you estimate your life span, which affects the amount of income you will need over your lifetime. For example, many people may live until age 85 or 90 and should plan how to meet financial needs through that age.

Focus on . . .

PHISHING

When providers of financial products contact you directly by e-mail or using Web sites, you should be careful. There are many scams on the Internet. Web pages that appear to be genuine may not be posted by the company indicated.

One common Internet scam is called **phishing**. In this scam, a person is sent an e-mail saying, for example, that there is a problem with his or her bank account. The individual is asked to confirm a Social Security number, account number, password, or other sensitive information. The From field of the e-mail may have the real name of your bank. The real company

logo may be shown. However, the message is not from the real bank. Do not respond to such an attempt to get personal information. The message is most likely from a phisher. The phisher wants to use your information illegally. **Identity theft** occurs when someone uses your personal information without your permission to commit fraud or other crimes.

If you think that a message regarding your bank account or other financial matters may be real, contact the bank or other business by phone. Ask if there is a problem with your account. Do not reply to the e-mail message or go to the link provided.

Step 2 Analyze Information

Take a careful look at the documents and information you have gathered. Find out if any data are missing, and take steps to get the data. Carefully look at each document, and make notes about what you see. Review your income and expense statement to see what your current sources of income are. Look at your expenses. Do you have enough income to pay for your expenses and save for the future? If not, try to find ways to increase income and decrease expenses.

Review your personal balance sheet. What are your assets? What liabilities do you have? What is your net worth? Review a current monthly or yearly budget. Look at the items for which you spend money. Is there a way you can spend less and save more to meet long-term goals?

As you review your financial plan each year, consider the following questions. Some of them may apply now. Others may not apply to you for a few years or for many years.

- Is your income steadily growing over time? If so, by what amount and percentage? For example, you may have \$2,000 more in income this year than last year. This is a favorable trend that will help you reach your goals.
- Is your net worth growing over time? When you compare the current balance sheet to previous ones, do you see growth? If so, by what amount and percentage?
- How are your spending habits changing? What types of things are you buying (needs versus wants), and what are your purchasing plans over time?
- Who else depends on your income? Do you have a spouse or children that will be affected by your financial plan? What will they contribute?

- What new goals do you need to add and plan for? Do you need a plan to pay for a college education for your child? Is it time to plan for retirement? Does your will need to be updated to include a new grandchild?

Step 3 Set Goals

Two types of goals should be considered when creating a financial plan—personal goals and financial goals. **Personal goals** are the things you want to achieve. Living in your own apartment, owning a car, and taking a two-week vacation are personal goals. Personal goals should be set first because your financial goals will be based on them.

Financial goals describe how you will pay for your personal goals. Financial goals may be short-term, intermediate, or long-term. Short-term goals include what you will do this week, this month, and this year. A financial plan for the short term tells you on a week-to-week or month-to-month basis what you would like to achieve. Perhaps you would like to save \$40 by the end of the month. Perhaps you want to add \$200 to your savings account by the end of the year. Short-term financial goals are usually for between 1 week and 2 years. Using monthly and yearly budgets can help you achieve short-term goals and save for long-term goals.

Intermediate goals include what you want to achieve up to 3 or 4 years from now. You may wish to save money for college or for a future purchase or need. You may want to increase your yearly income by \$100 a month within 3 years. Intermediate goals are usually for between 2 and 5 years.

Long-term goals typically include what you want to achieve more than 5 years from now. You may wish to save enough money to buy a car



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Expensive vacations require planning and financial resources.

or go on an expensive vacation. You may want to repay loans for money you borrowed to complete college. When you begin working full-time, you may contribute to a 401(k) to save money for your retirement.

Achieving intermediate and long-term goals may require that you save money for a long time. Doing without an item you would like to buy now in order to save money for a long-term goal is an example of delayed gratification. For instance, you may have a goal of saving \$30 per month to help pay for your college education. This month, you would like to buy a music CD. However, if you do so, you will not be able to make your savings goal. Doing without the CD now in order to be able to pay for college later is an example of delayed gratification.

Step 4 Develop a Timeline

Plan a time to put your goals into action. How soon do you need or want to achieve a certain goal? For each personal goal, there may be a financial goal you must first achieve. Financial goals can further be divided into parts or steps. For each step, consider how long it will take to complete. Then set a target date for completion. The record of what you intend to accomplish is your financial plan. Once you clearly understand your current finances and the goals you want to accomplish, you can then take steps to reach your goals. A sample timeline for one goal is shown in Figure 4-3.1.

FIGURE 4-3.1 ONE GOAL IN A FINANCIAL PLAN

BILL WONG FINANCIAL PLAN Updated April 1, 20--			
Net Worth on April 1, 20-- \$525.56			
Personal Goal	Financial Goal	Steps to Take	Timeline
Live in my own house in the country	Own a house in the country	1. Save money for a down payment (\$12,000)	5 years
		<ul style="list-style-type: none"> • Set aside \$200 per month • Open a separate account for money saved • Talk to a mortgage broker to get prepared 	Once per month April 8 (next week) Make an appointment for April 15
		2. Have a job that provides enough income to make monthly payments	5 years

Step 5 Implement and Evaluate the Plan

Once you have decided on your personal and financial goals, begin working toward achieving them. Check off the items on your timeline as they are completed. Set new steps as you learn about other or better ways of meeting your goals. Most importantly, take a look at your financial plan often. At least once each year, you should evaluate the financial plan and update or revise it as needed.

Your financial plan represents your personal and financial goals at one point in time. Those goals are likely to change over time. For example, you may inherit money, or you may have children. You may have a job opportunity overseas, or you may wish to spend more time on a hobby or a side business. As your personal and family goals change, your financial plan should be updated to reflect new goals. The financial plan is a work in progress; it is never finished. As one goal is accomplished, another personal goal is defined.

Keep your financial plan and all the related documents in a safe place where you can work on them regularly.

Ethics

FINANCIAL PLANNERS AND COMMISSION EARNINGS

A **financial planner** is a person who provides financial advice to individuals. Financial planners help people develop financial plans in a very formal setting. If you work with a financial planner, you will share your personal information. Data about your assets, liabilities, and net worth are examples of the information you will share. The financial planner should guard your information and should not share it with others or use it for personal benefit. To do otherwise would be unethical. You must be able to trust the planner with your most sensitive personal data.

Some financial planners work for commission income. That means they make money when they sell financial products to their customers. When planners sell

products that earn higher commissions, rather than products that customers really need, they are being unethical. For consumers, it can be hard to tell whether or not they are buying the best product at the lowest price. To avoid this kind of dilemma, hire a financial planner who does not work on commission. Instead, pay for the advice separately from buying any financial products, such as insurance.

Every year, people are cheated out of their money by dishonest advisors. Be sure you can trust your financial planner. Find out if he or she has been in business long, whether complaints have been filed against her or him, and if he or she has a criminal background. Ask what measures the planner will take to keep your data secure.

4-3 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. What is the purpose of a financial plan?
2. List the five steps in creating a financial plan.
3. What types of information or documents are needed to create a financial plan?
4. What information should you be able to learn from your personal balance sheet?
5. Why are personal goals set before financial goals? How do financial goals help make achieving personal goals possible?
6. How are short-term goals different from long-term goals?
7. What does the term *delayed gratification* mean?
8. How often should you review your financial plan at a minimum?
9. Why might you choose a financial planner who does not work on commission rather than one who does?

4-3 Activity 2 Personal Financial Plan

1. Review the example of one goal in a financial plan shown in Figure 4-3.1 on page 112.
2. Gather the personal income and expense statement, the personal balance sheet, and the personal budget you created earlier. Gather any other financial documents you have. See the list under Step 1 Gather Information on page 109 for examples.
3. Use spreadsheet or word processing software for this activity, if it is available. If not, complete the work using paper and pen. Center the following heading at the top of the document:

(YOUR NAME) FINANCIAL PLAN
Updated (current date)

4. Refer to your personal balance sheet created earlier to find your net worth amount. Enter this amount below the headings. For example:
Net Worth on (current date) \$525.56
5. Below the net worth information, create a table with four columns as shown in Figure 4-3.1. Enter the following column headings:

Personal Goals
Financial Goals
Steps to Take
Timeline

6. Think of a personal goal you would like to accomplish within the coming year. List this short-term goal in the table under Personal Goals.
7. Think of the financial goal or goals you will need to meet in order to achieve the personal goal. List these goals in the table under Financial Goals.
8. Determine the steps you will need to take to achieve the financial goals. Refer to your budget and income and expense statement. Do you need to increase your income or savings to meet the goals? Do you need to decrease expenses? List the steps you will take to meet the goals in the table under Steps to Take.
9. Set a time for completing each step you listed. Enter the completion time for each step in the table under Timeline.
10. Repeat steps 6 through 9 to list other goals. List at least one more short-term goal to be achieved in 2 years or sooner. List at least two intermediate goals to be completed within 3 to 5 years. List at least two long-term goals to be completed in more than 5 years. You may list as many other goals as you wish. For the long-term goals, the steps to take may be more general than for the short-term or intermediate goals. Having long-term goals that you do not yet know exactly how to accomplish is fine.
11. Work toward achieving your goals by taking the steps you have listed. Refer to your timeline often to see if you are accomplishing the steps or goals when planned.
12. At least once a year, review and revise your financial plan. Check off goals that you have achieved. Add new goals as your needs and wants change over time. Refine the steps to take in achieving your long-term goals as the steps needed become clearer.





EXPLORING CAREERS IN SCIENCE, TECHNOLOGY, ENGINEERING, AND MATHEMATICS

Do you always want to understand how things work? Are you inventive and curious? Do you like to find new and better ways to build things? Are you fascinated by technology? If the answer is yes, a career in science, technology, engineering, and mathematics might be right for you. Jobs in this area are varied. Some workers in this field do scientific research or testing. Others are engineers who design products or buildings. Some workers in this area develop new technologies that are used in consumer and business products.

Jobs in this career area are found in government and businesses. Some inventors and engineers are entrepreneurs and have their own small businesses. The need for some jobs in science, technology, engineering, and mathematics is expected to grow. The need for other jobs will stay about the same or decrease. The outlook varies by job.

Skills Needed

Some of the skills and traits needed for a career in science, technology, engineering, and mathematics include the following:

- Math and science knowledge
- Analytical skills
- Communications skills
- Computer/technology skills
- Decision-making skills
- Problem-solving skills
- Leadership skills

Job Titles

Many jobs are available in science, technology, engineering, and mathematics. Some job titles for this career area include the following:

- Biological scientist
- Civil engineer
- Conservation scientist
- Drafter
- Economist
- Engineering technician
- Physicist
- Science technician
- Technical writer

Explore a Job

1. Choose a job in science, technology, engineering, and mathematics to explore further. Select a job from the list above, or choose another job in this career area.
2. Access the *Occupational Outlook Handbook* online. A link to the site is provided on the Web site for this textbook.
3. Search for more information about the job you selected to answer these questions:
 - What is the nature of the work this job involves?
 - What is the job outlook for this job?
 - What training or qualifications are needed for this job?
 - What are the median annual earnings for this job?

Summary

- Many people have unlimited wants and needs but limited resources to meet those wants and needs.
- Because resources are limited, people must make choices. Every choice is a trade-off between the item or benefit you get and an opportunity cost (the item or benefit given up).
- Income and assets are financial resources that can be called on to meet our wants and needs.
- A personal income and expense statement lists income, expenses, and net income. A personal balance sheet lists assets, liabilities, and net worth.
- Budgeting helps you manage your financial resources.
- Building a budget requires you to estimate income, plan savings, and estimate expenses.
- A budget analysis shows how planned spending (budget) compares to actual spending. Any differences are called variances.
- Manual and computerized recordkeeping methods will help you keep organized and prepare better financial records.
- A financial plan contains personal goals and financial goals that allow you to achieve personal goals.
- Five steps in financial planning are gathering information, analyzing information, setting goals, setting steps with a timeline, and implementing and evaluating the plan.

Key Terms

assets

budget

discretionary

income

financial goals

financial plan

financial planner

financial resources

fixed expenses

identity theft

liability

net worth

opportunity cost

personal goals

phishing

trade-off

variable expenses

variances

wants

ACTIVITY 1

Review Key Terms

Use the key terms from Chapter 4 to complete the following sentences:

1. Your next best choice, called the _____, is what you give up when you make a decision to buy an item.
2. The amount of your assets minus your liabilities is called your _____.

3. _____ is the amount of money a person has to spend after needs are met.
4. A spending and saving plan based on expected income and expenses is called a(n) _____.
5. Rent or insurance payments are examples of _____ because they do not change each month.
6. An overall plan called a(n) _____ contains your personal and financial goals.
7. _____ are things you want to achieve.
8. A(n) _____ is a person who gives financial advice to individuals.
9. When you choose to give up one item to buy another, you are making a(n) _____.
10. Items of value that you own, called _____, may be appreciating or depreciating.
11. _____ are expenses that can go up and down each month.
12. Differences between planned and actual income or expenses are called _____.
13. _____ describe how you will pay for achieving your personal goals.
14. _____ occurs when a person's personal information is used without permission to commit fraud or theft.
15. A debt you owe, called a(n) _____, must be repaid.
16. _____ is a scam that uses an e-mail message to get a person to give out personal information.
17. Things we desire to buy, called _____, go beyond filling survival needs and basic comforts.
18. _____ are money and other items of value that can be used to acquire goods and services.

ACTIVITY 2 Math Minute

Complete these problems to build your math skills. You may use spreadsheet software or complete the problems manually.

1. Michael makes \$127 a week and gets paid four times a month. What is his monthly pay? His yearly pay?
2. Rachelle makes \$96 a week and gets paid 52 weeks a year. What is her yearly pay? Her monthly pay?
3. Maria's planned income for July was \$539. The actual amount she earned was \$522. Compute the variance amount and percent. Note if the variance is favorable (F) or unfavorable (U). Round to the nearest whole percent.

4. Chin's planned entertainment expense was \$125. The actual amount he spent was \$106. Compute the variance amount and percent. Note if the variance is favorable (F) or unfavorable (U). Round to the nearest whole percent.

ACTIVITY 3

Make a Financial Decision



You belong to a school club that has ten members and two teacher advisors. The club members and advisors are planning to attend a conference in your state capital. Apply the decision-making process you learned in this chapter to help you decide how your club should travel to the conference. Work with a classmate to complete this activity.

1. Define the need clearly. Write a statement that says exactly what you need to decide.
2. List options for filling the need. What methods of transportation might your club use to reach the state capital? (If you live in the state capital, assume you will need to travel 20 miles to the meeting site.) Do research as needed to find the cost of each option. Remember to consider the distance both to and from the state capital. Record detailed notes to show how the cost for each item was calculated.
3. Compare the options you have identified. List the advantages and disadvantages of each one.
4. Make a decision based on your research and evaluation of the information you have gathered. Explain why you choose one option over the others.
5. Describe how you would take action based on your decision if this were a real situation.

ACTIVITY 4

Create a Household Budget



In this chapter, you created a realistic budget that applies to your needs now. In this activity, you will pretend that you have graduated from high school and are living on your own. You will create a household budget that would provide for your needs in that situation.

1. Review the personal budget shown in Figure 4-2.2 on page 102. You will prepare a household budget for next month. Use spreadsheet software to prepare the budget, if it is available.
2. Use the budget in Figure 4-2.2 as an example of how to set up and format the document.



3. Assume you work 40 hours per week 4 weeks per month. You earn \$8.00 per hour. Your take-home pay (after taxes and other deductions) is \$224 per week. Calculate your monthly take-home pay. Enter this amount in the Income section of the budget. Enter **\$60** per month that you earn doing odd jobs such as mowing grass or babysitting for a friend. Calculate the total income.
4. Enter an amount you want to save for the month. Use an amount that you think is realistic. You may need to adjust this amount later.
5. In the Expenses section, list your estimated expenses for one month. Think of all the expenses you would have if you were living on your own. Assume that health insurance premiums have been deducted from your paycheck. Also assume that the taxes you have withheld from your paycheck are all the taxes you have to pay. You do not need to list these items as expenses. A list of typical expenses for a household budget follows. You may add other items that you think would be realistic. You may leave out items that you think you would not want to have, such as satellite TV.
 - Rent
 - Car payment
 - Telephone
 - Cell phone
 - Electricity
 - Water
 - Groceries
 - Clothing and shoes
 - Internet access
 - Gasoline
 - Lunches at work
 - Satellite TV
 - Other entertainment
 - Car license and maintenance
 - Auto and renter's insurance
 - Miscellaneous
6. Do research to find typical monthly costs for these items in your area. For example, look at advertisements for apartments in a newspaper to find rent costs. Ask your parents or other adults how much they usually pay for items such as electricity and water. Calculate the total expenses.
7. Calculate the total savings and expenses. Is the budget in balance? If it is not, change the savings or expense amounts (within realistic limits) to make the budget balance. Some ideas to help balance your budget follow.
 - Can you find an apartment where the water or electricity is included in the rent?
 - Perhaps you cannot afford a car. If you take the bus to work and other places instead, you will not have a car payment, gasoline costs, or car insurance costs. Instead, add the cost of bus fares and an occasional taxi fare.

- Perhaps you cannot afford both a cell phone and a house phone. Can you do without one of them to save money?
- Consider getting a two-bedroom apartment and sharing it with a friend. Your friend would pay half of the rent, electricity, and water expenses.

ACTIVITY 5

Research Identity Theft



www.thomsonedu.com/school/pfl

1. Access the Internet. Using a search engine, search using the term *identity theft*.
2. Read several articles you find about identity theft.
3. Make a list of steps consumers can take to avoid being the victim of identity theft.
4. Make a list of steps consumers should take if they learn they are the victim of identity theft.
5. For each site you used to find information, list the article or Web page name, the Web site, the Web address, and the date you accessed the site. For example: "Welcome to the Federal Trade Commission, Your National Resource about Identity Theft," Federal Trade Commission Web site <http://www.consumer.gov/idtheft/> (accessed May 12, 20--).

ACTIVITY 6

Evaluate a Financial Plan



Take a look at the financial plan on the next page, and answer these questions:

1. Do you think the personal goals are realistic for a student who is currently a sophomore in high school?
2. Label each personal goal as short-term, intermediate, or long-term.
3. If this student gets a job, how much will she have to earn in take-home pay in order to meet her financial goals?
4. How can you add to or refine this plan to make it better?

GLORIA CADIZ FINANCIAL PLAN
Updated January 1, 20--

Net Worth on January 1, 20-- \$150

Personal Goals	Financial Goals	Steps to Take	Timeline
1. Get a degree in landscape architecture	• Save \$1,050 for college tuition, books, and fees	• Save \$35 per month	• 30 months
	• Get financial aid to cover the balance	• Apply for financial aid	• January 20-- (next year as a junior)
		• Apply for a scholarship	• April 20-- (next year)
2. Own a car	• Save \$500 for a car down payment	• Save \$25 per month	• 20 months
	• Borrow money from bank	• Get a job so I will qualify for a loan	• Get a summer job and a part-time job by January 1, 20--
3. Take a vacation in Hawaii before starting college	• Save \$1,500 for a vacation	• Save \$50 per month	• 30 months
	• Buy new clothes for trip	• Make reservations early to get the best deal	• January 20-- (in 2 years)