

# BUDGETING

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A Financial Beginnings Financial Education Program

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# BUDGETING

## SESSION OBJECTIVES

Budgeting is the foundation of personal financial planning. Budgeting allows us to manage our money by tracking our income and expenses. Since every person is different, it is important to know how to create a budget to use for our own specific needs.

### By the end of this session you will:

- ★ Understand the primary components of a budget and how to create and maintain a budget.
- ★ Understand the different types of income and how taxes apply.
- ★ Understand some useful budgeting concepts such as fixed and variable expenses.
- ★ Understand how short-term and long-term financial goals are set and utilized.
- ★ Learn tips on keeping your budget relevant.

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## ★ WHAT IS A BUDGET AND A FINANCIAL PLAN?

Simply stated, a **Budget** is a summary of your planned expenses compared with your planned income, for a pre-defined time period (such as the next month or next year). The primary purpose of a budget is to help you accumulate savings and avoid unnecessary or unplanned debt. An item related to budgeting is a financial plan, which involves setting specific goals (i.e., buy a house in five years) and identifying the means for accomplishing these goals.

An important point to remember about budgeting: personal budgeting techniques/tools are generally straightforward and uncomplicated, which means that success is more dependent on discipline and attention to detail rather than on understanding some budgeting methodology.

## ★ WHY DEVELOP A BUDGET?

If your future spending is limited to moderately small expenses (such as the cost of an iPod or a weekend trip to the coast), then creating a budget may not be a priority. However, for most people, this is unlikely and impractical.

**It's far more likely that you'll have to deal with some or all of the following types of (larger) expenses:**

- Purchasing a car
- Paying for college
- Purchasing a house/condo
- Saving for retirement

The cost of these items can range from \$25,000 to over \$100,000, and together they could easily exceed \$500,000 when taken in combination. The probability of accumulating this level of savings without some sort of roadmap (i.e., budget, financial plan) is low.

**Additionally, the prospect of dealing with savings, budgeting, and investing is realistically unavoidable:**

- 50% of households own stock (many through retirement plans).
- 90% have bank accounts.
- 100% have bills.

### Case: Cheryl

Cheryl, a single parent, has two children, ages 5 and 9. She works as a receptionist and makes \$26,000 a year. Cheryl pays \$700 a month in rent for her two-bedroom apartment.

Cheryl was unemployed for a few months before she found her job, and during that time she rang up \$2,200 in credit card debt. Her credit card APR is 24.99%. Even though it's a struggle to pay the credit card bill, Cheryl always pays it on time.

Cheryl's kids have two good friends in the neighborhood, Danny and LaTonya, and when they come over, Cheryl often ends up feeding all the children dinner and taking care of Danny and LaTonya until their parents get home from work.

Cheryl's office is in a downtown shopping area, and she likes to stop in at her favorite clothing store during her lunch break. While she usually waits until items she likes are on sale, sometimes she makes an impulse buy using her credit card, even though the item may not be on sale.

Cheryl is planning to take her kids on vacation in three months to visit their grandparents in another state. She needs to save about \$1,200 for the plane tickets and travel costs.

*What are some ways that Cheryl can cut down on her expenses so that she can afford to take the vacation with her family?*

There are four basic elements in a budget, as shown in the chart below:

- Income sources
- Expense items
- Surplus (+) or shortfall (-) calculations
- Time horizon (i.e., one month, six months, one year or greater)

**Time Horizon**

	Item	Jan–June, 2016	Jul–Dec, 2016	2016	2017	2018
<b>Income Source</b>	Salary	\$14,000	\$14,000			
	Bank interest	\$300	\$300			
	<b>Total income</b>	\$14,300	\$14,300			
<b>Expense Items</b>	Rent	\$4,800	\$4,800			
	Groceries	\$2,000	\$2,200			
	Car insurance	\$500	\$500			
	Entertainment	\$200	\$300			
	Emergency		\$7,500			
	<b>Total expenses</b>	\$7,500	\$15,300			
<b>Surplus/Shortfall</b>	<b>Income–expenses</b>	\$6,800	\$(1,000)			

**Types of income**

Income can be created in various ways. Below are some examples of different types of income sources.

**Earned income**

- Working a job (earning a salary)
- Consulting for another company
- Owning a business

**Portfolio income**

- Trading or selling paper assets (stocks or bonds)
- Buying or selling real estate
- Buying or selling physical assets (antiques)

**Passive income**

- Rental income
- Interest
- Royalties from intellectual property (books, patents)

**Types of expenses**

In many cases expenses are other people’s form of income. It is just as important to understand our expenses so that we can find ways to minimize them to fit in our budget. Below are some examples of different types of expenses.

**Fixed expenses** do not change from one time period to the next. This means that every month you can almost guarantee that the cost will be the same as it has been.

**Examples of fixed expenses are:**

- Rent
- Car payment
- Loan payments
- Internet bill
- Phone bill (assuming you do not go over on data)

**Variable Expenses** can change from one time period to another. For example, spending the same amount on groceries from month to month is very unlikely, so we consider them a variable expense. Variable expenses are more controllable than fixed expenses in the short term. However, even fixed expenses can be reduced. For example, you can refinance your home mortgage at a reduced rate or get a less expensive car with lower monthly payments.

**Examples of variable expenses are:**

- Groceries
- Entertainment
- Clothing
- Gas
- Income tax

Use **Appendix A: Monthly Payment Schedule**, to track your expenses

## Taxes

As you probably noticed, taxes are included in both fixed and variable expenses. The reason is that there are different types of taxes that are dependent on the situation.

**Property tax**, a fee charged by the government based upon the estimated value of the property, is unlikely to change during the year. **Income tax**, a fee imposed by the government based upon the amount of income a person makes, is most likely variable because the tax is dependent on the income made. This can be flexible if the individual has multiple, various, or variable sources of income.

## ★ TYPICAL ITEMS IN A BUDGET

- Automobile (car payments, maintenance, etc.)
- Child care
- Clothing
- Communications services (cell, Internet, cable TV)
- Contributions or donations
- Entertainment
- Food (groceries, restaurants)
- Gifts
- Housing (rent, mortgage payment, home repair)
- Insurance (car, home, health/medical)
- Loans (student loans or personal loans)
- Medical (insurance, co-payments, medication)
- Taxes (state, federal)
- Other transportation (mass transit, taxicabs)
- Utilities (electricity, natural gas)
- Vacations



Even though savings is not technically an expense item, many people view it as one. This lends to the term "pay yourself first". You don't necessarily need all of these items in your budget, but you do need to make sure to capture your expenses in major categories. Also, make sure that your budget fits your needs.

## ★ HOW TO CONSTRUCT A BUDGET

**Budgets** use data on income vs. expenses to help you accumulate savings and avoid unnecessary debt.

Remember, personal budgeting techniques/tools are generally straightforward and uncomplicated. Successful budgeting is more dependent on an individual's discipline in following the budget and less dependent on detail or complex budgeting methodology.

**Goal setting** involves setting goals (e.g., buy a car), setting a timeline for when you would like to achieve these goals (e.g., in two years), and identifying the means for accomplishing them (e.g., I will set aside \$300 a month for the down payment).

Setting specific financial goals ensures that your income and expenses are in line with what you may want and need. Otherwise, you can end up consistently short of the cash needed for large (predictable) expenses like a house, a car, tuition, etc.

**To start:**

- Pick a time period to cover—one month, one year, etc. For someone with limited budgeting experience, a one month or per paycheck period is a good place to start.
- Identify your expected expenses in each area (food, rent, etc.), along with your planned income.
- Enter the data into a table and compare your income vs. expenses, with an objective of having your income exceed your expenses. Online or software programs for budgeting can simplify this process, or even using a spreadsheet can help in laying out a budget.

In general, personal budgeting emphasizes total income vs. total spending. However, for some planned expenses (i.e., new car, college, and house), there is a need to be more specific with your financial goals and how they will be achieved.

**For these items, you need to generate a specific plan that includes:**

- Stating your goal.
- Determining when you want to achieve the goal by.
  - Short-term—under 1 year
  - Long-term—longer than 1 year
- Determining a cost.
- Creating a plan to achieve the goal.

An example of this type of goal setting is shown below.

Item	When	Cost	Cost Coverage Plan
<b>Short-Term Goals</b>			
1) Vacation	1 year	\$2,000	\$50/wk. from salary to vacation account
2) New TV	3 months	\$500	Withdraw from savings
<b>Long-Term Goals</b>			
1) College	3 years	\$9,000/yr.	Yearly contributions to college fund Secure financial aid
2) Condo down payment	5 years	\$20,000	Sell shares of ABC mutual fund XYZ Corp. bond matures in 4 years

**What are some of your short-term goals?**

Short-Term goals	When	Cost	Savings Plan

**What are some of your long-term goals?**

Long-Term goals	When	Cost	Savings Plan

## ★ HOW TO FORECAST AND TRACK ITEMS IN A BUDGET

Your budget will be most useful when it contains reasonably accurate and complete information. Some of the ways that you can capture and summarize budget data include the following:

- Keep a notebook. Write down everything you buy and every bill you pay.
- Keep all of your receipts in an envelope, shoe box, etc. to be summarized later.
- Create a computer file to track your income and expenses. There are a variety of software tools that can be used to help develop and manage a budget, including: Quicken, Mint, BankTree, You Need a Budget (YNAB), Budget Express, etc. You can also use a generalized spreadsheet program such as Microsoft Excel to forecast and track budget items.
- Many banks and credit unions offer online budgeting tools as part of their online banking platforms.

**NOTE:** While drafting a budget is an important first step, budget revisions are just as important as the original budget. Many people make a budget and then forget to revisit it to make updates as needed. Remember to use it as an ongoing financial roadmap.

## ★ TOOLS TO HELP MANAGE YOUR BUDGET

### Focus on Major “Cost Drivers”

In order to have the maximum impact on spending reduction, you should focus first on the big “cost drivers”, or the categories or items where you spend the most. For example, it’s likely that a 5% reduction in your grocery dollars will reduce your overall spending much more than a 50% reduction in magazine subscriptions, so take a look at your larger budget line items first.

### “What-If” Budgets

Budgets are forecasts of your money for the future. Because of the uncertainty of a forecast, it may be worthwhile to look at a few different budgets, each tied to different assumptions around major shifts in income or spending. These are called “what-if” scenarios and could involve items like the following:

- A new job pays much more or much less than expected.
- Uncle Fred gives you his car and now you don’t have to buy one.
- You change to a much less expensive cable TV, cell phone, and internet plan.

### Use specific techniques to reduce spending:

There are numerous, proven techniques that are often effective in keeping expenses under control. For example:

- **Groceries**—Use store brands vs. national brands; shop at low-cost retailers; don’t shop when you’re hungry
- **Transportation**—Combine insurance policies (like home and auto) under a single provider; buy used cars vs. new cars
- **Entertainment**—Use restaurant discount offers; take off-season vacations

Research and take advantage of these published tactics, to be used in combination with the cost saving methods you develop yourself.

Use **Appendix B: Budget Worksheet**  
to test your budgeting skills!

**What are the primary components of a budget?**

Budgets have four components: income sources, expense items, a time horizon and savings/shortages. First, pick a time period you would like to consider and then start plugging in your income and expenses. List all of your available income for the time span and then deduct all of your expenses. Be sure to account for all of your spending and take into consideration unexpected expenses. The amount you have left over is left for savings! If you have a negative amount then you have a shortage of funds and need to go back to the drawing board.

**What is income? What are taxes?**

Income is a crucial part of a budget because it is the starting amount that usually determines your expenses. If your income increases because of a job promotion, for example, then your expenses can increase accordingly. One of the expenses that we tend not to consider, but we should, are taxes. Taxes are fees that the government imposes and can come in many forms. Two types of taxes are property tax and income tax. Income tax will most likely be the first expense you encounter, as it is imposed when you start working. It is important that you budget for taxes, because often they can be expensive.

**What are expenses? How do you budget for them?**

To track your expenses you can use a notebook to write everything down, keep a computer document, or any of the several online tools. By maintaining these items you can ensure that your budget is accurate and relevant. It can be easy to lose track of your expenses and get yourself into debt, but if you follow your budget, you set yourself up for success in accumulating savings. There are two types of expenses: fixed and variable. Fixed expenses do not change often. They are more predictable and often the easiest to incorporate in a budget. Variable expenses are flexible and can change from month to month. They are often more difficult to account for because we never really spend the same amount on a variable expense from month to month. In your budget it is crucial to account for both types of expenses.

**How do goals help us to achieve financial success?**

It is likely that you will set a variety of financial goals. Whether it be buying a new car in two years or purchasing a house in ten years, we set goals to help us achieve these desires. Budgets help us to understand what it takes to achieve our financial goals. One of the most important aspects of setting goals is listing the way in which we will acquire the funds. This may include withdrawing money from savings, working ten extra hours a week or selling assets to pay for the item.

**How do you keep a budget relevant?**

Budgets do not do us any good if they are stored away in a drawer, never to be seen. Instead, budgets should be something that is incorporated into our daily life. We need to take care to spend less than we make and to reduce our spending on unnecessary items. To keep a budget relevant we need to make sure that we keep accurate count of our expenses, focus on “cost-drivers” that can significantly impact our expenses, and consider “what-if” scenarios. Budgets are tailored to our specific needs; therefore, it is suitable to modify your budget as needed.



# APPENDIX A: Monthly Payment Schedule

Month: \_\_\_\_\_

Income	Expenses/Bills	Pay or Due Date	Amount Due	Paid

- Transfer your income sources and amounts from the Budget Worksheet to the income column on the Monthly Payment Schedule.
- Record the date the income amount is expected.
- Transfer your expenses, the date due, amount due and the date paid into the appropriate columns of the Monthly Payment Schedule.
- Use different colored ink for income and expenses.

# APPENDIX B: Budget Worksheet

In order to complete this worksheet, you will have to track your spending for a month. When you have the information, fill in the worksheet and compare the amount you spend to your monthly income. This will let you know if you are earning enough to cover your expenses. If you are spending more than you earn, you have a deficit, and you have to look for ways to cut back or to earn more income.

<b>Expenses</b>	<b>Average Monthly Cost</b>
<b>Housing</b>	
Rent or mortgage payment	\$ _____
Utilities (if paid separately)	\$ _____
Property taxes (if you own a home)	\$ _____
Renter's or homeowner's insurance	\$ _____
<b>Non-Housing</b>	
Groceries	\$ _____
Eating out	\$ _____
Daycare/tuition	\$ _____
Car payment	\$ _____
Car insurance	\$ _____
Gas	\$ _____
Car repairs	\$ _____
Other transportation	\$ _____
Health care	\$ _____
Clothing	\$ _____
Personal grooming	\$ _____
Entertainment	\$ _____
Telephone	\$ _____
Vacations	\$ _____
Taxes	\$ _____
Credit card payment	\$ _____
Student loan payment	\$ _____
Other loan payment	\$ _____
Bank fees	\$ _____
Savings	\$ _____
Other:	\$ _____
<b>Total expenses:</b>	\$ _____
<b>Monthly income:</b>	\$ _____
<b>Difference:</b>	\$ _____

# ACTIVITY: Budget Management

Tony is an 18-year-old high school graduate who makes about \$15,000 per year (after taxes) working as a cashier at a local drug store. Tony does not have a budget and seems to have problems making ends meet. After attending a personal finance class, he decided to track his expenses for a month and then develop a budget.

Monthly Expense	Amount
Rent	\$1,000
Food	\$200
Utilities (heat, electric, etc)	\$200
Cell phone	\$50
Car payment	\$150
Car insurance	\$75
Entertainment	\$150
Clothes	\$200
Gym membership	\$50
Miscellaneous	\$50

- 1) Use the following worksheet to the LEFT to determine Tony's net available after each expense.
- 2) List the expenses in order of priority.

Description	Expense	Income	\$ Available
Salary		\$1,250	\$1,250
Rent	\$1,000		\$250

Description	Expense	Income	\$ Available
Salary		\$1,250	\$1,250

3) How is Tony getting by? How does he cover his expenses?

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4) What options do you see for Tony to balance his monthly budget?

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5) Use the worksheet to the RIGHT (above) to put together a budget that works for Tony



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