Chapter Outline

LESSON 1
Creating a Budget

LESSON 2
Savings and Bank Accounts

LESSON 3
Real-Life Issues in Buying and Selling

“The safest way to double your money is to fold it over and put it in your pocket.”

Kin Hubbard, cartoonist and humorist
Quick Write

Why do you think it is important for you to have a financial plan? Do you think a plan is just as important for someone who is wealthy as it is for someone who’s just getting by? Why or why not?

The Components of a Personal Financial Plan

Would you put on a big party without planning? Not likely! First, you’d probably decide on the date and time. Then you’d figure out where to have it: at your house? At a restaurant? You would decide on the food, decorations, and music. Of course, you’d have to make a list of guests and send out invitations. Before the plans went too far, you’d have to make sure you could afford everything.

Planning for your financial future is much more important than planning a party. But it, too, involves answering a series of questions. What are your goals? Do you want to go to college? Buy a car? Buy a home? Build up a savings account? Start a family and then help your children become financially secure? Take an early retirement? All these things require money. And if you want to have money, you have to make a plan for how you’re going to get it and how you’re going to save and spend it.

Planning for your financial future involves answering a series of questions about your goals.

Courtesy of Lisa F. Young/Shutterstock
This textbook is about life skills and career opportunities. The tools offered in this book and in this chapter provide knowledge about money, how it is used, spent, and invested. They provide a starting point for building an entire set of needed skills in life, as well as finding a good career.

This chapter will provide you with the knowledge and skills to make decisions about how to use money and plan for wise spending and saving throughout your lifetime.

The word finance refers to management of money, and personal finance refers to how you manage your money and other things of financial value. A personal financial plan can make the difference between being able to do the things you want to do and feeling that you’ll never reach your goals in life.

Advantages of Understanding Personal Finance

An understanding of personal finance helps you:

- **Make good financial decisions**—Good financial decisions will increase the wealth you accumulate over time and make it more likely that you’ll be able to purchase the products and services you want.

- **Evaluate the opinions of financial advisers**—Financial advisers are experts in financial planning. When you’re older, you may want to get advice from such a professional. But it will be up to you to determine whether you’re getting good advice. You’ll also need to know the right questions to ask to feel more secure. No one can predict the future. The firm you’ve worked with for years may go out of business. You may become seriously ill and not be able to work. An investment may turn sour. The more you know about financial planning, the better you’ll be able to adapt to unexpected circumstances.

And who knows? If you decide, as you study the lessons in this book, that you want to pursue a career path in personal finance, you might want to become a financial adviser yourself.
Creating a Personal Financial Plan

The starting point in mastering your personal finance is to create a financial plan, or a document that outlines your financial goals and how you plan to reach them. A financial plan sets forth your decisions in six areas:

1. **Managing Your Budget**

   Your budget is a detailed summary of expected income and expenses during a given period. Income (money coming in) is what is earned or made available to you that you expect to receive on a regular basis. Expenses (money going out) are amounts of money you spend to pay bills or for other needs and wants. Needs are things that you must have to sustain your livelihood. Basic meals, necessary school expenses, and transportation money to get to school are examples. Wants are things that you do not have to have, but would like to have, or own.

   Let’s take a look at planning a school activity such as an awards banquet. Building a budget will allow you to make an informed decision about how many people to invite, how much food, drink, and decorations you can afford, and what type of entertainment to provide. You’ll also want to think about how many tables and chairs you may have to rent. You may have to consider how many tickets to sell. Some additional research will allow you to make better use of available money by checking local stores or catering services for the best deals in food and beverages.

   To use a budget as part of a long-term financial plan, rather than for a specific event such as a party, you list your expected expenses and income over a certain period. A financial plan is a long-term document. Creating a plan allows you to set financial goals. The plan can be for next year, the next 10 years, or even a lifetime.

   Based on the information in your long-term budget, you can decide if your income will be adequate to enable you to have the standard of living that you want to have. Your goal should be for your income to be greater than, not just equal to, your expenses. If this is the case, you will be able to save, and saving is essential for creating wealth and building a good future.

2. **Managing Your Liquidity**

   A financial plan must take into account your liquidity. Liquidity is access to funds to cover a short-term cash need. Even though they’ve made good plans, people often need money for an unexpected expense. They might own valuable items, such as land, a house, or a car, but those items will be useless if they need cash quickly. In that case, they will need liquidity.

   If liquidity is a problem, some people borrow money. Borrowing is usually necessary to finance a major expense, such as a college education, a house, or a new car. But borrowing has risks, as you’ll learn later in this lesson.

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3. Financing Your Large Purchases

**Financing** is obtaining or providing money for a specific purpose. The person obtaining the money is the borrower, and the provider of the money (usually a bank) is the lender. Financing generally comes in the form of loans.

For example, if you plan to go to college, your parents or guardian may be able to pay part of the cost from their savings. You may be able to contribute something from your earnings. But college can be expensive, and you and your family may not have enough to pay for everything. In this case, you may want to take out a student loan. This loan will cover the difference between what you and your family can give and the total cost of your education.

Most people need to take out loans at one point or another. But you should never get dependent on loans, because you must pay all those loans back. And when you repay them, you’ll have to pay interest, which is a charge on borrowed money. Interest charges seem small, but they add up.

For example, say you borrowed $10,000 to pay for part of your college tuition. The interest rate on the loan was 5 percent per year. If you didn’t make any payments in the year after you got your loan, you would have to add 5 percent, or $500, to the $10,000 that you borrowed. If you made no payments on your loan for 10 years, your interest would total a whopping $6,289. Of that sum, $5,000 would be interest on the $10,000 you had borrowed. The remaining $1,289 would be interest on accumulated unpaid interest, which is called compound interest.

Most people pay back their loans gradually. Their interest payments go down, rather than up, over the years. Still, interest payments add up, and you need to be aware of and keep track of them. More importantly, you should not become dependent on loans since interest payments are funds lost to you, and gained by someone else (the lender).

**Buying an item like a TV may require you to finance payments over time.**

*Courtesy of Yuri Arcurs/Shutterstock*
4. Protecting Your Assets

An asset is *something of value that you own*. Maybe you own a car. Or you might own stock in a company. Perhaps your collection of baseball cards is valuable. Or you may have inherited a gold ring from your grandmother or a piece of equipment from your grandfather’s wood shop. These are tangible assets. *Tangible* means *a physical item that you can touch*.

In making a financial plan, you will want to protect your assets. You can do this by buying insurance. **Insurance** is *an agreement between two parties under which one party—usually an insurance company—guarantees the other that if an asset is lost or destroyed, the insurance company will pay for it.* To insure an asset of any kind, you must pay a monthly fee, or premium, to the insurance company. We will discuss more about insurance in Chapter 2, Lesson 2.

Insurance also covers *intangible* assets—assets that are not tangible. For example, you can insure your health or your life. Health insurance covers medical benefits. Life insurance pays a certain amount of money, or benefit, should you die.

You will want to insure your most important assets. For example, if you buy a car you will need to buy insurance. Then, if you have an accident and the car is damaged, your insurance policy will pay for the repairs.

5. Investing for the Future

Investments are an important part of a financial plan because they are one of the best ways to help you increase your wealth over a desired period or over your lifetime. An **investment** is *something you own that you expect to increase in value over time*. At some point, you may buy a house and expect it to increase in value. That’s an investment. One type of investment to consider is **stocks**, which are *funds raised by companies through the sale of shares*. **Shares** are *equal parts into which company stocks are divided*. Investors may buy shares, thereby giving them part ownership in a company. When you purchase a **bond**, another kind of investment, you are **investing to help a company or government agency raise funds for a return greater than the money you invested**. A third popular investment is a **mutual fund**, an investment that often includes a mix of stocks, bonds, or other securities purchased in shares.

Some people buy art or jewelry because of its investment value. A car is not an investment because it typically decreases in value over time.

6. Investing in Your Retirement

A financial plan is a long-term document, so retirement should be a part of it. **Retirement** is *the period (usually later in life) during which you no longer work full time at a job*.

People retire at different ages. In the past, many people retired at age 65, when they qualified for Social Security benefits. However, recent federal law has changed the ages for Social Security eligibility, depending on a person’s year of birth. Today, many don’t
qualify until they are older than 65. In addition, many private retirement plans have changed. In general, retirement ages have gone up because people are living longer and can work longer.

If you entered military service, you could retire after just 20 years of service (although you may need to get another job at that time, possibly allowing you a second retirement income when you reach retirement age).

During retirement, you will not be getting a paycheck as you did when you had a full-time job, but you will still need money to live. So making sure you have enough money for retirement is important. And the better you plan for your future, the more likely you can choose when to retire. If you love your job and want to go on working into your 70s, that’s fine. However, if you would rather retire and move on to something else, you will need a steady source of retirement income.

You probably think that retirement seems so far away that it’s not worth thinking about. But just ask a grandparent or another older adult. Retirement age comes a lot quicker than most people think it will. If you start planning for retirement now, you’ll be glad you did. The longer you save money, the more it will earn for you over the years between the time you save or invest and the time you retire.

The Steps for Developing a Personal Financial Plan

Now that you know the basic ingredients of a financial plan, you should develop your own. Ready to start? Here are the six steps involved in creating a financial plan:

1. Establish Your Financial Goals

Zig Ziglar, the well-known motivational speaker, may have said it well that “money isn’t the most important thing in life but it’s reasonably close to oxygen on the ‘gotta have it’ scale.”

The first question might sound obvious, but it’s important: How important is money to you? Some people get along well with just the basics. Others want a more luxurious lifestyle.

Next, consider what you need money for. Do you want to buy a new car every year? Pay for college, or even graduate school? Help your family? Make a down payment on a home? Contribute to a worthy cause? To make your plan work, you must have goals. After all, as the saying goes, if you do not know where you are headed, any path will take you there.
When you set those goals, be realistic. For example, a financial plan that requires you to save more than half your income is probably not realistic, no matter how much you earn. A plan that requires you to accumulate $1 million within one year is certainly not realistic (unless you beat enormous odds and win a state lottery).

Timing is important. A financial plan usually covers three time segments:

- A short-term plan, usually covering the next year—the goal of a short-term plan might be to buy a car within six months.
- An intermediate-term plan, covering one to five years—for someone your age, the goal of an intermediate-term plan might be to save enough money for college tuition.
- A long-term plan, which covers more than five years—a long-term goal might be to save enough to retire by age 55.

2. Consider Your Current Financial Position

Look at your present financial situation. Any future decisions about what you want to buy, how much money to save or borrow, and where to invest your money, depend on it. If you’re lucky enough to have plenty of money, your financial decisions will be very different from those of someone who is struggling to make ends meet.

Chances are that your current financial position is limited. But that will change, and you need to know what to do with your finances when it does. The career path you choose and the amount of money you earn will greatly influence your financial position. So if your goals require a lot of money, you will want to choose a well-paying career.

But don’t choose a career just for the money. If you don’t enjoy your work, you’ll be miserable, no matter how much money you’ve got in the bank. Try to find an equal balance.

3. Identify and Evaluate Alternatives to Achieve Your Goals

If one of your goals is to save $200,000 within 10 years, you could try to do it by putting a big portion of your income each month into a savings account. Or you could put your earnings into an investment. Of these two alternatives, the first choice is safer. The US government insures the money in most bank and credit union savings accounts up to $250,000.

Savings accounts have another advantage. They pay you interest. While you pay interest on a loan, you earn interest on a savings account. The interest on your savings account will be a small percentage, paid monthly, of the amount that you have saved.
For example, say you deposited $1,000 into a savings account at 3 percent interest. One year later, your balance would be $1,030. Although it’s not likely, let’s assume that the interest rate stayed the same for the next nine years. Even if you made no additional deposits to your account, you would have a balance of $1,349 by the end of that time—thanks to compound interest.

A second way to reach your goal is to buy stocks or another investment. If you do, you’ll face a certain degree of risk, or uncertainty as to the outcome of an investment. The government does not insure stocks. You might make a lot of money buying stock from a company—more than you ever could through savings. But if the company has problems, you could lose some, or even all, of the money you invested.

You can also buy bonds. Bonds have much less risk than stocks, but the amount of money you earn from them is usually less. Both bonds and stocks are long-term investments. Many people have both savings accounts and investments in stocks and bonds. The portion of their income that they invest in each depends on how much risk they are willing to accept.

Financial advisers often advise you to spread your money into different types of investments in order to protect against big losses that may occur in any one type of investment.

4. Select the Best Plan to Achieve Your Goals

Choose the plan you think will best help you reach your goals. It should be a plan you can stick with. It should also have an acceptable level of risk. Set spending limits, or the amount above which you should not spend if you are to meet your financial goals.

5. Evaluate Your Plan

Don’t put your plan in a drawer and forget about it. Review it regularly to see how you’re doing. You may have decided that you want to save $100 a month, but after a year you find that this is impossible. If that’s the case, it’s time to reevaluate how much you can save.

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6. Revise Your Plan

Look over each item on your plan. Note where it’s worked and where it hasn’t. Then think about how your financial situation and goals have changed since you drew up your plan. Perhaps you’ve gotten a new job, with a 15 percent increase in pay. Or maybe you’ve just gotten married or had a baby. Major life changes will require changes in your financial plan.

No one can predict the future. You can only make an educated guess. When reality says you need to change, don’t be afraid to do so. Flexibility is a sign of strength, not of weakness. You’ll get better at planning with each plan you make. Financial planning should become a part of your life.

Conclusion

The point of having a budget is to compare your income versus your expenses. It helps you see what you are spending money on, and where you need to lower your spending—so you will have enough for expenses and still have money left over for savings.

Remember to set spending limits; you do not want your expenses to exceed your income.
Figure 1.1 shows a sample monthly budget for Steve Johnston. Steve is 20 years old. He’s an electrician apprentice. He’s living on his own for the first time, and finances are tight. Steve earns $24,000 a year after taxes and withholding, and wants to save at least $200 per month. His budget is in balance. In other words, the total income and total expenses are the same. That doesn’t mean that Steve is spending all the money he gets. Look closely and you’ll see that Steve has set a spending limit of $200 less than his income. In keeping with his financial plan, he’s putting $200 a month into a savings account. The next lessons will discuss how to save and invest your money, and how to make good buying decisions.

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<table>
<thead>
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<td><strong>Total Expenses</strong></td>
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**FIGURE 1.1**
Sample Monthly Budget for Steve Johnston

**CHECKPOINTS**

**Lesson 1 Review**

Using complete sentences, answer the following questions on a sheet of paper.

1. Why is a personal financial plan important?
2. What are the six areas for decision making when creating a personal financial plan?
3. What are the six steps for developing a personal financial plan?
4. What is a budget, and why is it important?

**APPLYING BUDGET SKILLS**

5. List your three financial goals for the next year, and for the next five years.

LESSON 1  Creating a Budget