F1 – Project-Stage 7: Creating a Budget and Planning for the Unexpected

TCHE322

Thomas (2009). Chapter 3
Lawrence et al (2011). Chapter 2
Tillery, S. M., & Tillery, T. N. (2017). Chapter 4
CFP Handbook (2015). Chapter 10

Personal finance planning

Personal finance planning process

1. Define financial goals.

2. **Develop financial plans** and strategies to achieve goals.

3. Implement financial plans and strategies.

4. Periodically develop and implement budgets to monitor and control process toward goals.

5. Use financial statement to evaluate results of plans and budgets, taking corrective action as required.

6. Redefine goals and revise plans and strategies as personal circumstances change.

Essential Information of personal financial plans *

1. A summary of the goals

2. Significant assumptions and justification

3. **Estimates**

4. Recommendations

5. A description of limitations on the work performed

6. The recommendations in the engagement should contain qualifications to the recommendations if the effects of certain planning areas on the client's overall financial picture were not considered.

** Adapted from Paragraph .35, Statement on Standards in Personal Financial Planning Services No. 1*

Schedule of lectures

Project topic covered

- Budget
- Expect the unexpected

Groupwork project activities

- Dealing with the uncertainties
- Budget allocation

Financial statements and budget

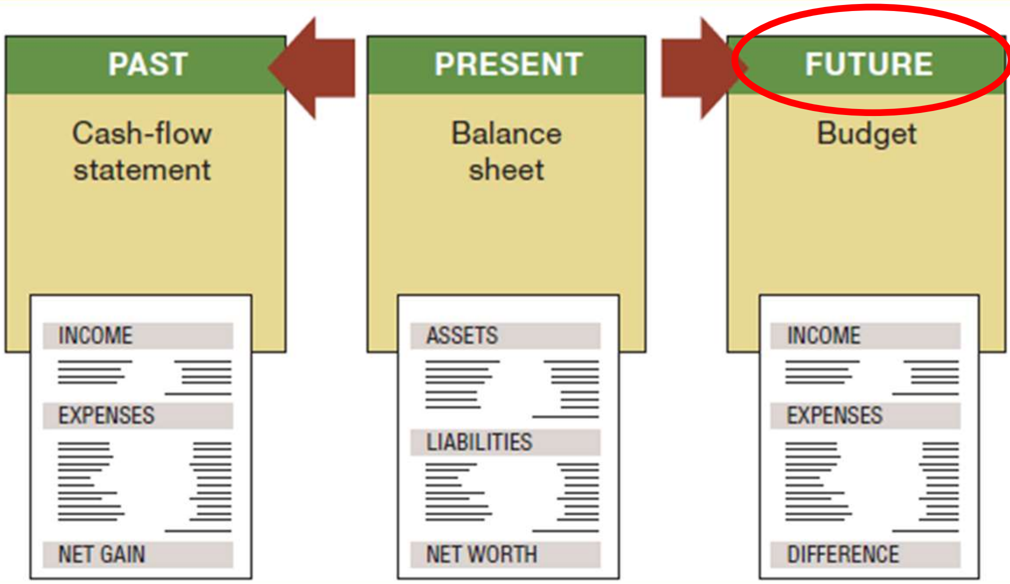


Figure 3.4
About Financial Statements and Budgets

Any uncertainty??

How could they affect the budget?

Budget: a statement that estimates the financial resources and expenditures for a given period.

Budgets are actually pro-forma or forecasted cash-flow statements that are used for the purpose of tracking actual expenses relative to the amount budgeted for them.

Make and Reconcile Budget Estimates

Budget estimates Projected dollar amounts to receive or spend in a budgeting period.

Take-home pay/disposable income Pay received after employer withholdings for taxes, insurance, and union dues.

Discretionary income Money left over after necessities such as housing and food are paid for.

Make and Reconcile Budget Estimates

Revise Budget Estimates When initial expense estimates exceed income estimates, three choices are available:

(1) earn more income,
(2) cut back on expenses, or
(3) try a combination of more income and fewer expenses.

The process of reconciling needs and wants is a healthy exercise.

- identify your priorities by telling you what is important in your life at the current time, and
- identify areas of sacrifice that you might make. Revising your short-term financial goals may also be required.

You have no choice: You must reconcile conflicting wants to revise your budget until total expenses do not exceed income. Perhaps you can change some “must have” items to “maybe next year” purchases.

Case study 5

Harry and Belinda Johnson

Figure 3.5

Goals Worksheet for Harry and Belinda Johnson

Date worksheet prepared Feb. 20, 2008

1 LONG-TERM GOALS	2 AMOUNT NEEDED	3 MONTH & YEAR NEEDED*	4 MONTHS TO SAVE	5 DATE START SAVING	6 MONTHLY AMOUNT TO SAVE (2 ÷ 4)
European vacation	$3,000	Aug. 2010	30	Feb. '08	$100
Down payment on new auto	5,000	Oct. 2011	45	Jan. '08	111

Date worksheet prepared Feb. 20, 2008

1 INTERMEDIATE-TERM GOALS	2 AMOUNT NEEDED	3 MONTH & YEAR NEEDED*	4 MONTHS TO SAVE	5 DATE START SAVING	6 MONTHLY AMOUNT TO SAVE (2 ÷ 4)
Down payment on home	$26,078	Dec. 2013	60	Jan. '08	$435

Date worksheet prepared Feb. 20, 2008

1 SHORT-TERM GOALS	2 AMOUNT NEEDED	3 MONTH & YEAR NEEDED*	4 MONTHS TO SAVE	5 DATE START SAVING	6 MONTHLY AMOUNT TO SAVE (2 ÷ 4)
Partial down payment on new auto	$1,332	Dec. '08	12	Jan. '08	$111
House fund	4,815	Dec. '08	12	Jan. '08	401
Christmas vacation	700	Dec. '08	12	Jan. '08	58
Summer vacation	600	Aug. '08	6	Mar. '08	100
Anniversary party	250	June '08	5	Feb. '08	50

*Goals requiring five years or more to achieve require consideration of investment return and after-tax yield, which will be presented in Chapter 4.

Plan cash flow

Cash-flow calendar Budget estimates for monthly income and expenses.

Table 3.8 Annual Budget Estimates for 2009 for Harry and Belinda Johnson

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Yearly Total	Monthly Average
INCOME														
Harry's salary	$2,500	$2,500	$2,500	$2,500	$2,500	$2,500	$2,575	$2,575	$2,575	$2,575	$2,575	$2,575	$30,450	$2,537.50
Belinda's salary	3,000	3,000	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	3,300	39,000	3,250.00
Interest	24	24	24	25	26	27	27	28	30	31	33	33	332	27.67
Trust	0	0	0	0	0	0	0	0	3,000	0	0	0	3,000	250.00
Total Income	$5,524	$5,524	$5,824	$5,825	$5,826	$5,827	$5,902	$5,903	$8,905	$5,906	$5,908	$5,908	$72,782	$6,065.17
EXPENSES														
Fixed Expenses														
Rent	$900	$900	$900	$900	$900	$900	$950	$950	$950	$950	$950	$950	$11,100	$925.00
....														
Total fixed expenses	$3,707	$3,707	$3,887	$3,967	$3,902	$4,627	$4,038	$3,916	$4,038	$4,038	$4,038	$4,478	$48,343	$4,028.58
Variable Expenses														
Savings/investments	$0	$0	$0	$0	$0	$0	$0	$0	$3,000	$0	$0	$0	$3,000	$250.00
Revolving savings fund	140	140	140	140	140	0	250	0	215	190	0	0	1,355	112.92
Food	350	350	350	350	350	350	350	350	350	350	350	350	4,200	350.00
....														
Total variable expenses	$1,817	$1,817	$1,937	$1,858	$1,924	$1,900	$1,864	$2,237	$4,867	$1,868	$2,075	$2,680	$26,844	$2,237
Total Expenses	$5,524	$5,524	$5,824	$5,825	$5,826	$6,527	$5,902	$6,153	$8,905	$5,906	$6,113	$7,158	$75,187	$6,265.58
Difference (available for spending, saving, and investing)	$0	$0	$0	$0	$0	−$700	$0	−$250	$0	$0	−$205	−$1,250	−$2,405	
Revolving savings withdrawals						700		250			205	200	1355	
Uncovered shortfall	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	−$1,050	−$1,050	

Table 3.9 Cash-Flow Calendar for Harry and Belinda Johnson

Month	1 Estimated Income	2 Estimated Expenses	3 Surplus/Deficit (1 − 2)	4 Cumulative Surplus/Deficit
January	$ 5,524	$ 5,524	$ 0	$ 0
February	5,524	5,524	0	0
March	5,824	5,824	0	0
April	5,825	5,825	0	0
May	5,826	5,826	0	0
June	5,827	6,527	−700	−700
July	5,902	5,902	0	−700
August	5,903	6,153	−250	−950
September	8,905	8,905	0	−950
October	5,906	5,906	0	−950
November	5,908	6,113	−205	−1,155
December	5,908	7,158	−1,250	−2,405
Total	**$72,782**	**$75,187**	**−2,405**	

Summary form

Planning for occasional, nonmonthly expenditures

"borrow from yourself" by using a **revolving savings fund**

revolving savings fund Variable budgeting tool that places funds in savings to cover large irregular or higher-than-usual expenses.

Short-time financial goals

Table 3.10 Revolving Savings Fund for Harry and Belinda Johnson

Month	Large Expenses	Amount Needed	Deposit into Fund	Withdrawal from Fund	Fund Balance
January		$ 0	$ 140	$ 0	$ 140
February		0	140	0	280
March		0	140	0	420
April		0	140	0	560
May		0	140	0	700
June	Party and insurance	700	0	700	0
July		0	250	0	250
August	Vacation	250	0	250	0
September		0	215	0	215
October		0	190	0	405
November	Holiday gifts	205	0	205	200
December	Holiday gifts and vacation	1250	0	200	0
Total		$2405	$1355	$1355	–$1050

Spending control

- ✓ Monitor unexpended balances to control overspending
- ✓ Budget for shopping trips
- ✓ Use a subordinate budget*
- ✓ Pay by check to record the purpose of expenditures
- ✓ Keep track of credit transactions
- ✓ Justify exceptions to avoid lying to yourself
- ✓ For the strongest control, use the envelope system**

*subordinate budget Detailed listing of planned expenses within a single budgeting classification.

**envelope system Placing exact amounts into envelopes for eachbudgetary purpose.

Did You Know?...

The Top 3 Financial Missteps in Budget Planning

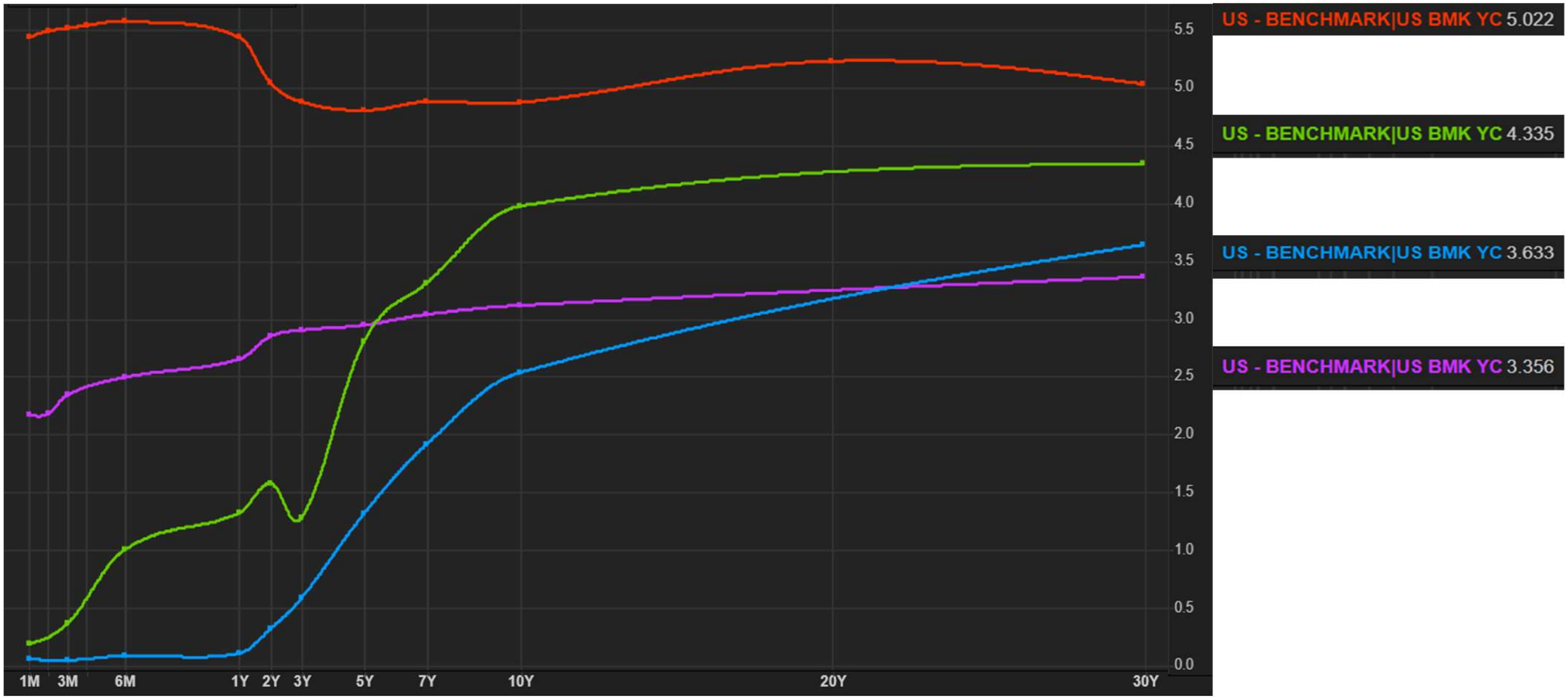
People slip up in budget planning when they do the following:

1. Fail to plan for occasional, nonmonthly expenditures
2. Underestimate how much they spend each month
3. Use credit cards to "balance" their budget

Personal Financial Planning Assumption and Expect the unexpected

- Macroeconomic conditions encompass and influence many of the fundamental assumptions used in the financial planning process, including but not limited to interest rates, inflation rates, and capital market rates of return.
- Some economic concepts and measures need to be considered in making financial planning:
    - Supply and demand
    - National income accounts (including GDP)
    - Business cycles (unemployment, recession, fiscal and monetary policy)
    - Interest rates (including their term structure and the yield curve)
    - Inflation
    - Exchange rates

Yield curves in US over time



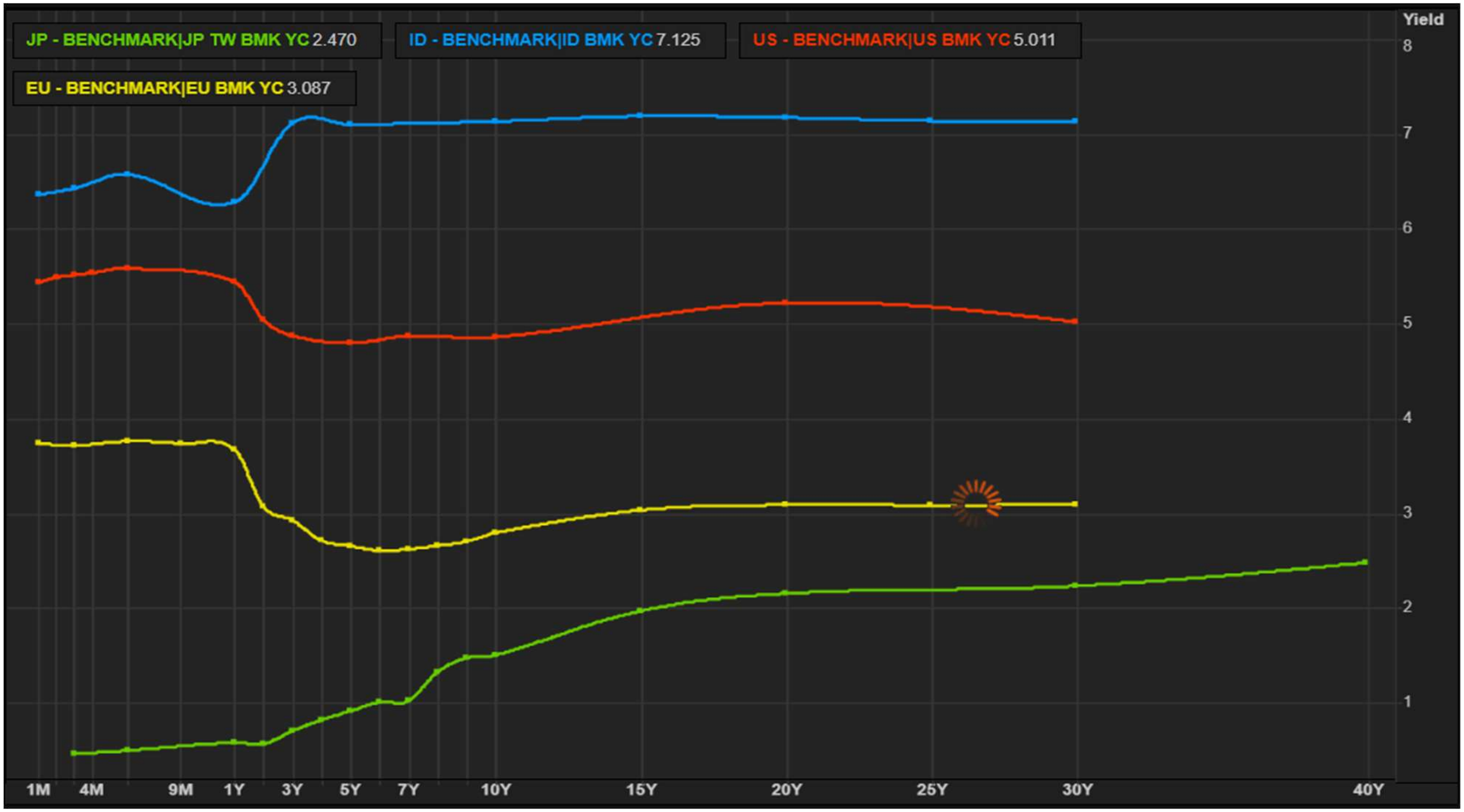
30/10/2023

30/10/2008

30/10/2013

30/10/2018

Yield curves on 31 October 2023 in several countries



Personal Financial Planning Assumption and Expect the unexpected

- When analyzing information obtained while performing a PFP engagement, the member should:

a. evaluate the reasonableness of estimates and assumptions that are significant to the plan;

b. use assumptions that are appropriate and consistent with each other;

c. consider the interrelationship of various PFP activities. (Ref: par. .03).*

Some types of assumptions addressed in the PFP process:

- ✓client assumptions: Client assumptions about goals need to be analyzed to understand whether the goals are reasonable, or unreasonable and unattainable.
- ✓inflation, rates of return, longevity, and tax rates

** Paragraph .31, Statement on Standards in Personal Financial Planning Services No. 1*

Groupwork project activities - **Creating a Budget and Planning for the Unexpected**

- Mini case study practice
- Dealing with the uncertainties
- Budget allocation

Mini case study

A client, Joseph (age 42), who is a single dad to five-year-old twin girls, came into your office today. His wife passed away last year, and he received $200,000 in life insurance. He provides you, the financial planner, with the following information for the upcoming year:

> income $95,000; principal and interest payments on his home mortgage $14,000; homeowner's insurance $1,000; property taxes $5,500; living expenses $45,000, including after-school care for his daughters; credit card debt payments $7,500; savings $5,000; student loan payments $6,000; and car payments $6,000.

He plans on using the life insurance to fund his daughters' college educations; unfortunately, he has needed to dip into the funds to pay for living expenses and only $160,000 remains.

An examination of Joseph's cash flow may allow for him to free up future cash flows so he can replenish some of the funds he hoped to use for his daughters' educations.

Create a budget for his daughters' college educations. All relevant assumptions are required.

Harry and Belinda Johnson case study

Following up the case study 5 Harry and Belinda Johnson, create budgets for their goals.