3. Budgeting and Measuring Your Financial Health: Giving Every Dollar a Name

Introduction

Once you have a correct perspective on wealth, have begun your Personal Financial Plan, and have set your personal goals, the next step is to determine how you are going to attain your goals. Although some goals require only discipline and time, many goals also require careful financial planning. For these goals, it is essential to determine what resources you currently have, how much time until the resources are needed, and what additional resources are needed to help you attain those financial goals.

The purpose of this chapter is to help you measure your financial health and then create a plan to improve it. Before you can determine what you must do to get where you want to go, you must first determine where you are currently. To determine your current financial status or health, you must learn how to prepare various financial statements and learn what they represent. Once you identify from your financial statements where you are financially, and from your goals where you want to be, you can develop a plan for accomplishing your goals.

Objectives

Once you have completed this chapter, you should be able to do the following:

1. Understand the principles of successful budgeting
2. Develop and implement a budget
3. Calculate your net worth using a personal balance sheet
4. Develop a personal income statement and use it to analyze your spending

To determine where you are financially, you must first understand financial statements. Financial statements are documents that accurately reflect your personal financial position at a specific point in time. These statements help you evaluate your financial health.

There are several different kinds of financial statements. A budget records expected income and spending for the future, generally for a month or a year. A balance sheet records your assets (what you own) and liabilities (what you owe) at a specific point in time, usually at the end of a month, quarter, or year. An income statement records spending over a specific period of time, generally a month or a year. A budget is planning for future spending, a balance sheet is a record of your spending (as represented by your assets and liabilities) as of the present time, and an income statement is a record of your past spending.

Every company uses financial statements to determine how to manage themselves so as to achieve their shareholders' goals. Similarly, individuals and families can use financial statements to help them understand where they are financially and to help them meet their goals.

Understand the Principles of Successful Budgeting

Using a budget effectively will likely have a greater impact on whether or not you will achieve your financial goals than any other change you could make to your financial habits. As such, it is a critical topic. On this topic, Spencer W. Kimball said:

> Every family should have a budget. Why, we would not think of going one day without a budget in this Church or our businesses. We have to know approximately what we may receive, and we certainly must know what we are going to spend. And one of the successes of the Church would have to be that the Brethren watch these things very carefully, and we do not spend that which we do not have.[1]

If one of the reasons for the successes of large organizations, such as the LDS Church, is that those responsible watch budgets carefully, shouldn't we, as individuals and families, watch our own budgets carefully as well?

In addition to keeping a record of expected income and expenses for the coming month or year, a budget is a way of making sure your financial resources are being used for the things that matter most to you—your personal and family goals.

While it is fairly easy to record your cash inflows and outflows and to make plans for achieving your financial goals, it takes discipline and sacrifice to actually follow through on the plans you outlined in your budget. While not easy, the results are apparent. Research has shown that those who effectively budget accumulate more wealth than those who do not.

The principles of effective budgeting are simple:

1. **Know yourself.** This includes understanding your vision, goals, and plans. These have to be important for you if you want to work toward them.

2. **Spend less than you earn.** Someone said, "if you find yourself in a hole, stop digging."[2]

3. **Keep good records for spending, taxes, and other purposes.** These will be needed to help you minimize your tax payments to the government.

4. **Use a budgeting method that meets your individual and family needs and** objectives. There is not one "right way" to budget.

5. **Eliminate (unproductive) consumer debt and minimize (productive) mortgage and education debt.** As discussed earlier, debt is an enemy to growth.

Whatever method you choose, it should accomplish the above five principles.

There are five main types of budgeting methods to help meet your needs and objectives:

1. The Envelope Method
2. The 60% Rule
3. Spreadsheets
4. Budgeting Software
5. DNAH-ial Methods (Do Nothing and Hope)

The Envelope Method. The requirements for this method are few and inexpensive. You prepare envelopes for each category. The logic is to plan your spending for each month, take the money planned for each category, and place that money in individual envelopes. Once a bill comes, take the money from the corresponding envelope and pay the bill. Once the money is gone from one envelope and you need more, you must shift money between other envelopes or make do with what you have. The key is there is no getting money outside the system. It is simple and very effective if done correctly.

The 60% Solution. This method requires a journal or spreadsheet. The logic is to determine your gross salary each month and then take 60% of that amount and only spend that amount each month. You then take 20% of your salary and save it for long-term goals and 20% of your salary and save it to pay your taxes at year-end. Once you have spent your money, you cannot go outside the method for more money. While not as effective, as long as individuals stick to the 60% rule it can help significantly in the savings process.

Spreadsheet Methods. This method requires a computer and spreadsheets. The logic is to determine your gross salary and take home pay each month after taxes and other deductions. You then determine spending by categories (rows) and dates (columns), and prepare a budget for each category. As bills come in, you pay the bills and input the spending on each date (column) and row (category). If done well, you plan in adequate amounts for a financial reserve and for long-term goals. This method can be useful if it is updated regularly and reviewed often.

Computer Software Methods. The requirements for this method are more expensive. They require a computer and personal finance software, such as Mint.com (free), Quicken, Mvelopes, etc. The logic is to determine your gross salary and take home each month after taxes and other deductions. Then you determine your spending by category, and budget each category in the software program. You also determine your savings and budget each period for savings. The key is to work within your budget for each spending and saving category. As the software obtains receipts and credit card information from financial institutions directly via the Internet, you categorize the information. You can plan in adequate amounts for a financial reserve and for long-term goals. If set up correctly, this method can save significant time and effort and can be a great tool to help you achieve your goals.

DNAH-ial Methods (Do Nothing and Hope). This is the method used by most individuals, and it is the cheapest and least time consuming. It requires nothing. Individuals deny there is a concern, and hope things work out. They only respond when things get so bad that they have to act. The downside is that there is no planning, no preparation for long-term goals and objectives, and likely no savings.

Which is the best method? In my experience, the best plans are those that:

1. Are low cost and relatively easy to use;
2. Allow downloading of bills from banks and credit card companies—makes data entry easier;
3. Allow adequate categorization of spending for income, spending, reporting and tax purposes; and
4. Minimize the time spent in doing finances (I spend roughly 1-2 hours per week).

Individuals and families should use whatever method is best for them. However, what I recommend for most individuals and families is Mint.com for those starting out, spreadsheets for the few Excel wizards among us, and Quicken for more advanced users.

Develop and Implement a Budget

There is a process to creating an effective budget:

1. Know what you want to accomplish.
2. Track spending.
3. Develop a cash budget.
4. Implement your budget.
5. Compare your budget to your actual expenses and make changes where necessary to achieve your goals.

An example of a budget is found in Chart 1. In addition, examples of more detailed budgeting spreadsheets can be found in the Learning Tools section of the website (Learning Tools 4 and 31).

Step 1: Know What You Want to Accomplish

The first step in creating an effective budget is to know what is important to you and then write it down in the form of goals. In the previous section, you thought about what you wanted out of life, and you wrote down your goals. You should be working toward these goals. It is not enough to just want to save money—you should know what you are saving for. Your goals must be SMARTER: specific, measurable, achievable, reportable, time-bound, evaluated, and reassessed.

Step 2: Track Spending (Your Expenses)

The second step in creating an effective budget is generating a statement that accurately reflects your income and expenses for a month or for another specified period of time.

Certain methods of payment are easier to track than others. Checks and credit cards, for example, leave an automatic paper trail that is easy to examine at the end of a week or a month. Cash, on the other hand, is more difficult to track because an automatic physical record is not created each time it is used. To accurately track all expenses, you must keep a notebook in which you record all expenditures paid for in cash, or, better yet, record them electronically.

Chart 1. Budget Example

Monthly Budget for the Month of ________ 20XX

Income:	Budget	Actual	Difference
Wages/Salaries (After Taxes)	________	________	________
Other Income	________	________	________
Total Income	________	________	________
Expenditures			
Tithes and Offerings	________	________	________
Savings	________	________	________
Food	________	________	________
Mortgage or Rent	________	________	________
Utilities	________	________	________
Transportation	________	________	________
Debt Payments	________	________	________
Insurance	________	________	________
Medical	________	________	________
Clothing	________	________	________
Other	________	________	________
Total Expenditures	________	________	________
Income minus Expenditures	________	________	________

Budgeting software may also be helpful as you track your expenses. Software such as Intuit, Quicken, Microsoft Money, and the free Mint.com can reduce the time necessary to follow your finances. Such software is especially useful if it is tied to your bank, credit card companies, or investment accounts through the Internet. Budgeting software is a great investment that can save you time if it is set up and runs properly and in a timely manner, but it is not required to become financially self-reliant.

To develop a cash budget, you must first determine your annual income. One way to do this is to examine last year's total income and make adjustments for the current year for any additional expected work or sources of income. You should also estimate your tax liability for the current year and your monthly take-home pay.

Next, you must determine your expenses. To complete this step, refer to the record you made while tracking your expenses. First, identify all fixed expenses. Be sure your fixed expenses are truly fixed expenses. Fixed expenses are expenses those you don't directly control; they are often (but not always) monthly or semiannual expenses. Examples of fixed expenses include mortgage payments, rent, tuition and books, and life and health insurance costs. While some might consider cable TV or cell phone plans fixed expenses, they are generally variable expenses.

After you have identified your fixed expenses, identify your variable expenses. Variable expenses are expenses those you have control over—you can modify or eliminate the amount you spend on these things. Variable expenses include things like food (to a degree), entertainment, fuel, clothing, magazine subscriptions, and cable TV (contrary to some people's beliefs, you can live without cable TV, the internet, or an iPad).

If reviewing your fixed and variable expenses shows that your expenditures exceed your income, or if you find that you live month to month and do not put money into some sort of savings account, look for ways to reduce your fixed expenses and reduce or eliminate your variable expenses.

One of the worst uses of your hard-earned income is paying interest, particularly on credit card and consumer loans. Carefully consider how credit card or loan payments will impact your future income. Pay off your credit card debt and avoid consumer debt! You want to be earning interest on investments, not paying it on debts.

Heber J. Grant said:

> If there is any one thing that will bring peace and contentment into the human heart, and into the family, it is to live within [one's] means. And if there is any one thing that is grinding and discouraging and disheartening, it is to have debts and obligations that one cannot meet.[3]

I would like to recommend a better way to budget. Many individuals determine how much they will save according to how much money is left at the end of each month. They receive their paychecks, pay their tithes and expenses, and then save what they do not spend during the rest of the month. This is an incorrect pattern for budgeting monthly income because individuals are paying themselves last. I recommend a different pattern.

After you have paid your tithes and offerings to the Lord, *pay yourself a predetermined amount directly into savings* then budget and live on the remaining income. Using this pattern will help you keep your priorities in order (see Chart 3).

Gordon B. Hinckley stated:

> In managing the affairs of the Church, we have tried to set an example. We have, as a matter of policy, stringently followed the practice of setting aside each year a percentage of the income of the Church against a possible day of need. I am grateful to be able to say that the Church . . . is able to function without borrowed money. If we cannot get along, we will curtail our programs. We will shrink expenditures to fit the income. We will not borrow.[4]

Chart 2. Budgeting: The Old Way

From my work with students, I have found that the average student cannot account for about 20 percent of what he or she spends each month. Many students are not sure what is important to them, so they spend money on many different things in an attempt to find out what makes them happy. Once they understand what is important to them, write down their goals, and begin working toward those goals, they find that saving between 10 and 20 percent of their income is not a difficult challenge. They begin spending their money on things that really matter—things that take them toward their personal and family goals.

L. Tom Perry suggested something similar to this new pattern for budgeting when he wrote:

> After paying your tithing of 10 percent to the Lord, you pay yourself a predetermined amount directly into savings. That leaves you a balance of your income to budget for taxes, food, clothing, shelter, transportation, etc. It is amazing to me that so many people work all of their lives for the grocer, the landlord, the power company, the automobile salesman, and the bank, and yet think so little of their own efforts that they pay themselves nothing.[5]

I strongly recommend that students, after graduating, set a goal to save between 10 percent and

20 percent of every dollar they make after college. My wife and I set that goal nearly 30 years ago, and it has made a significant difference in the life we live today.

Chart 3. Budgeting: The Better Way

Step 3: Develop a Cash Budget (A Better Way)

The third step in creating an effective budget is to develop a cash budget. A cash budget is a plan for controlling cash inflows and outflows. Its purpose is to balance income with expenditures and savings. The old method for preparing a cash budget is found in Chart 2.

Step 4: Implement Your Budget

The fourth step in creating an effective budget is to try your budget for a month. Record all income and expenses in their proper categories; accurate record-keeping is a crucial part of good budgeting. Add up all the amounts listed in each category, and make a note of how much you have left over in each category at the end of each week. Be financially prudent—don't buy things you don't need or haven't budgeted for.

Adjust your plan as necessary to make it work for you. Try to be financially prudent, and use each month as a learning experience to help you do better the next month.

For income, negative is under budget and positive is over budget. For taxes and expenses, negative is under budget and positive is over budget.

If you can't figure out where you are, the best map in the world can't help you get where you want to go. A well-developed budget that is based on your current financial situation can be your best road map to financial freedom. Marvin J. Ashton stated:

> Some claim living within a budget takes the fun out of life and is too restrictive. But those who avoid the inconvenience of a budget must suffer the pains of living outside of it. The Church operates within a budget. Successful business functions within a budget.

Families free of crushing debt have a budget. *Budget guidelines encourage better performance and management*.[6]

Step 5: Compare Your Budget to Your Actual Expenses and Make Changes Where Necessary to Achieve Your Goals

The fifth step in creating an effective budget is to compare your budget to your actual spending (see Chart 4). As necessary, adjust the amounts you have budgeted for different expenses to create a more effective budget. As you make adjustments, don't reduce payments to God or to yourself.

Chart 4. Budget Example with Differences

Bill and Suzy Smith
Monthly Budget for the Month of September 20XX

Income:	Budget	Actual	Difference
Wages	2,875	2,760	-115
Taxes	375	360	15
Wages/Salaries (After Taxes)	2,500	2,400	100
Other Income	200	250	50
Total Income	2,700	2,650	-50
Expenditures			
Tithes and Offerings	325	318	-7
Savings	405	398	-7
Monthly Living Expenditures			
Food	300	320	20
Mortgage or Rent	700	700	0
Utilities	300	325	25
Transportation	180	165	-15
Debt Payments	50	50	0
Insurance	150	150	0
Medical	40	40	0
Clothing	150	100	-50
Other	100	75	-25
Monthly Living Expenditures	1,970	1,925	-45
Total Expenditures	2,700	2,641	-59
Total Income minus Expenditures	0	9	-9

Creating a budget is a learning experience. You will not create a perfect budget right away, but you can refine it after each month. If your budgeting plan fails repeatedly, the "envelope system" may work.

Calculate Your Net Worth Using a Personal Balance Sheet

The second thing you must do to determine where you are financially is to calculate your net worth using a personal balance sheet, which is a snapshot of your financial position on a given date, usually the end of a month or year. It lists the dollar amounts of your liabilities (what you owe to others) and of your assets (what you own of monetary value).

How do you calculate your net worth? Your net worth (also referred to as equity) is the difference between your assets and your liabilities.

There are multiple ways to appraise each type of asset or liability. Calculate the value of each asset or liability correctly, because if you do not, you will have an incorrect view of your financial position. Having an incorrect view of your financial position may result in making bad financial decisions.

An example of a balance sheet is found in Chart 5. In addition, a balance sheet template can be found in the Learning Tools section of the website (**Learning Tool 4: Budget Balance Sheet and Income Statements**).

Assets: What You Own

Your assets are not limited to the total amount of money you have on hand; rather, they include all the valuable goods you own. Their value is based on the assumption that you could sell these goods and receive their market value. Assets come in many forms, including monetary assets, investment assets, and retirement assets; assets also include real estate, vehicles, personal property, and so on.

Assets can be subdivided into four categories: income-generating assets, appreciating assets, depreciating assets, and income-consuming assets. Income-generating assets are the best type of assets. These assets generate income or capital gains, which may eventually allow you to have income without having to work. Included in this category are financial assets such as stocks, bonds, or mutual funds; rental properties that are structured well; and even some types of insurance.

Appreciating assets are those that may have historically appreciated in value. Examples include your home, education, and certain types of business assets.

Depreciating assets depreciate in value. Often, the minute you take ownership of these assets (e.g., drive a car off the lot), they drop in value. This category includes assets such as automobiles, recreational vehicles, boats, etc.

Finally, income-consuming assets are those that require a constant infusion of cash to keep operative. Examples include automobiles (which require maintenance, fuel, and insurance), homes (property taxes, repair, upkeep, and insurance), and recreational properties (property taxes, repair, upkeep, and insurance), etc.

Different types of assets fulfill different needs for an individual or family, such as liquidity, protection, and capital appreciation.

Monetary (or current) assets include cash and other financial assets that can easily be converted into cash. This characteristic is known as liquidity. Liquidity is important in case of an emergency because it means that funds can be accessed in a relatively short period of time. Examples of monetary assets include cash, savings accounts, certificates of deposit, money market deposit accounts, and other financial assets that can be easily accessed in times of need. The value of a monetary asset is usually calculated according to its current market value—the price at which it could be sold. Monetary assets are also called current assets.

Investment assets are similar to monetary assets in that they can be redeemed for cash; however, they are generally less liquid and are used to save for a particular long-term goal. These assets provide mid- to long-term capital appreciation for the investor. Examples of investment assets include stocks, bonds, and mutual funds that an individual or family purchases now with the hope that the investments will be worth more in the future. The value of an investment asset is usually calculated according to its current market value.

Retirement assets are a particular type of investment asset in which money is specifically set apart to be used after retirement. These assets are used both to save and to earn a return for retirement. They are designed to provide funds that will allow you to live comfortably after you retire. Be aware that there are significant penalties (i.e., taxes and fees) if you use these assets before you turn retirement age as defined by the government (59½ for qualified retirement plans). Examples of retirement assets include company pensions, IRAs, and traditional and Roth 401(k) plans. The value of a retirement asset is usually calculated according to its current market value.

Housing or real estate assets include tangible assets such as land, dwellings, vacation homes, and rental properties. For many people, housing assets represent the bulk of their savings. These assets are often, but not always, the place where you live and will eventually retire. People often purchase housing assets to fulfill personal goals or to earn capital appreciation and income. The value of a housing asset is based on its current market value or its appraised value; the appraised value is established by an independent appraiser who takes into account similar houses in the neighborhood or city.

Automobiles and other vehicle assets include tangible assets such as cars, trucks, and recreational vehicles, which typically must be inspected and licensed. These assets provide transportation, recreation, and other benefits. The value of a vehicle asset is based on its current market value or its book value. The value of this type of asset usually depreciates each year.

Chart 5. Balance Sheet Example

Bill and Suzy Smith
Balance Sheet as of: _____________, 201X

Assets:	Amount	Liabilities:	Amount
Current (or Monetary) Assets		Current Liabilities	
Cash and Checking	$1,000	Current Unpaid Balances	$200
Savings/CDs	5,000	Visa/MasterCard	500
Other Assets	0		
Investments			
Stocks/Bonds	0	Long-Term Liabilities	
Mutual Funds	2,500	Mortgage Loan	0
Other Investments	0	Auto Loans	500
Retirement Plans		College Loans	3,000
401(k), 403b, 457 Plans	1,200	Other Debts	0
IRAs	500		
Housing			
Primary Residence	0		
Automobiles			
Automobiles	3,500	Total Liabilities	4,200
Personal Property			
Misc. Assets	750		
Total Assets	$14,450		

Net Worth (Assets minus Liabilities) $10,250

Personal property assets include tangible assets such as boats, furniture, and clothing that are purchased to meet specific individual needs or wants. The value of a personal property asset is determined by its current market value, which typically depreciates each year.

Other assets include any other tangible or intangible assets, such as business ownership, collections, and hobbies. These assets differ greatly, but they are all generally used to fulfill specific personal or business objectives. The value of these assets is usually calculated according to current market value or appraised value; however, because of the individual nature of these assets, they are often difficult to appraise and may have value only to their owner.

Add up the values of all your different types of assets to determine their total dollar value.

Liabilities: What You Owe

While liabilities also come in many forms, there are two major forms of liabilities: current and long-term.

Current liabilities are debts that must be paid off within the next year; they are usually debts for the short-term expenses of your home or business. Current liabilities include debts related to credit cards, utility bills, tuition and books, and non-mortgage housing expenses. These liabilities should be recorded on your personal balance sheet at the current amount owed plus any accrued interest.

Long-term liabilities are debts that must be paid off at a date farther away than one year from now; these debts are typically used to cover long-term expenses, such as student loans, auto loans, and home mortgages. These liabilities should be recorded on your personal balance sheet at the current amount owed.

Net Worth: What You Are Worth Financially

The difference between your assets and liabilities is known as your equity, or net worth. Do you owe more than you own? If so, you are technically insolvent!

What is a good level of net worth? The word *good* is relative when it comes to net worth. Your optimal level of net worth will depend on your age, your goals, and where you are in the stages of your financial life. These stages include the wealth-accumulation stage, the approaching-retirement stage, and the retirement stage of your life. As a general rule, a good level of net worth means that your assets are greater than your liabilities. As you age, the difference between your assets and liabilities should increase, with your assets always being the greater of the two.

The question of where you are now versus where you should be is a personal question that you must answer for yourself. As you try to answer this, ask yourself the following questions:

- What does my balance sheet show?
- Is my net worth growing?

The answers to these questions often depend on the stage you are at in life. For example, if you just graduated from high school or college, you are most likely in the accumulation stage of your life; therefore, your net worth should be growing. If you are retired, then you are probably using your savings for retirement expenses. In this case, your net worth is likely decreasing. Ask yourself these important questions:

- Am I reaching my personal goals?
- Am I planning for emergencies?
- Do I have adequate liquid assets?

- Am I out of credit card and consumer debt (other than using my credit card for convenience and paying off the balance each month)?
- Am I saving sufficiently for retirement and for my other financial goals?

If you can answer each of these questions affirmatively, you are likely financially "healthy." However, remember that we all can—and should—improve!

Chart 6. Income Statement Example, Bill and Suzy Smith

Monthly Income Statement
for the Month of ______, 201X

Income:	Actual
Wages/Salaries (After Taxes)	2,400
Other Income	250
Income Available for Living Expenses	2,650
Expenditures for Donations/Savings	
Tithes and Offerings	318
Savings	398
Expenditures for Living Expenses	
Food	320
Rent	700
Utilities	325
Transportation	165
Debt Payments	50
Insurance	150
Medical	40
Clothing	100
Other	75
Total Expenditures for Living Expenses	1,925
Total Living Expenses and Offerings/Savings	2,641
Total Income minus Expenditures	9

Develop a Personal Income Statement and Use It to Analyze Your Spending

A personal income statement is like a financial motion picture of your cash inflows and outflows. This type of statement is based entirely on actual cash flows, not accruals. An example of an income statement is found in Chart 6. If the statement looks familiar, it is because the income statement is just the "actual" column of your budget.

Income: Cash Inflows

Income includes cash inflows such as wages, tips, royalties, salaries, and commissions. Income is the amount you earn, which is not necessarily equal to the amount you receive. This is because some expenses, such as taxes, health-care costs, 401(k) contributions, and so on, are deducted from your check before you receive it.

Expenditures: Cash Outflows

As discussed in the Chapter 2 section, "Develop and Implement a Budget," *fixed expenses* are expenses that you don't directly control, and *variable expenses* are those that you have control over.

There may be differences of opinion concerning what constitutes a fixed versus a variable expense. For example, while one spouse might consider dates each weekend a fixed expense, another might consider it a variable expense. Be careful that variable expenses are not considered fixed expenses. Realize also that most fixed expenses are variable over longer periods of time; for example, you can buy a smaller house or get by with a used instead of a new car.

Using Ratios to Analyze Your Spending

Once you have completed your personal balance sheet and your personal income statement, use your financial statements to answer the following three questions.

Question 1: Do I have adequate liquidity in case of emergency? Two ratios can help you determine whether or not you have enough monetary assets to pay for a large, unexpected expense or to tide you over in case of a period of reduced or eliminated income: the current ratio and the "month's living expenses covered" ratio.

The current ratio tells you how many times over you could pay off your current liabilities with the cash you have on hand. To calculate your current ratio, divide the amount of your monetary assets (your current assets) by the amount of your current liabilities. The more times you can pay off your current liabilities, the better off you are financially. A ratio greater than two is recommended. Track the trend of this ratio; if it's going down, you need to make changes to improve your financial situation.

The second important ratio is the "month's living expenses covered" ratio. This ratio tells you how many months you could survive financially if you lost all current sources of income. To calculate this ratio, divide the amount of your monetary assets by the amount of your monthly living expenses. Realize that your living expenses should not include charitable contributions, taxes, or savings, because if you lost your job, you would not have these expenses or savings.

A ratio that allows you to pay your living expenses for three to six months is recommended. The ratio should be equal to at least as many months as it would take to get a new job if you lost your current job. Again, track the trend of this ratio—it should be improving. If it isn't, you need to make some changes to improve your financial situation.

In the example above, the current ratio is calculated as current assets divided by current liabilities. Bill and Suzy have $6,000 in current assets divided by $700 in current liabilities, or a current ratio of 8.57. Bill and Suzy could pay their current bills 8.6 times with the money they have in their savings. They are well above the recommended ratio.

Their "month's living expenses covered" ratio is calculated as monetary assets divided by monthly living expenses. Bill and Suzy have $6,000 in current or monetary assets divided by $1,925, which is their monthly living expenses, or a ratio of 3.1 times. Bill and Suzy could pay 3.1 months of living expenses with their existing monetary assets. They are within the recommended range of three to six months, although they are on the lower side.

Question 2: Can I meet my debt obligations? The debt ratio and the long-term debt coverage ratio can help you determine whether or not you can meet your current or long-term debt obligations.

Your debt ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This ratio is equal to your total liabilities divided by your total assets and represents the percentage of assets that are financed with borrowed money. Track this trend; this ratio should go down as you grow older.

Your long-term debt coverage ratio tells you how long you could continue to make payments on your long-term debt based on the amount of money you have for living expenses. To calculate this ratio, divide the amount you have available for living expenses (i.e., wages minus taxes) by the amount of your long-term debt payments. The higher this ratio, the better; a higher ratio indicates that you could cover your debt payments for a longer period of time. Track this trend; this ratio should go up over time.

In the example above, Bill and Suzy's debt ratio is $4,200 divided by $14,450 or 29 percent. Roughly 29 percent of their assets are financed with borrowings, and most of that is with student loans. Once Bill and Suzy buy their first home, this ratio will likely increase. A good goal is to make this ratio zero percent, meaning you have paid off all your liabilities, including your mortgage.

Their long-term debt coverage ratio is $2,650 divided by $50, or a ratio of 53 times. They have very little debt and are doing well. Debt coverage ratios should be higher than 2.5. Because they are renting and don't have a mortgage, this ratio is very low.

The inverse of the long-term debt coverage ratio is called the debt service ratio. The debt service ratio is long-term debt payments divided by monthly living expenses. Ideally, this ratio should be very low—at least less than 40 percent. In Bill and Suzy's case, their long-term debt payments are $50 divided by money available for monthly living expenses, or $2,650. Their ratio is 1.9 percent. Only 1.9 percent of their income goes to paying long-term debts. Taking one divided by the long-term debt coverage ratio of 53 gives the same result.

Question 3: Am I saving as much as I think I am? The net savings ratio and the gross savings ratio can help you determine whether you are saving as much of your income as you think you are.

Your net savings ratio tells you what proportion of your after-tax income you are saving. To calculate this ratio, divide the amount of income you save by the amount of income you use to cover living expenses. In the United States, the average ratio has ranged between negative 2 percent and 8 percent; however, your ratio may vary from this average depending on your current financial stage and your personal goals. As always, track the trend of this ratio—if it is decreasing, make the necessary changes.

Your gross savings ratio tells you what proportion of your before-tax income you are saving. This ratio is equal to your total savings divided by your total income. I recommend that, at a minimum, this ratio should be 10 percent. For most students, I recommend between 10 and 20 percent. As you get older, this savings ratio should also increase.

In the example given, Bill and Suzy's net savings ratio is calculated as their monthly savings divided by their total income after taxes, or $398 divided by $2,650, giving a ratio of 15 percent. They are saving 15 percent of their net pay.

Bill and Suzy's gross savings ratio is calculated as the monthly savings divided by their total income before taxes, or $398 divided by $2,760, or 14 percent. They are saving 14 percent of their total pay. While 14 percent is good, I recommend you set a goal to save 20 percent of your gross income, if possible.

Summary

Before you can attain your goals, you must first understand where you are financially. To do this, you must prepare the various financial statements described in this chapter. Of these financial statements, the most important is your budget. Following your budget is critical to living within your means. You must know what income you have coming in and what income you are spending.

In this chapter, I have recommended a new way of budgeting. Instead of saving what is left over at the end of the month, I have suggested that you determine your income, pay the Lord first, pay yourself second (between 10 percent and 20 percent), and then budget and live on the remainder. This practice will help you save for your goals much more quickly and will greatly improve your chance of attaining them.

I also explained the importance of using your personal balance sheet to create a snapshot of where you are financially and to help you calculate your net worth. Remember, your net worth will change depending on where you are in life, and ideally, it should get better over time.

Finally, I touched on the personal income statement and explained specific ratios that can help you see how well you are doing with regard to liquidity, debt, and savings. Ideally, these ratios should also be improving over time.

Joseph B. Wirthlin commented:

> I advise you to be patient in financial matters. Avoid rash or hurried financial decisions; such decisions require patience and study. Get-rich-quick schemes seldom work. Beware of debt. Be especially careful of easily obtained credit even if the interest is tax deductible. You young couples should not expect to begin your married lives with homes, automobiles, appliances, and conveniences comparable to those your parents have spent years accumulating.[7]

Assignments

Financial Plan Assignments

While the previous chapter helped you determine your vision and where you wanted to be, this chapter helps you see where you are right now. Financial statements help you understand your current financial position.

If you are not already living on a budget, your assignment is to begin today. Begin keeping a record of all your expenses, using the recording method of your choice. Your budget is probably the single-most important tool that will help you attain your goals. Use it wisely and refer to it often. It is important to remember that recording expenses alone is not budgeting. Recording expenses is just record-keeping. You need to give every dollar a name and plan where your money should go and then see that you follow your plan.

Your budget is a record of your planned expenses, your actual expenses, and the difference. Start with **Learning Tool 1-04** which is your Budget Template. Your budget is your spreadsheet that documents your planned, actual and different. Your budget template is where the thinking and analysis takes place. What did you do well during the month? Where did you do poorly and why? It is not enough to just record your expenses and income. You must use that information to be a better steward.

You can use any of the first four useful methods (sorry but the DNAH-ial method is no longer useful). We encourage you to use programs such as Mint.com or Quicken, or spreadsheet programs such as **Learning Tools 4 and 31.** Start by determining the categories for your spending, such as Auto, Charity, Education, Family Activities, Gifts, Groceries, Household, Insurance, Investments, Kids, Lunches, Medical, Tax, Utilities, Vacation, etc. Then have your days in a specific column, which sum to your total. The key columns are your budget, your actual (also called your income statement), and the difference.

In addition to making a budget, put together your own personal or family balance sheet. Be conservative in evaluating your assets, and be exact in evaluating your liabilities. Follow the methods discussed in this chapter and see where you are financially.

Finally, calculate your financial ratios regarding liquidity, debt, and savings. Are your assets as liquid as they should be? Are you reducing debt as you should? Are you saving as much as you should?

Learning Tools

The following Learning Tool may be helpful as you prepare your personal financial statements.

4. Budget, Balance Sheet, and Income Statements

This is an excel spreadsheet that includes a one-year budget, a two-period balance sheet, an income statement, and financial ratios for determining where you are financially.

31A. Debt Free Planned Spending Spreadsheet

This is a very detailed excel spreadsheet that includes a one-year budget. It also includes instructions for putting this together (LT31B).

Review Materials

Terminology Review

60% Solution budgeting method. A process of budgeting where you determine your gross salary each month, take 60% of that amount and only spend that amount each month. Do not spend beyond that amount. This leaves 20% of your salary for long-term goals and 20% of your salary for taxes at year-end.

Appreciating assets. These are assets which may or which have historically appreciated in value.

Assets. These are things that you own that have value.

Automobiles and Other Vehicles. These are depreciating assets, such as cars, trucks, and RVs that normally must be inspected and licensed.

Balance sheet (personal). This is a financial snapshot of your financial position on a given date.

Budgeting Process. These are the steps you take to create your budget. It includes: 1.

Know what you want to accomplish, 2. Track your spending (your expenses), 3. Develop your cash budget, 4. Implement your budget, 5. Compare it to actual expenses, then make changes where necessary to achieve your goals.

Budgeting the Better Way. This is a budgeting process where you pay the Lord first, and yourself second, then pay your bills. This makes paying yourself a higher priority.

Budgeting the Old Way. This is a budgeting process where whatever was left at the end of the month went into savings. The challenge is that there is never anything left at the end of the month.

Computer Software budgeting method. This process uses commercially available budgeting software such as such as Mint.com (free), Quicken, Mvelopes, or others. Determine your gross salary and take home each month after taxes and other deductions, determine spending by category, and budget each category. Work to within your budget for each spending category. You will obtain receipts and credit card information directly via internet from financial institutions.

Current ratio. This is your monetary assets divided by your current liabilities. This ratio tells you how many times you could pay off your current liabilities with your liquid cash on hand.

Debt ratio. This is your total liabilities divided by your total assets. This ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This represents the percentage of your assets financed with borrowing.

Depreciating assets. These are assets which depreciate. Often, the minute you take ownership of these assets, i.e. drive these assets off the car lot, they drop in value.

DNAH-ial Budgeting Method. This is a method many people use. It stands for DNAH ial - Do nothing and hope. It is not recommended.

Envelope budgeting method. A process of budgeting where you prepare divide spending each month into categories, create envelopes for each category of spending, and once a bill comes, take the money from the corresponding envelope and pay the bill.

Expenses. This is where your money goes. There are two types of expenses: fixed expenses, which are expenses you don’t directly control; and variable expenses, which are expenses you can control.

Financial Ratios. These are ratios that can help you to analyze your spending.

Gross Savings Ratio. This is your income for savings divided by your gross income. This ratio tells you what proportion of your total income is being saved.

Housing. These are appreciating tangible assets, such as land, dwellings, vacation home, or rental property used for personal goals or capital income.

Income Statement (personal). This is a financial record your inflows and outflows of cash. It is on a cash basis. The statement is based entirely on actual cash flows, not accruals.

Income-consuming assets. These are assets perhaps listed above which require a constant infusion of cash to keep operative.

Income-generating assets. These are the best type of assets. These assets generate income or capital gains which may eventually allow you to have income without your having to work.

Investment Assets. These assets include stocks, bonds, mutual funds that are invested for the future. These are also income-producing assets used to accumulate wealth to satisfy specific goals.

Liabilities. This is what you owe to others. Liabilities come in two major forms: current liabilities, liabilities that must be paid-off within the next year, and long-term liabilities, liabilities that extend beyond one year.

Long-term Debt Coverage ratio. This is your income available for living expenses divided by long-term debt payments. This ratio tells how long you could make monthly payments on your debt based on the amount of money you have available for living expenses (which is wages less taxes). The inverse of this ratio is the Debt Service ratio.

Monetary (or Current) Assets. This is cash or other assets that can be easily converted into cash. These may be also income-producing assets. They provide necessary liquidity in case of an emergency.

Month's Living Expenses Covered ratio. This is your monetary assets divided by your monthly living expenses. This ratio tells you how many months you could survive in the event of the loss of all current income. Your living expenses do not include charitable contributions, taxes or savings.

Net worth or equity. This is the difference between your assets, the things you own of value, and your liabilities, what you owe to others.

Personal Property. These are depreciating tangible assets, such as boats, furniture, clothing, etc.

Retirement plans. These are income-producing assets, such as pensions, IRAs, 401Ks, Roths, SEPs. etc. by you or employer used to accumulate wealth for retirement.

Savings Ratio. This is your income for savings divided by your income available for living expenses. This ratio tells you what proportion of your after-tax income is being saved.

Spreadsheet budgeting method. Using a computer and spreadsheets, determine your gross salary and take home each month after taxes and other deductions. Determine spending by categories (rows) and dates (columns), and budget for each category. As bills come in, input the spending on each date (column) and row (category).

Review Questions

1. Why is it necessary to understand financial statements? Why is it necessary to create your own personal financial statements?
2. According to Spencer W. Kimball, who should have a budget? Why?
3. What is the process of creating an effective budget?
4. What is the main difference between the "old way" and the "new way" of budgeting (see Chart 1 and Chart 2)? Why is this so important to the success of your financial plan?
5. Why is it important to calculate your net worth? What does your net worth say about your financial position? What is a "good" net worth?

Case Studies

Case Study 1

Data

Steve and Mary Jo, both 35 years old, own a house worth $150,000 and have a yearly income of $50,000, monetary assets of $5,000, two cars worth $20,000, and furniture worth $10,000. The house has a $100,000 mortgage, they have college loans of $10,000 outstanding, and the cars have outstanding loans of $10,000 each. Bills totaling $1,150 for this month have not been paid ($1,000 is to pay off their credit card that they use for bills). They are requesting your help.

Calculations

Using the data above, create a balance sheet to calculate Steve and Mary Jo's net worth. How are they doing?

Case Study 1 Answers

The balance sheet for Steve and Mary Jo should look like this:

Assets	
Primary Residence	$150,000
Monetary Assets	$5,000
Automobiles	$20,000
Furniture	$10,000

Total Assets	$185,000
Liabilities	
Current Bills	$1,150
First Mortgage	$100,000
College Loan	$10,000
Automobiles (2 * $10,000)	$20,000
Total Liabilities	$131,150
Net Worth (Assets – Liabilities)	$53,850

Generally, they are doing OK. While they have a positive net worth, most of that value is from the equity of their home.

Case Study 2

Data

Steve and Mary Jo, who make $50,000 per year, calculated their average tax rate at 15 percent. They contribute 12 percent of their income to charity and pay themselves 10 percent of their income. They have 25 years and $100,000 remaining on their 6-percent mortgage ($7,730 per year), three years and $20,000 remaining on their 7-percent auto loan ($7,410), and 10 years and $10,000 remaining on their 3-percent college loan ($1,160). In addition, utilities and property taxes were $2,270 per year, food was $6,000, insurance was $1,500, and other expenses were $5,430.

Calculations

Calculate their income statement using the "better" method, and round values to the nearest $10. How are they doing?

Case Study 2 Answers

Their income statement should look like this:

Annual Income	
Wages	$50,000
Taxes (15%)	7,500
Income for Living Expenses	42,500
Paying the Lord (12%)	6,000
Paying Yourself (10%)	5,000
Total Income	$31,500
Expenses	
Mortgage	$7,730
Utilities, Taxes	2,270
Food	6,000
Insurance	1,500
College Loan	1,160
Car Payment	7,410

Other Expenses	5,430
Total Living Expenses	$31,500

They seem to be doing OK; they are saving money, and it appears that they are living within their income. We need more information though.

This is the way Steve and Mary Jo calculated their annual expenses. (For information on using a financial calculator, see **Learning Tool 3: Financial Calculator Tutorial**, and **Learning Tool 12: Excel Financial Calculator**.)

Mortgage PV = $100,000, I = 6%, N = 25 * 12, PMT = ? * 12 = $7,730
College Loan PV = $10,000, I = 3%, N = 10 * 12, PMT = ? * 12 = $1,160
Car PV = $20,000, I = 7%, N = 3 * 12, PMT = ? * 12 = $7,410

Case Study 3

Data

Steve and Mary Jo would like you to help them understand where they are financially. You have Steve and Mary Jo's balance sheet and income statements, which were prepared earlier.

Calculations

They ask for help to calculate each of the six key liquidity, debt, and savings ratios.

Application

Using the data and calculations, comment on how well they are doing. What can and should they be doing to improve?

Case Study 3 Answers

Liquidity Ratios

Current ratio = current assets / current liabilities
$5,000 / 1,150 = 4.35 times

Month's living expense covered ratio = monetary assets / (annual living expenses / 12)

$5,000 / (31,500 / 12) = $5,000 / 2,624 [(M + F + I + CL + CP + OE) / 12] = 1.9 months (Living expenses do not include charity, taxes, or paying yourself because if you were not earning money, you would not pay these expenses.)

Steve and Mary Jo are somewhat liquid. They have a good current ratio (>2) but could only cover annual living expenses for less than two months (>3–6+ months is much better). They need to cut expenses and reduce debt.

Debt Ratios

Debt ratio = total liabilities / total assets
$131,150 / 185,000 = 70.9%

Long-term debt coverage ratio = income available for living expenses (wages – taxes or W – T) / long-term debt payments (debt you would not pay off in 12 months)
$42,500 (W – T) / (7,730 + 1,160 + 7,410) (M + CL + CP) = $42,250 / 16,300 = 2.6 times

Their debt service ratio or inverse of the long-term debt coverage ratio is $16,300 / 42,500 = 38.6%.

They have lots of debt—71 percent of their assets are financed, and their long-term debt ratio is 2.6 times, just above the 2.5 times caution level. Thirty-nine percent of their total income available goes to cover just debt payments. Just think—they could be investing that money instead of paying it!

Savings Ratios

Savings ratio = income available for savings and investment / income available for living expenses
$5,000 (PY) / 42,500 (W – T) = 11.8%

Gross savings ratio = income available for savings and investment / gross salary
$5,000 / 50,000 = 10%

They are saving 11.8 percent of their income available for living expenses, and 10 percent of their gross salary. This is OK, but it should be the minimum amount. I hope students taking this class will save much more, perhaps 20 percent of their gross salary.

Ratio Summary

Overall Situation	Actual	Recommended
Liquidity		
Current Ratio	4.4 Times	> 2
Month’s LEC Ratio	1.9 Times	> 3 – 6+
Debt		
Debt Ratio	70.9%	0% (See Note 1)
LT Debt Cov. Ratio	2.6 Times	> 2.5
% Inc. to Pay Debt	38.0%	0% (See Note 1)
Savings		
Savings Ratio	11.8%	> 10%
Gross Savings Ratio	10.0%	10% Min (See Note 2)

Notes:

1. It depends on your age. Ideally, it should decrease to zero.
2. While the minimum is 10 percent, it should increase as the situation allows.

Recommendations:

Liquidity—Steve and Mary Jo are somewhat liquid, but they do not have enough monetary assets. They need to significantly increase their monetary assets by saving more. They should set a goal to have an LEC ratio of at least three to six times. To conserve cash, they need to reduce spending, and perhaps sell some assets. They are paying so much on debt payments that they cannot build their savings and emergency fund. They likely need a stricter budget.

Debt—Steve and Mary Jo are carrying way too much debt. Seventy-one percent of their assets are financed by debt. They are very close to the danger range of a debt coverage ratio of 2.5 times. Currently, 38 percent of their income is used for long-term debt payments. While they have equity in their home, that is where most of their net worth currently resides. Given the recent housing crisis, the amount of equity in their home has likely dropped. They should cut expenses, reduce their debt, and perhaps sell their expensive cars and purchase cheaper ones.

Savings—Steve and Mary Jo are saving 10 percent of their income, which is good. However, their total investment assets are only $5,000. Having $5,000 in monetary assets at a savings rate of $5,000 per year means they only began saving within the last year. While they can't do anything about the fact that they should have begun saving earlier, they need to save more now. I would encourage them to reduce their spending and increase their savings goal to 20 percent, if possible. After a three-to-six month emergency fund, I would help them to take additional funds and use it to pay off debt.

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[1] Conference Report, April 1975, pp. 166–167.
[2] Anonymous.
[3] Gospel Standards, compiled by G. Homer Durham, 1941, 111.
[4] "To the Boys and to the Men," *Ensign,* Nov. 1998, 51.
[5] "Becoming Self-Reliant," *Ensign*, Nov. 1991, 64.
[6] "It's No Fun Being Poor," *Ensign,* Sept. 1982, 72; italics added.
[7] "Patience, a Key to Happiness," *Ensign*, May 1987, 30.