GE1202 Managing Your Personal Finance

Lecture 2
Money Management

Money Management

- Daily spending and saving decisions are at the centre of your financial planning activities
- The key to successful personal financial management is the ability to maintain financial records and plan your spending
- **Money management** refers to the day–to–day financial activities necessary to manage current personal economic resources while working toward long–term financial security
- There are three major money management activities
  1. Storing and maintaining personal financial records and documents
  2. Creating personal financial statements
  3. Creating and implementing a plan for spending and saving – Budgeting

Personal Financial Records and Documents

- They are the written evidence of business transactions, ownership of property, and legal matters
- Invoices, credit card statements, insurance policies, MPF statements and tax forms
- An organized system of financial records provides a basis for
  1. Handling daily business activities
  2. Planning and measuring financial progress
  3. Completing required tax reports
  4. Making effective investment choices
  5. Determining available resources for current and future spending

Personal Financial Statements

- Personal financial statements tell you the starting point of your financial journey
  - **Personal balance sheet**
  - **Cash flow statement**
- These reports provide information about your current financial position and present a summary of your income and spending
  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

Personal Balance Sheet

- A balance sheet (also called a *net worth statement* or *statement of financial position*) reports what you **own** and what you **owe**
- The difference between what you own and what you owe is your **net worth**
- Use the following procedures to prepare a personal balance sheet
  1. Listing items of value
  2. Determining amounts owed
  3. Computing net worth

Listing Items of Value

- The items with value are your **assets**
- Assets are cash and other tangible property with a monetary value
- Four basic categories of assets
  - **Liquid assets**
    - Cash and items that can easily be converted to cash
  - Real estate
    - Home, condominium, vacation property, etc
  - Personal possessions — automobiles and other personal belongings
    - Difficult to convert to cash
    - The values have to be revised over time to adjust for **depreciation**
  - Investment assets
    - Funds for long-term financial needs
    - Fluctuate in value

Determining Amounts Owed

- The amounts owed to others are **liabilities**
- A liability is a debt you owe now, not you may owe in the future
- Liabilities fall into two categories
  - Current liabilities
    - Debts must be paid within a short time, usually less than a year
    - Medical bills, tax payments, insurance premiums, cash loans and charge accounts
  - Long-term liabilities
    - Debts need not to pay in full until more than a year from now
    - Auto loans, education loans and mortgages

Computing Net Worth

- **Net worth** is the difference between total assets and total liabilities
- It does not calculate the money available to use, but indicates your financial position on a give date
- Having high new worth does not mean no financial difficulties
- Low **liquidity** can cause **insolvency**
  - The inability to pay debts when they are due
  - Liquid assets vs current liabilities

Financial Ratios

- Financial ratios provide guidelines for measuring the changes in your financial situation.

Ratio	Calculation	Interpretation	Comment
Debt ratio	Liabilities divided by net worth	Shows relationship between debt and net worth	A low debt ratio is best
Current ratio	Liquid assets divided by current liabilities	Indicates the amount of liquid assets for every $1 of current liabilities	A high current ratio is desirable to have cash available to pay bills
Liquidity ratio	Liquid assets divided by monthly expenses	Indicates the number of months in which living expenses can be paid if an emergency arises	a high liquidity ratio is desirable
Debt–payment ratio	Monthly credit payments divided by disposable income	Indicates how much of a person's earnings goes for debt payment (excluding a home mortgage)	Most financial advisers recommend a debt–payments ratio of less than 20%
Savings ratio	Amount saved each month divided by gross income	% of income left after use	Financial experts recommend monthly savings of 5–10%

Example of a Personal Balance Sheet

Assets	HK$		Liabilities	HK$	
Liquid Assets			**Current Liabilities**		
Checking account balance	1,450		Medical bills	150	
Savings/Money market accounts	5,235		Credit card balance	3,340	
Cash value of life insurance	3,685		Balance due on auto loan	1,750	
Total liquid assets		10,370	Total current liabilities		5,240
Real Estate			**Long-term Liabilities**		
Current market value of home		189,900	Mortgage	91,600	
Personal Possessions			Student Laon	2,960	
Market value of automobile	8,000		Total Long-term Liabilities		94,560
Furniture and appliances	5,900		**Total liabilities**		99,800
Sterero and video equipment	4,800				
Home computer	1,400				
Total household assets		20,100			
Investment Assets					
Retirement accounts	26,780				
Mutual funds	11,890				
Total investment assets		38,670			
Total assets		259,040			
Net worth				159,240	

Cash Flow Statement

- Cash flow is the *actual* inflow and outflow of cash during a given time period
  - Inflow: earnings, interest, dividend
  - Outflow: rent, food, loan payment
- Cash flow statement (personal income and expenditure statement) is a summary of cash receipts and payments for a given period
  - Provides data to prepare for a budget
- 3 steps to prepare for a cash flow statement
  - Record income
  - Record cash outflow
  - Determine net cash flow

Step 1: Record Income

- Income is the inflows of cash for an individual or a household
  - Money earned from a job
  - Commissions
  - Self-employment incomes
  - Interest
  - Dividends
  - Gifts
  - Grants
  - Scholarships
  - Pensions
  - Government payments

Step 1: Record Income

- Sometimes, you cannot use the entire of your salary
  - You need to pay tax and other items
- In some countries, taxes and other items will be deducted automatically from the month salary
- The money left for use is called **take-home pay** or **disposable income**
- **Discretionary income** is money left over after paying for housing, food, and other necessities
  - Ranges from less than 5% for people under 25 to more than 40% for the elderly

Step 2: Record Cash Outflows

- Cash outflows can be divided into two major categories
- **Fixed expenses**
  - Payments that do not vary from month to month
    - Rents, mortgage payments, instalment loan payments, internet services charges, etc
    - Money set aside each money for payments due once or twice a year
- **Variable expenses**
  - Flexible payments that change from month to month
    - Food, clothing, utilities, recreation, medical expenses, gifts and donations, etc
- Keeping record on expenses can be a very tedious job.
  - Especially, when many costs may be met using cash where no record is normally kept
- Smart phone and computer apps can be helpful

Step 3: Determine Net Cash Flow

- The difference between income and outflows can either be positive or negative
  - Positive: income > outflow
    - **Surplus**, the source of saving, investment or paying off debts
  - Negative: income < outflow
    - **Deficit**: financed by the withdrawals from savings or borrowing

Cash flow statement for the month ended September 30, 2016			
Income (cash inflows)			
Salary	10,875		
Interest earned on savings	85		
Earnings from investment	155		
Total income			11,115
Cash outflows			
Fixed Expenses			
Rent	2,875		
Loan payment	540		
Life insurance	80		
Total fixed outflows		3495	
Variable expenses			
Food at home	650		
Food away from home	420		
Clothing	375		
Personal care	212.5		
Recreation	250		
Electricity	120		
Total variable outflows		2027.5	
Total outflows			5522.5
Cash surplus (deficit)			5592.5

Budgeting

- **Budgeting** is a fundamental tool that enables individuals to understand their pattern of income and expenses and provides opportunity to regulate their expenditure and take control of their finances.
- A budget is a financial plan that compares an individual's expected future income and expenditure.
- Ensure that personal expenditure does not exceed income
- Planning for the unexpected is one of the key to successful management of personal finances.
  - Facing a serious illness
  - Being made redundant

A Plan for Effective Budgeting

- Seven steps to set up a budget
  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

Set Financial Goals

- Your future plans are the foundation for a financial direction
- Financial goals are plans for your spending, saving, and investing.
- Understanding your goals is the source of estimating amount to save
  - You plan to go for a trip to Europe after graduate
  - You plan to study a Master degree after graduate
- A specific target motivates people to take action

Estimate Income

- After setting goals, you need to estimate available money for a given time period
  - A common budget period is a month
  - Many payments are due each month
- In determining available money, include only money that you are sure you will receive
  - Estimate your income of the low side to help avoid overspending
  - Bonuses, gifts, or unexpected income should not be considered until actually received
  - Budgeting income can be difficult if earnings vary by season or income is irregular

Budget an Emergency Fund and Savings

- To set aside money for unexpected expenses or loss of income
- Financial advisers suggest that an emergency fund representing three to six months of living expenses be established for use in periods of financial difficulty
- This amount vary based on a person's life situation and employment stability
- A frequent budgeting mistake is to save the amount your have left at the end of the month
- Saving is vital for long-term financial security
  - "Pay yourself first"

Budget Fixed Expenses

- The amount you budget for various items will depend on your current needs and plans for the future
- Suggestion for different life situations

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

Budget Variable Expenses

- Planning for variable expenses is not as easy as budgeting for savings or fixed expenses
  - Fluctuate by household situation, time of year, health, economic conditions, and a variety of other factors
- Estimation done on past spending and changes in cost of living

Record Spending Amounts

- After having established a spending plan, you need to keep track of your actual income and expenses
- This process is similar to preparing a cash flow statement
- A **budget variance** is the difference between the amount budgeted and the actual amount received or spent
  - Expenses
    - Deficit — actual spending > planned spending
    - Surplus — actual spending < planned spending
  - Incomes
    - Deficit — actual income < planned income
    - Surplus — actual income > planned income

Review Spending and Saving Patterns

- Budgeting is a circular, ongoing process
- You will need to review and perhaps revise your spending plan on a regular basis
- *Review your financial progress*
  - Review areas where spending has been more or less than expected
  - Prepare an annual summary to compare the actual spending with budgeted amounts for each month
  - Find out the areas where changes in your budget may be necessary

Review Spending and Saving Patterns

- *Revise your goals and budget allocations*
  - Most common areas of overspending: entertainment and food (especially away–from–home–meals)
  - Common budget adjustment techniques: Purchasing less expensive brand items; buying quality used products; avoiding credit card purchases
  - When household budgets must be cut, spending is most frequently reduced for vacations, dining out, cleaning service, and charitable donations
  - You may also revise your financial goals.
    - Are you making progress toward achieving your objectives?
    - Have changes in personal or economic conditions affected the desirability of certain goals?
    - Have new goals surfaced that should be given a higher priority?

Psychology of Successful Budgeting

- Successful budgets are commonly viewed as being
  - *Well planned* — takes time and effort; involve everyone affected
  - *Realistic* — not designed to prevent you from enjoying life but to help you achieve what you want most
  - *Flexible* — an easily revise budget help to cope with unexpected change in life situation and expenses
  - *Clearly communicated* — it should be written and available to all household members
- A *mental budget* may be more appropriate to young single adults then parents with children

Monthly Budget for Ho

Financial goal: Reducing credit card debt

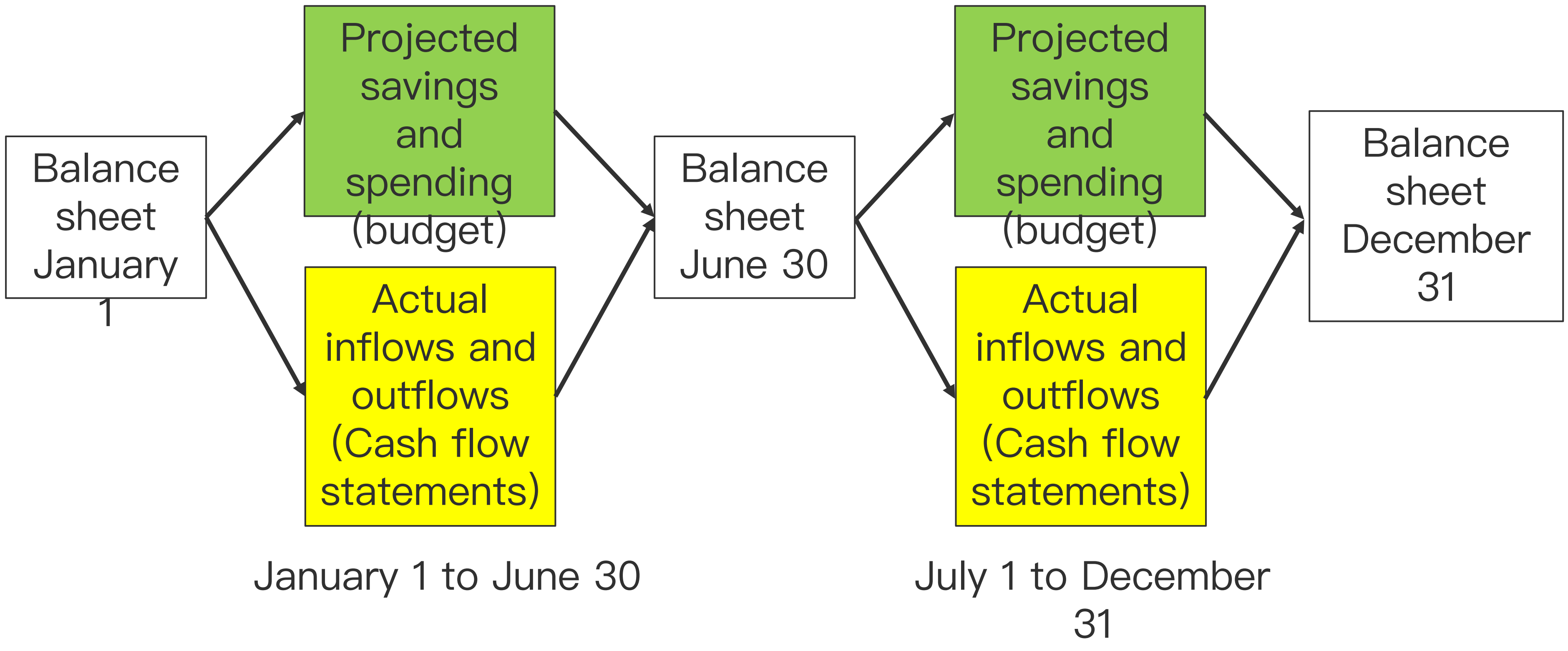
	Budgeted Amounts $	Budgeted Amounts %	Actual Amounts	Variance
Projected inflows				
Salary	28740	100	28740	/
Projected outflows				
Emergency Fund and Savings				
Emergency fund savings	1150	4	1150	/
Savings for vacation	1250	4	1250	/
Savings for investments	2000	7	200	/
Total savings	4400	15	4400	/
Fixed Expenses				
Rent	12000	42	12000	/
Life insurance	320	1	320	/
Total fixed expenses	12320	43	12320	/
Variable expenses				
Food	6740	23	6220	-520
Utilities (phones, electric, water, internet)	1200	4	1130	-70
Clothing	500	2	400	-100
Transporation	1300	5	1420	120
Entertainment	1500	5	1610	110
Miscellaneous expenses	780	3	600	-180
Total variable expenses	12020	42	11380	-640
Total outflow	28740	100	28100	-640

Money Management and Achieving Financial Goals

- Your personal financial statement and budget allow you to achieve your financial goals with
  1. Your balance sheet: reporting your current 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
- Many people prepare a balance sheet on a periodic basis
- Between those points in time, your budget and cash flow statement help you plan and measure spending and saving activities.

Money Management and Achieving Financial Goals

- Example
  - You might prepare a balance sheet on January 1, June 30, and December 31.



Selecting a Saving Technique

- Most people find saving difficult
- Financial advisers suggest these methods to make it easier
  1. Each payday, deposit an amount (a % of income or a specific amount) in a savings account not readily available for regular spending
  2. Payroll deduction — buying funds or saving plans which automatically deduct an amount from your payroll account
  3. Saving coins or spending less on certain items can help you save
  4. *Give your parents addition money*

Calculating Savings Amounts

- To achieve your financial objectives, you should convert your savings goals into specific amounts
- Using the time value of money calculations can help you calculate progress toward achieving your financial goals
- Your use of a savings or investment plan in vital to the growth of your money
- Small amounts of savings can grow faster than most people realize

Calculating Savings Amounts

- How much will you have if you save $10 per day into a deposit which gives daily interest of 0.014% from now till you graduate?