# CHAPTER 1

# Overview of a Financial Plan

Imagine that you are taking a vacation next year. You have many financial choices to make. How big is your vacation budget and how do you want to allocate it? The more money that you save now, the more you will have to spend on your vacation.

Now, imagine that you are planning your financial future. You have many choices to make. What type of house should you buy? How much of your budget should be allocated to food and utilities? How much can you afford to spend on clothes? Should you spend all of your money as you earn it, or should you use some money for investment opportunities? Should you buy a new car? Should you buy a house? When do you want to retire? Do you want to leave an estate for your heirs? All of these decisions require detailed planning.

In a world where there are few guarantees, thorough financial planning, prudent financial management, and careful spending can help you achieve your financial goals.

The personal financial planning process enables you to understand a financial plan and to develop a personal financial plan. The simple objective of financial planning is to make the best use of your resources to achieve your financial goals. The sooner you develop your goals and a financial plan to achieve those goals, the easier it will be to achieve your objectives.

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## The objectives of this chapter are to:

- Explain how you benefit from personal financial planning
- Identify the key components of a financial plan
- Outline the steps involved in developing your financial plan

# HOW YOU BENEFIT FROM AN UNDERSTANDING OF PERSONAL FINANCE

**personal finance**
The process of planning your spending, financing, and investing to optimize your financial situation.

**personal financial plan**
A plan that specifies your financial goals and describes the spending, financing, and investing plans that are intended to achieve those goals.

**Personal finance** (also referred to as **personal financial planning**) is the process of planning your spending, financing, and investing to optimize your financial situation. A **personal financial plan** specifies your financial goals and describes the spending, financing, and investing plans that are intended to achieve those goals. Although the U.S. is one of the wealthiest countries, many Americans do not manage their financial situations well. Consequently, they tend to rely too much on credit and have excessive debt. Consider these statistics:

- More than 1.2 million people filed for personal bankruptcy in 2008.
- The level of savings in the U.S. is only about 1 percent of income earned. (Some investments, including retirement accounts, are not included as savings.)
- About half of all surveyed people in the U.S. who are working full-time state that they live from one paycheck to the next, without a plan for saving money.
- About 40 percent of people who work full time do not save for retirement. Those who do typically save a relatively small amount of money.

The lack of savings is especially problematic given the increasing cost of health care and other necessities. You will have numerous options regarding the choice of bank deposits, credit cards, loans, insurance policies, investments, and retirement plans. With an understanding of personal finance, you will be able to make decisions that can enhance your financial situation.

How much do you know about personal finance? Various government agencies of various countries have attempted to assess financial literacy in recent years. Surveys have documented that people tend to have very limited personal finance skills. In addition, surveys have found that many people who believe they have strong personal finance skills do not understand some basic personal finance concepts. Take the Financial Literacy Test, provided just before this chapter. Even if your knowledge of personal finance is limited, you can substantially increase your knowledge and improve your financial planning skills by reading this text. An understanding of personal finance is beneficial to you in many ways, including the following:

## Make Your Own Financial Decisions

**opportunity cost**
What you give up as a result of a decision.

An understanding of personal finance enables you to make informed decisions about your financial situation. Each of your spending decisions has an **opportunity cost,** which represents what you give up as a result of that decision. By spending money for a specific purpose, you forgo alternative ways that you could have spent the money and also forgo saving the money for a future purpose. For example, if your decision to use your cell phone costs $100 per month, you have forgone the possibility of using that money to buy concert tickets or to save for a new car. Informed financial decisions increase the amount of money that you accumulate over time and give you more flexibility to purchase the products and services you want in the future.

## Judge the Advice of Financial Advisers

The personal financial planning process will enable you to make informed decisions about your spending, saving, financing, and investing. Nevertheless, you may prefer to rely on advice from various types of financial advisers. An understanding of personal finance allows you to judge the guidance of financial advisers and to determine whether their advice is in your best interest (or in their best interest).

EXAMPLE

You want to invest $10,000 of your savings. A financial adviser guarantees that your investment will increase in value by 20 percent (or by $2,000) this year, but he will charge you 4 percent of the investment ($400) for his advice. If you have a background in personal finance, you would know that no investment can be guaranteed to increase in value by 20 percent in one year. Therefore, you would realize that you should not trust this financial adviser. You could either hire a more reputable financial adviser or review investment recommendations made by financial advisers on the Internet (often for free).

### Become a Financial Adviser

An understanding of personal finance may interest you in pursuing a career as a financial adviser. Financial advisers are in demand because many people lack an understanding of personal finance or are not interested in making their own financial decisions. A single course in personal finance is insufficient to start a career as a financial adviser, but it may interest you in taking additional courses to obtain the necessary qualifications.

## COMPONENTS OF A FINANCIAL PLAN

A complete financial plan contains your personal finance decisions related to six key components:

1. Budgeting and tax planning
2. Managing your liquidity
3. Financing your large purchases
4. Protecting your assets and income (insurance)
5. Investing your money
6. Planning your retirement and estate

These six components are very different; decisions concerning each are included in separate plans that, taken together, form your overall financial plan. To begin your introduction to the financial planning process, let's briefly explore each component.

### A Plan for Your Budgeting and Tax Planning

**budget planning (budgeting)** The process of forecasting future expenses and savings.

**Budget planning** (also referred to as **budgeting**) is the process of forecasting future expenses and savings. That is, it requires you to decide whether to spend or save money. If you receive $750 in income during one month, your amount saved is the amount of money (say, $100) that you do not spend. The relationship between income received, spending, and saving is illustrated in Exhibit 1.1. Some individuals are "big spenders": they focus their budget decisions on how to spend most or all of their income and therefore have little or no money left for saving. Others are "big savers": they set a savings goal and consider spending their income received only after allocating a portion of it toward saving. Budgeting can help you estimate how much of your income will be required to cover monthly expenses so that you can set a goal for saving each month.

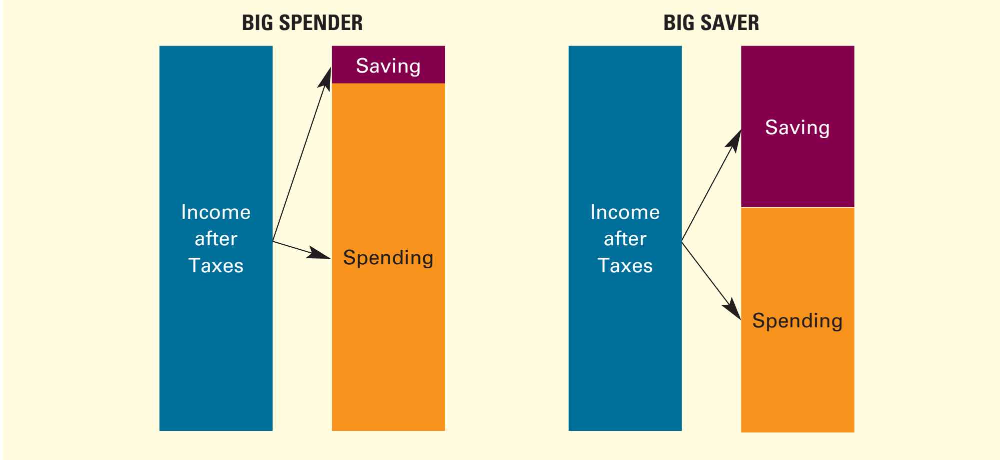
**assets** What you own.

**liabilities** What you owe; your debt.

**net worth** The value of what you own minus the value of what you owe.

The first step in budget planning is to evaluate your current financial position by assessing your income, your expenses, your **assets** (what you own), and your **liabilities** (debt, or what you owe). Your **net worth** is the value of what you own minus the value of what you owe. You can measure your wealth by your net worth. As you save money, you increase your assets and therefore increase your net worth. Budget planning enables you to build your net worth by setting aside part of your income to either invest in additional assets or reduce your liabilities.

Exhibit 1.1 How a Budget Plan Affects Savings




Your budget is influenced by your income, which in turn is influenced by your education and career decisions. Individuals who pursue higher levels of education tend to have smaller budgets during the education years. After obtaining their degrees, however, they typically are able to obtain jobs that pay higher salaries and therefore have larger budgets.

A key part of budgeting is estimating the typical expenses that you will incur each month. If you underestimate expenses, you will not achieve your savings goals. Achieving a higher level of future wealth requires you to sacrifice by keeping spending at a lower level today.

Many financial decisions are affected by tax laws, as some forms of income are taxed at a higher rate than others. By understanding how your alternative financial choices would be affected by taxes, you can make financial decisions that have the most favorable effect on your cash flows. Budgeting and tax planning are discussed in Part 1 because they are the basis for decisions about all other parts of your financial plan.

## A Plan to Manage Your Liquidity

You should have a plan for how you will cover your daily purchases. Your expenses can range from your morning cup of coffee to major car repairs. You need to have **liquidity,** or access to funds to cover any short-term cash needs. You can enhance your liquidity by utilizing money management and credit management.

**liquidity**
Access to funds to cover any short-term cash deficiencies.

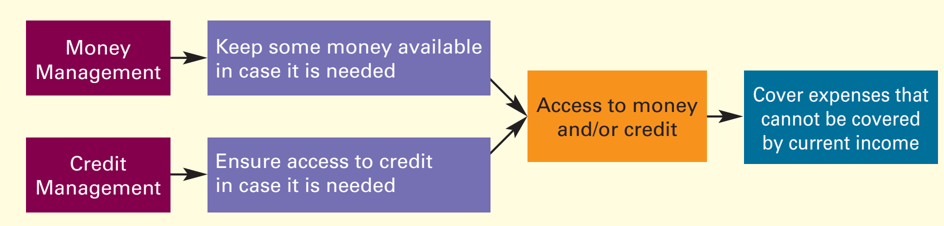
**money management**
Decisions regarding how much money to retain in a liquid form and how to allocate the funds among short-term investment instruments.

**credit management**
Decisions regarding how much credit to obtain to support your spending and which sources of credit to use.

**Money management** involves decisions regarding how much money to retain in a liquid form and how to allocate the funds among short-term investments. If you do not have access to money to cover your cash needs, you may have insufficient liquidity. That is, you have the assets to cover your expenses, but the money is not easily accessible. Finding an effective liquidity level involves deciding how to invest your money so that you can earn a return, but also have easy access to cash if needed. At times, you may be unable to avoid cash shortages because of unanticipated expenses.

**Credit management** involves decisions about how much credit you need to support your spending and which sources of credit to use. Credit is commonly used to cover both large and small expenses when you are short on cash, so it enhances your liquidity. Credit should be used only when necessary, however, as you will need to pay back borrowed funds with interest (and the interest expenses may be very high). The use of money management and credit management to manage your liquidity is illustrated in Exhibit 1.2.

**Exhibit 1.2 Managing Your Liquidity**




## A Plan for Your Financing

Loans are typically needed to finance large expenditures, such as the payment of college tuition or the purchase of a car or a home. The amount of financing needed is the difference between the amount of the purchase and the amount of money you have available, as illustrated in Exhibit 1.3. Managing loans includes determining how much you can afford to borrow, deciding on the maturity (length of time) of the loan, and selecting a loan that charges a competitive interest rate.

## A Plan for Protecting Your Assets and Income

**insurance planning**
Determining the types and amount of insurance needed to protect your assets.

To protect your assets, you can conduct **insurance planning**, which determines the types and amount of insurance that you need. In particular, automobile insurance and homeowner's insurance protect your assets, while health insurance limits your potential medical expenses. Disability insurance and life insurance protect your income.

## A Plan for Your Investing

Any funds that you have beyond what you need to maintain liquidity should be invested. Because these funds normally are not used to satisfy your liquidity needs, they can be invested with the primary objective of earning a high return. Potential investments include stocks, bonds, mutual funds, and real estate. You must determine how much of your funds you wish to allocate toward investments and what types of investments you wish to consider. Most investments are subject to **risk** (uncertainty surrounding their potential return), however, so you need to manage them so that your risk is limited to a tolerable level.

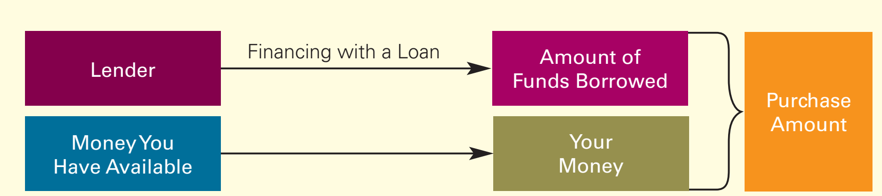
**risk**
Uncertainty surrounding the potential return on an investment.

## A Plan for Your Retirement and Estate

**retirement planning**
Determining how much money you should set aside each year for retirement and how you should invest those funds.

**Retirement planning** involves determining how much money you should set aside each year for retirement and how you should invest those funds. Retirement planning must begin well before you retire so that you can accumulate sufficient money to invest and support yourself after you retire. Money contributed to various kinds of retirement plans is protected from taxes until it is withdrawn from the retirement account.

**Exhibit 1.3 Financing Process**



**estate planning**
Determining how your wealth will be distributed before or upon your death.

**Estate planning** is the act of planning how your wealth will be distributed before or upon your death. Effective estate planning protects your wealth against unnecessary taxes, and ensures that your wealth is distributed in the manner that you desire.

## How the Text Organization Relates to the Financial Plan's Components

Each of the six parts of this text covers one specific component of the financial plan. The components of the financial plan are illustrated in Exhibit 1.4. Each part is shown as a step in the exhibit with the lower steps serving as a foundation for the higher steps. Part 1 (Tools for Financial Planning) describes budgeting, which focuses on how cash received (from income or other sources) is allocated to saving, spending, and taxes. Budget planning serves as the foundation of the financial plan, as it is your base for making personal financial decisions.

The next component is liquidity management (Part 2) because you must have adequate liquidity before financing or investing. Once your budget plan and your liquidity are in order, you are in a position to plan your financing (Part 3) for major purchases such as a new car or a home. Part 4 explains how to use insurance to protect your assets and your income. Next, you can consider investment alternatives such as stocks, bonds, and mutual funds (Part 5). Finally, planning for retirement (Part 6) focuses on the wealth that you will accumulate by the time you retire.

An effective financial plan enhances your net worth and therefore builds your wealth. In each part of the text, you will have the opportunity to develop a component of your financial plan. At the end of each chapter, the Building Your Own Financial Plan exercise offers you guidance on the key decisions that you can make after reading that chapter. Evaluate your options and make decisions using the Excel-based software on the CD-ROM available with your text. By completing the Building Your Own Financial Plan exercises, you will build a financial plan for yourself by the end of the school term. Exhibit 1.5 lists examples of the decisions you will make for each component.

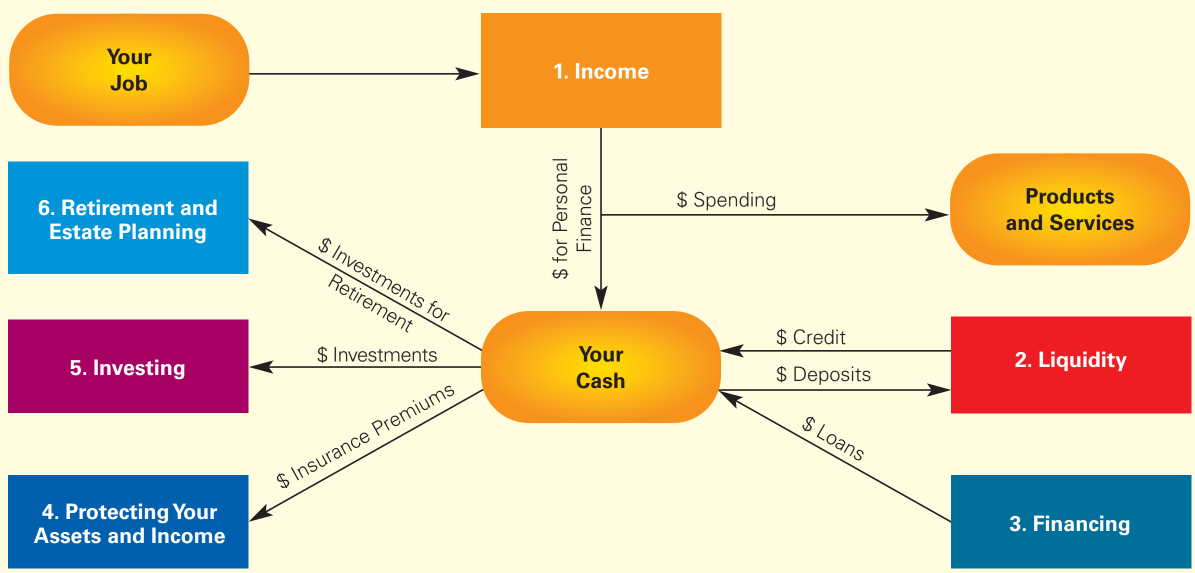
**How the Components Relate to Your Cash Flows.** Exhibit 1.6 illustrates the typical types of cash inflows (cash that you receive) and cash outflows (cash that you spend). This exhibit also shows how each component of the financial plan reflects decisions on how to obtain or use cash. You receive cash inflows in the form of income from your employer and use some of that cash to spend on products and services. Income (Part 1) focuses on the relationship between your income and your spending. Your budgeting decisions determine how much of your income you spend on products and services. The residual funds can be allocated for your personal finance needs. Liquidity management (Part 2) focuses on depositing excess cash or obtaining credit if you are short on cash. Financing (Part 3) focuses on obtaining cash to support your large purchases. Protecting your assets and income (Part 4) focuses on determining your insurance needs and

**Exhibit 1.4** Components of Your Financial Plan

## Exhibit 1.5 Examples of Decisions Made in Each Component of a Financial Plan

| A Plan for: | Types of Decisions |
|---|---|
| 1. Managing your income | What expenses should you anticipate? |
| | How much money should you attempt to save each month? |
| | How much money must you save each month toward a specific purchase? |
| | What debt payments must you make each month? |
| 2. Managing your liquidity | How much money should you maintain in your checking account? |
| | How much money should you maintain in your savings account? |
| | Should you use credit cards as a means of borrowing money? |
| 3. Financing | How much money can you borrow to purchase a car? |
| | Should you borrow money to purchase a car or should you lease a car? |
| | How much money can you borrow to purchase a home? |
| | What type of mortgage loan should you obtain to finance the purchase of a house? |
| 4. Protecting your assets and income | What type of insurance do you need? |
| | How much insurance do you need? |
| 5. Investing | How much money should you allocate toward investments? |
| | What types of investments should you consider? |
| | How much risk can you tolerate when investing your money? |
| 6. Your retirement and estate | How much money will you need for retirement? |
| | How much money must you save each year so that you can retire in a specific year? |
| | How will you allocate your estate among your heirs? |

## Exhibit 1.6 How Financial Planning Affects Your Cash Flows



spending money on insurance premiums. Investing (Part 5) focuses on using some of your cash to build your wealth. Planning for your retirement (Part 6) focuses on periodically investing cash in your retirement account.

If you need more cash inflows beyond your income, you may decide to rely on savings that you have already accumulated or obtain loans from creditors. If your income exceeds the amount that you wish to spend, you can use the excess funds to make more investments or to repay some or all of the principal on existing loans. Thus, your investment decisions can serve as a source of funds (selling your investments) or a way of using additional funds (making additional investments). Your financing decisions can serve as a source of funds (obtaining additional loans) or a use of funds (repaying existing loans).

## DEVELOPING THE FINANCIAL PLAN

Six steps are involved in developing each component of your financial plan.

### Step 1. Establish Your Financial Goals

You must determine your financial goals.

First, determine your general goals in life. These goals do not have to be put in financial terms. For example, you may have goals such as a family, additional education, a vacation to a foreign country for one week every year. You may envision owning a five-bedroom house, or having a new car every four years, or retiring when you reach age 55.

**Types of Financial Goals.** Your general goals in life influence your financial goals. It takes money to support many of your goals. If you want to have a family, one of your financial goals may be that you and your spouse earn enough income and save enough money over time to financially support a family. If you want a vacation to a foreign country every year, one of your financial goals may be that you earn enough income and save enough money to financially support your travel. If you want a large home, one of your financial goals should be that you earn enough income and save enough money over time to make a substantial real estate purchase. If you want to retire by age 55, this will require you to save enough money by then so that you could afford to stop working. You may also establish financial goals such as helping a family member or donating to charities.

**Set Realistic Goals.** You need to be realistic about your goals so that you can have a strong likelihood of achieving them. A financial plan that requires you to save almost all of your income is useless if you are unable or unwilling to follow that plan. When this overly ambitious plan fails, you may become discouraged and lose interest in planning. By reducing the level of wealth you wish to attain to a realistic level, you will be able to develop a more useful plan.

**Timing of Goals.** Financial goals can be characterized as short term (within the next year), intermediate term (typically between one and five years), or long term (beyond five years). For instance, a short-term financial goal may be to accumulate enough money to purchase a car within six months. An intermediate-term goal would be to pay off a school loan in the next three years. A long-term goal would be to save enough money so that you can maintain your lifestyle and retire in 20 years. The more aggressive your goals, the more ambitious your financial plan will need to be.

### Step 2. Consider Your Current Financial Position

Your decisions about how much money to spend next month, how much money to place in your savings account, how often to use your credit card, and how to invest your money depend on your financial position. A person with little debt and many assets will clearly make different decisions than a person with mounting debt and few assets. And a single individual without dependents will have different financial means than a couple with children, even if the individual and the couple have the same income. The appropriate plan also varies with your age and wealth. If you are 20 years old with zero funds in your bank account, your financial plan will be different than if you are 65 years old and have saved much of your income over the last 40 years.

Since your financial planning decisions are dependent on your financial position, they are dependent on your education and career choice, as explained next.

**How Your Future Financial Position Is Tied to Your Education.** Your financial position is highly influenced by the amount of education you pursue. The more education you have, the higher your earnings will likely be. As Exhibit 1.7 shows, the difference in annual income between a high school graduate and a bachelor's degree holder in 2007 was more than $18,000. Before you choose a major, consider your skills, interests, and how your choice can prepare you for different career paths. A major in biology or chemistry may allow you to pursue careers in the biotechnology industry, while a major in English may allow you to pursue a career in journalism.

**How Your Future Financial Position Is Tied to Your Career Choice.** Your career choices also affect your income and potential for spending and saving money. If you become a social worker, you will be in a different financial position than if you choose to work as an electrical engineer. As a social worker, you will need to save a much higher proportion of your income to achieve the same level of savings that you could amass as an electrical engineer. If you choose a career that pays a low income, you will need to set attainable financial goals. Or you may reconsider your choice of a career in pursuit of a higher level of income. However, be realistic. You should not decide to be a doctor just because doctors' salaries are high if you dislike health-related work. You should choose a career that will be enjoyable and will suit your skills. If you like your job, you are more likely to perform well. Since you may be working for 40 years or longer, you should seriously think about the career that will satisfy both your financial and personal needs.

The fastest-growing occupations are identified in the first column of Exhibit 1.8. The expected change in the employment level for each of these positions is shown in the second column, while the required degree is shown in the third column. Notice that an associate or bachelor's degree is needed for many of the occupations.

Many people change their career over time. As the demand for occupations changes, some jobs are eliminated and others are created. In addition, some people grow tired of their occupation and seek a new career. Thus, career choices are not restricted to students who are just completing their education. As with your initial career decision, a shift to a new career should be influenced by your views of what will satisfy you.

Various Web sites can help you estimate the income level for a specific career. Additional information about careers and Web site links on salary levels for various

**Exhibit 1.7 Comparison of Income among Education Levels**

| Education | Median Level of Annual Income |
|---|---|
| Master's degree | $55,426 |
| Bachelor's degree | 45,773 |
| Associate degree | 36,333 |
| Some college, no degree | 33,837 |
| High-school graduate | 27,240 |
| Some high school, no degree | 20,398 |

*Source*: U.S. Census Bureau, 2007.

**Exhibit 1.8 Fastest-Growing Occupations, 2000–2010**

| Occupation | Percentage Change in Employment | Degree Required |
|---|---|---|
| Network systems | 53% | Bachelor's degree |
| Personal and home health aides | 51 | |
| Computer software engineers | 45 | Bachelor's degree |
| Veterinary technicians | 41 | |
| Personal financial advisors | 41 | Bachelor's degree |
| Makeup artists, theatrical, and performance | 40 | |
| Medical assistants | 35 | |
| Veterinarians | 35 | Associate degree |
| Substance abuse and behavioral disorder counselors | 34 | Bachelor's degree |
| Skin care specialists | 34 | |
| Financial Analysts | 34 | Bachelor's degree |
| Social and human service assistants | 34 | |
| Gaming surveillance officers and investigators | 34 | |
| Physical therapy assistants | 32 | Associate degree |
| Pharmacy technicians | 31 | |
| Forensic science technicians | 31 | Bachelor's degree |
| Dental hygienists | 30 | Associate degree |
| Mental health counselors | 30 | Master's degree |
| Mental health and substance abuse social workers | 30 | Master's degree |
| Marriage and family therapists | 30 | Master's degree |
| Dental assistants | 29 | |
| Computer systems analysts | 29 | Bachelor's degree |
| Database administrators | 29 | Bachelor's degree |
| Environmental science and protection technicians | 28 | Associate degree |

*Source*: Bureau of Labor Statistics, U.S. Department of Labor, 2008–2009 Occupational Handbook.

types of careers are provided at www.pearsonhighered.com/madura. Even if the income level in a particular career you desire is less than what you expected, you may be able to maintain the same financial goals by extending the period in which you hope to achieve those goals.

## FINANCIAL IMPACT

### How Your Future Financial Position Is Tied to the Economy

Economic conditions affect the types of jobs that are available to you, and the salary offered by each type of job. They affect the price you pay for services such as rent. They affect the value of assets (such as a home) that you own. They also affect the return that you can earn on your investments.

The financial crisis of 2008–2009 affected the financial position of individuals in many ways. First, it resulted in lower housing prices. Second, it resulted in lower values of many types of investments, such as stocks. Third, it caused a reduction in new job opportunities. Fourth, it resulted in the elimination of some jobs. Fifth, it resulted in lower salaries for the existing job positions, as employers could not afford to give high raises to their employees.

Overall, the financial crisis reduced the asset values and wealth of individuals. At the beginning of 2008, the wealth of households in the U.S. was estimated by the federal government to be about $62 trillion. By 2009, the wealth of households in the U.S. was estimated to be about $51 trillion, reflecting a reduction of $11 trillion, or 18 percent of total wealth. The financial crisis also resulted in a higher level of debt for individuals. The total debt of households was about 23 percent larger than the annual income. In other words, if households used all of their annual income just to repay debt, they would not be able to pay off all of the debt. Overall, the financial crisis may force individuals to revise their financial goals in order to make them attainable. Alternatively, the crisis might require that individuals allow a longer period of time in order to reach their financial goals.

QUESTIONS

a. **Economic Impact on Net Worth.** Assume that you have established a plan to achieve a particular level of wealth in three years, but the economic conditions suddenly cause your existing income to decline and the value of your existing assets to decline. Should you leave your financial plan as it is, or adjust it?

b. **Economic Impact on Job Strategy.** During a weak economy, jobs are scarce, and some individuals may consider starting their own businesses. What is the disadvantage of this idea during a weak economy?

## Step 3. Identify and Evaluate Alternative Plans That Could Achieve Your Goals

You must identify and evaluate the alternative financial plans that could achieve your financial goals (specified in Step 1), given your financial position (determined in Step 2). For example, to accumulate a substantial amount of money in 10 years, you could decide to save a large portion of your income over those years. This plan is likely to achieve your goal of accumulating a substantial amount of money in 10 years. However, this plan requires much discipline. Alternatively, you could plan to save only a small portion of your income, but to invest your savings in a manner that earns a very high return so that you can accumulate a substantial amount of money in 10 years. This alternative plan does not require you to save as much money. However, it places more pressure on you to earn a high return on your investments. To earn such a high return, you will likely have to make risky investments in order to achieve your goals. You might not achieve your goals with this alternative plan because your investments might not perform as well as you expected.



## Step 4. Select and Implement the Best Plan for Achieving Your Goals

You need to analyze and select the plan that will be most effective in achieving your goals. For example, if you are disciplined and conservative, you will likely select the first of the two plans identified in the previous paragraph. The type of plan you select to achieve your financial goals will be influenced by your willingness to accept risk and your self-discipline.

**Using the Internet.** The Internet provides you with valuable information for making financial decisions. Your decision to spend money on a new stereo or to save the money may be dependent on how much you can earn from depositing the money. Your decision of whether to purchase a new car depends on the prices of new cars and financing rates on car loans. Your decision of whether to purchase a home depends on the prices of homes and financing rates on home loans. Your decision of whether to invest in stocks is influenced by the prices of stocks. Your decision of where to purchase insurance may be influenced by the insurance premiums quoted by different insurance agencies. All of these financial decisions require knowledge of prevailing prices or interest rates, which are literally at your fingertips on the Internet.

The Internet also provides updated information on all parts of the financial plan, such as:

- Current tax rates and rules that can be used for tax planning
- Recent performance of various types of investments
- New retirement plan rules that can be used for long-term planning

Many Web sites offer online calculators that you can use for a variety of financial planning decisions, such as:

- Estimating your taxes
- Determining how your savings will grow over time
- Determining whether buying or leasing a car is more appropriate

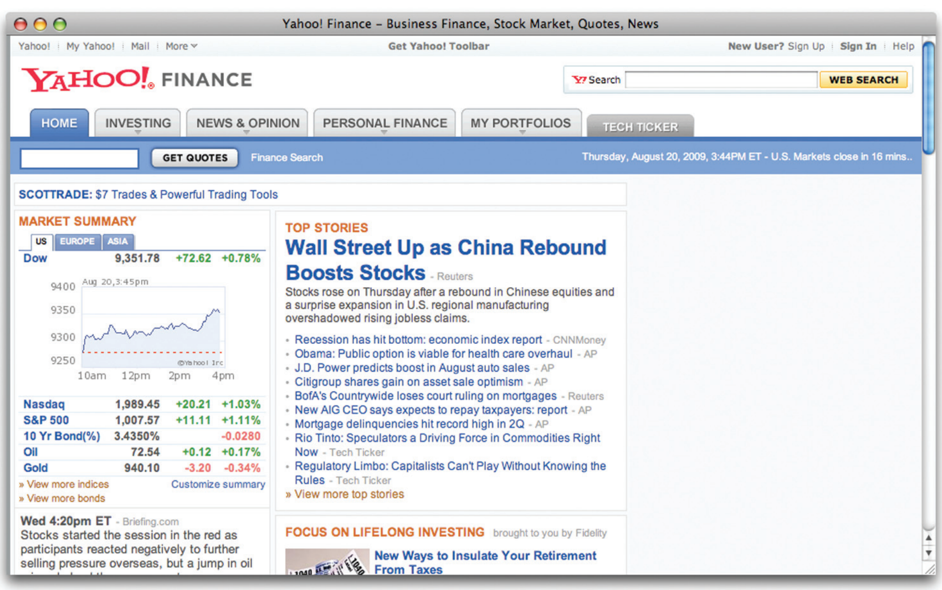
Special features in each chapter called Financial Planning Online illustrate how the Internet can facilitate the creation of the various parts of the financial plan. Financial Planning Online exercises are also provided at the end of each chapter so that you can practice using the Internet for financial planning purposes. URLs in this text are available and updated on the text's Web site for easy navigation.

When you use online information for personal finance decisions, keep in mind that some information may not be accurate. Use reliable sources, such as Web sites of government agencies or financial media companies that have a proven track record for reporting financial information. Also, recognize that free personal finance advice provided online does not necessarily apply to every person's situation. Get a second opinion before you follow online advice, especially when it recommends that you spend or invest money.

## Financial Planning Online 1.1: **Financial Planning Tools for You**

**Go to**
finance.yahoo.com/

**This Web site provides** much information and many tools that can be used for all aspects of financial planning, including tax rates, bank deposit rates, loan rates, credit card information, mortgage rates, and quotations and analysis of stocks, bonds, mutual funds, and insurance policies. It also provides information for creating retirement plans and wills.



## FOCUS ON ETHICS: **Personal Financial Advice**

Many individuals have a limited background in financial planning and rely on professionals in the financial services industry for advice when developing their financial plan. While most advisers take their responsibilities seriously and are very ethical, there are some unethical and incompetent advisers.

One of the aspects of financial services products that creates a potential conflict of interest for your adviser is the variety of fee and commission structures available on even a single product such as a life insurance policy. Your objective is to get the best advice appropriate for your needs. The adviser's objective should be the same, but the method (or product) selected could possibly be chosen because of the commission structure the product offers. There is a potential conflict of interest any time a salesperson charges a fee or commission.

Check the credentials of the adviser. Financial services professionals are licensed for the products they sell and they must meet continuing education requirements to maintain those licenses. There are special certifications such as the CFP®, the Certified Financial Planner designation, and the CLU, Chartered Life Underwriter, that indicate a level of competence in some aspects of financial planning.

While most financial services professionals are indeed professional and knowledgeable in their field, it is still your responsibility to ensure that their advice serves your needs. It should be your decision which product to buy, how much insurance coverage you should have, and when to change investments. Educating yourself on these financial products will help you make sound decisions.

### Step 5. Evaluate Your Financial Plan

After you develop and implement each component of your financial plan, you must monitor your progress to ensure that the plan is working as you intended. Keep your financial plan easily accessible so that you can evaluate it over time.

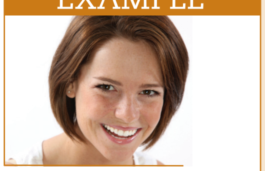
### Step 6. Revise Your Financial Plan

If you find that you are unable or unwilling to follow the financial plan that you developed, you need to revise the plan to make it more realistic. Of course, your financial goals may have to be reduced as well if you are unable to maintain the plan for achieving a particular level of wealth.

As time passes, your financial position will change, especially upon specific events such as graduating from college, marriage, a career change, or the birth of a child. As your financial position changes, your financial goals may change as well. You need to revise your financial plan to reflect such changes in your means and priorities.

The steps in developing a financial plan are summarized in Exhibit 1.9. To see how the steps can be applied, consider the following example.

**EXAMPLE**



Stephanie Spratt graduated from college last year with a degree in marketing. After job searching for several months, she was just hired by the sales department of an advertising firm at an annual salary of $38,000. She is eager to have money from her salary to spend and to give up her interim part-time job waiting tables.

Stephanie plans to save a portion of every paycheck so that she can invest money to build her wealth over time. She realizes that by establishing a financial plan to limit her spending today, she can increase her wealth and therefore her potential spending in the future. At this point, Stephanie decides to develop an overview of her current financial position, establish her goals, and map out a plan for how she might achieve those goals, as shown in Exhibit 1.10.

## Exhibit 1.9 Summary of Steps Used to Develop a Financial Plan

1. Establish your financial goals.
   - What are your short-term financial goals?
   - What are your intermediate-term financial goals?
   - What are your long-term financial goals?
2. Consider your current financial position.
   - How much money do you have in savings?
   - What is the value of your investments?
   - What is your net worth?
3. Identify and evaluate alternative plans that could achieve your goals.
   - Given your goals and existing financial position described in the previous steps, how can you obtain the necessary funds to achieve your financial goals?
   - Will you need to reduce your spending to save more money each month?
   - Will you need to make investments that generate a higher rate of return?
4. Select and implement the best plan for achieving your goals.
   - What are the advantages and disadvantages of each alternative plan that could be used to achieve your goals?
5. Evaluate your financial plan.
   - Is your financial plan working properly? That is, will it enable you to achieve your financial goals?
6. Revise your financial plan.
   - Have your financial goals changed?
   - Should parts of the financial plan be revised in order to increase the chance of achieving your financial goals? (If so, identify the parts that should be changed, and determine how they should be revised.)

Key decisions that relate to Stephanie's financial plan will be summarized at the end of each chapter. Your financial planning decisions will differ from Stephanie's or anyone else's. Nevertheless, the process of building the financial plan is the same. You need to establish your goals, assess alternative methods for reaching your goals, and decide on a financial plan that can achieve your goals.

## Exhibit 1.10 Overview of Stephanie Spratt's Financial Plan

**Step 1. Current Financial Position:**

*I have very little savings at this time and own an old car. My income, which is about $30,000 a year after taxes, should increase over time.*

**Step 2. Financial Goals:**

*I would like to:*

- *buy a new car within a year,*
- *buy a home within two years,*
- *make investments that will allow my wealth to grow over time, and*
- *build a large amount of savings for retirement in 20 to 40 years.*

**Step 3. Plans to Achieve the Goals:**

*Since my current financial position does not provide me with sufficient funds to achieve these financial goals, I need to develop a financial plan for achieving these goals. One possible plan would be to save enough money until I could purchase the car and home with cash. With this plan, however, I would not have sufficient savings to purchase a home for many years. An alternative is to save enough money to make a down payment on the car and home and to obtain financing to cover the rest of the cost. This alternative plan allows me to allocate some of my income toward investments.*

*My financing decisions will determine the type of car and home that I will purchase and the amount of funds I will have left to make other investments so that I can build my wealth over time.*

**Step 4. Selecting and Implementing the Best Plan:**

*Financing the purchase of a car and a home is a more appropriate plan for me. I will prepare a budget so that over time I can accumulate savings that will be used to make a down payment on a new car. Then, I will attempt to accumulate savings to make a down payment on a new home. I need to make sure that I can afford financing payments on any money that I borrow.*

**Step 5. Evaluating the Plan:**

*Once I establish a budget, I will monitor it over time to determine whether I am achieving the desired amount of savings each month.*

**Step 6. Revising the Plan:**

*If I cannot save as much money as I desire, I may have to delay my plans for purchasing a car and a home until I can accumulate enough funds to make the down payments. If I am able to exceed my savings goal, I may be able to purchase the car and the home sooner than I had originally expected.*

## SUMMARY

- Personal financial planning is the process of planning your spending, financing, and investing to optimize your financial situation. Your financial planning decisions allow you to develop a financial plan, which involves a set of decisions about how to manage your spending, financing, and investments.
- A financial plan has six components: (1) budgeting, (2) managing your liquidity, (3) financing large purchases, (4) protecting your assets and income, (5) investing, and (6) planning beyond your career.
- The financial planning process involves six steps: (1) establishing your financial goals, (2) considering your current financial position, (3) identifying and evaluating alternative plans that could achieve your goals, (4) selecting and implementing the best plan for achieving your financial goals, (5) evaluating the financial plan over time to ensure that you are meeting your goals, and (6) revising the financial plan when necessary.

## REVIEW QUESTIONS

*All Review Questions are available in* myfinancelab *at www.myfinancelab.com*

1. **Personal Finance Decisions.** Define personal financial planning. What types of decisions are involved in a personal financial plan?
2. **Opportunity Cost.** What is an opportunity cost? What might be some of the opportunity costs of spending $10 per week on the lottery?
3. **Personal Finance Benefits.** How can an understanding of personal finance benefit you?
4. **Financial Plan Components.** What are the six key components of a financial plan?
5. **Budget Planning.** Define budget planning. What elements must be assessed in budget planning?
6. **Net Worth.** How is your net worth calculated? Why is it important?
7. **Tax Effects on Planning.** What factors influence income? Why is an accurate estimate of

expenses important in budget planning? How do tax laws affect the budgeting process?

8. **Liquidity.** What is liquidity? What two factors are considered in managing liquidity? How are they used?
9. **Financing.** What factors are considered in managing financing?
10. **Investing.** What is the primary objective of investing? What else must be considered? What potential investment vehicles are available?
11. **Protecting Your Assets.** What are the three elements of planning to protect your assets? Define each element.
12. **Your Cash Flows.** How does each element of financial planning affect your cash flows?
13. **Steps in Financial Planning.** What are the six steps in developing a financial plan?
14. **Financial Goals.** How do your financial goals fit into your financial plan? Why should goals be realistic? What are three time frames for goals? Give an example of a goal for each time frame.
15. **Your Financial Position.** Name some factors that might affect your current financial position.
16. **Financial Goals and Planning.** How do your current financial position and goals relate to your creation of alternative financial plans?
17. **Implementing Your Plan.** Once your financial plan has been implemented, what is the next step? Why is it important?
18. **Revising Your Plan.** Why might you need to revise your financial plan?
19. **Online Information.** List some information available on the Internet that might be useful for financial planning. Describe one way you might use some of this information for financial planning purposes.
20. **Financial Advisers.** Offer an example of unethical behavior that financial advisers might engage in. How can an understanding of personal financial planning help you deal with this potential behavior?

## FINANCIAL PLANNING PROBLEMS

*All Financial Planning Problems are available in* myfinancelab *at www.myfinancelab.com*

1. **Estimating Savings.** Julia brings home $1,600 per month after taxes. Julia's rent is $350 per month, her utilities are $100 per month, and her car payment is $250 per month. Julia is currently paying $200 per month to her orthodontist for her braces. If Julia's groceries cost $50 per week and she estimates her other expenses to be $150 per month, how much will she have left each month to put toward savings to reach her financial goals?
2. **Estimating the Opportunity Cost.** Julia (from problem 1) is considering trading in her car for a new one. Her new car payment will be $325 per month, and her insurance cost will increase by $60 per month. Julia determines that her other car-related expenses (gas, oil) will stay about the same. What is the opportunity cost if Julia purchases the new car?
3. **Estimating Net Worth.** Mia has $3,000 in assets, a finance company loan for $500, and an outstanding credit card balance of $135. Mia's monthly cash inflows are $2,000, and she has monthly expenses of $1,650. What is Mia's net worth?
4. **Estimating Net Worth.** At the beginning of the year, Arianne had a net worth of $5,000. During the year she set aside $100 per month from her paycheck for savings and borrowed $500 from her cousin that she must pay back in January of next year. What was her net worth at the end of the year?
5. **Estimating Net Worth.** Anna has just received a gift of $500 for her graduation, which increased her net worth by $500. If she uses the money to purchase a stereo, how will her net worth be affected? If she invests the $500 at 10 percent interest per year, what will it be worth in one year?
6. **Estimating Cash Flows.** Jason's car was just stolen, and the police informed him that they will probably be unable to recover it. His insurance will not cover the theft. Jason has a net worth of $3,000, all of which is easily convertible to cash. Jason requires a car for his job and his daily life. Based on Jason's cash flow, he can't currently afford more than $200 in car payments. What options does he have? How will these options affect his net worth and cash flow?
7. **ETHICAL DILEMMA:** Sandy and Phil have recently married and are both in their early 20s. In establishing their financial goals, they determine that their three long-term goals are to purchase a home, to provide their children with

college education, and to plan for their retirement.

They decide to seek professional assistance in reaching their goals. After considering several financial advisers who charge an annual fee based on the size of their portfolio, they decide to go to Sandy's cousin Larry, who is a stockbroker. Larry tells them that he is happy to help them, and the only fee he will charge is for transactions. In their initial meeting, Larry recommends stocks of several well-known companies that pay high dividends, which they purchase. Three months later, Larry tells them that due to changing market conditions, they need to sell the stocks and buy several others. Three months later, the same thing happens. At the end of the year Phil and Sandy, who had sold each of the stocks for more than they had paid for them, were surprised to see that the total dollar value of their portfolio had declined. After careful analysis, they found the transaction fees exceeded their capital gains.

a. Do you think Larry behaved ethically? Explain.

b. Would Larry have a personal reason for handling Sandy and Phil's portfolio as he did? Explain.

## FINANCIAL PLANNING ONLINE EXERCISE

1. The purpose of this exercise is to familiarize you with the wide variety of personal finance resources on Yahoo!. Go to finance.yahoo.com/personal-finance.

   a. Determine how inflation and taxes will affect your investments. Click "Taxes" and using the calculator "How do taxes and inflation impact my return?" answer this question: Assuming a before-tax return on your savings of 8%, a state marginal tax rate of 5%, a federal marginal tax rate of 25%, no itemized deductions, and an annual inflation rate of 3%, what would a $10,000 investment be in 10 years?

   b. Return to finance.yahoo.com/personal-finance. Click on "Banking and Budget" and using the calculator "Value of reducing or foregoing expenses" determine how much you could save in 10 years if you stopped buying soft drinks from a vending machine. Assume you currently spend $35 per month on soft drinks and you could invest this money at a rate of return of 8%.

   c. Now click "Loans" and using the calculator "What would my loan payments be?" determine what your loan payment would be if you borrowed $30,000 at 6% for 60 months and made monthly payments. For your 10th payment, how much of the loan payment would be interest? (*Hint*: Find the loan amortization table.)

   d. Click "Retirement" and using the calculator "How much will I need to save for retirement?" complete the following exercise: Assuming an inflation rate of 3%, a desired retirement age of 65, 30 years of retirement income, income replacement of 100%, and returns both pre- and post-retirement of 8%, use your current age and other current information to compute how much you will need to save for retirement. (*Hint*: If you are not currently working and have no income, use your estimated income upon graduation.) Make this calculation both including and excluding Social Security.

   e. Using the section entitled "Rates," click each of the tabs. Have interest rates on home mortgages increased or decreased over the last week? On home equity loans? On savings? On auto loans? On credit cards? How do national auto loan rates compare to auto loan rates in your local area? (*Hint*: Click "View rates in your area" to answer this question.)

## VIDEO EXERCISE: Benefits of Financial Planning

Go to one of the Web sites that contain video clips (such as www.youtube.com) and view some video clips about financial planning. Conduct a search of the site using phrases such as "value of financial planning" or "benefits of financial planning." Select one video clip on this topic that you would recommend for the other students in your class.

1. Provide the Web link for the video clip.
2. What do you think is the main point of this video clip?
3. How might you change your financial planning as a result of watching this video clip?

## BUILDING YOUR OWN FINANCIAL PLAN

These end-of-chapter exercises are designed to enable you to create a working lifelong financial plan. Like all plans, your personal plan will require periodic review and revision. In this first exercise, you should review your current financial situation. If you are a full-time student, base your review on what you anticipate your financial situation will be upon your graduation. After carefully reviewing your current or anticipated financial situation, create three short-term goals and three intermediate-term and long-term goals.

Your short-term goals should be goals that you can realistically accomplish in one year. They may include, but are not limited to, paying off credit card balances, beginning a 401(k) or other retirement-type savings program, or getting your cash inflows and outflows in balance.

Your intermediate-term goals are goals that you should realistically be able to accomplish in one to five years. They may include, but are not limited to, purchasing a new vehicle or paying off school loans.

Long-term goals will take longer than five years to accomplish realistically. They may include, but are not limited to, purchasing a home, taking a major trip (such as a summer in Europe), or saving sufficient funds to retire at a predetermined age.

The goals that you develop are a first draft and may be added to or modified as you proceed through this course. This course is designed to provide you with information and insight that will help you make informed decisions about your financial future. As you gain experience in financial planning, new goals may emerge, and existing goals may change. Once you have completed your financial plan, you should review your goals annually or whenever a significant change occurs in your life (e.g., marriage, divorce, birth of a child, or a significant change in employment circumstances).

Go to the worksheets at the end of this chapter and to the CD-ROM accompanying this text to begin building your financial plan.

## THE SAMPSONS—A CONTINUING CASE

Dave and Sharon Sampson are 30 years old and have two children, who are five and six years old. Since marrying seven years ago, the Sampsons have relied on Dave's salary, which is currently $48,000 per year. They have not been able to save any money, as Dave's income is just enough to cover their mortgage loan payment and their other expenses.

Dave and Sharon feel they need to take control of their finances. Now that both children are in school, they have decided that Sharon will look into getting a part-time job. She was just hired for a part-time position at a local department store at a salary of $12,000 per year. Dave and Sharon are excited by the prospect of having additional cash inflows—they now feel they have the leeway to start working toward their financial goals.

The Sampsons own a home valued at about $100,000, and their mortgage is $90,000. They have a credit card balance of $2,000. Although they own two cars and do not have any car loans, Sharon's car is old and will need to be replaced soon. Sharon would really like to purchase a new car within the next year; she hopes to save $500 each month until she has accumulated savings of $5,000 to use for a down payment.

The Sampsons are also concerned about how they will pay for their children's college education. Sharon plans to save an additional $300 each month that will be set aside for this purpose.

The Sampsons also know they need to save for their retirement over time. Yet they do not have a plan right now to achieve that goal because they are focused on saving for a new car and their children's education. If the Sampsons were to start saving for retirement, they would probably consult a financial adviser.

The Sampsons have decided to develop a financial plan. They realize that by formally identifying their main goals, they will be able to implement and monitor their plan over time. At the end of every chapter, you will help the Sampsons develop their financial plan using the key concepts presented in the chapter.

Go to the worksheets at the end of this chapter, and to the CD-ROM accompanying this text to begin this case.

NAME DATE

# Chapter 1: Building Your Own Financial Plan

## GOALS

1. Evaluate your current financial situation.
2. Set short-term, intermediate-term, and long-term goals.

## ANALYSIS

1. Complete the Personal Financial Goals worksheet below.

## Personal Financial Goals

| Financial Goal | Dollar Amount to Accomplish | Priority (Low, Medium, High) |
|---|---|---|
| **Short-Term Goals** | | |
| 1. | | |
| 2. | | |
| 3. | | |
| **Intermediate-Term Goals** | | |
| 1. | | |
| 2. | | |
| 3. | | |
| **Long-Term Goals** | | |
| 1. | | |
| 2. | | |
| 3. | | |

2. A key part of the process of establishing your goals is evaluating your financial situation and career choices. Go to the "Occupational Outlook Handbook, 2004–05 Edition" (www.bls.gov/oco/home.htm) and research two careers that interest you. Complete the worksheet on the next page with the information you find on this Web site.

NAME DATE

## Personal Career Goals

| | Career One | Career Two |
|---|---|---|
| Job Title | | |
| Educational Requirements | | |
| Advancement Potential | | |
| Job Outlook | | |
| Salary Range | | |
| Continuing Education Requirements | | |
| Related Occupations | | |
| Brief Description of Working Conditions | | |
| Brief Job Description | | |

## DECISIONS

Describe your strategies for reaching your goals.

NAME DATE

# Chapter 1: The Sampsons—A Continuing Case

## CASE QUESTION

Help the Sampsons summarize their current financial position, their goals, and their plans for achieving their goals by filling out the following worksheets.

## Current Financial Position

| Major Assets | Amount |
|---|---|
| Savings (High, Medium, or Low) | |
| Money Owed | |
| Salary | |

## Financial Goals

**Goal 1. Purchase a new car for Sharon this year**

| | |
|---|---|
| How to Achieve the Goal | |
| How to Implement the Plan | |
| How to Evaluate the Plan | |

**Goal 2. Pay for the children's college education in 12–17 years from now**

| | |
|---|---|
| How to Achieve the Goal | |
| How to Implement the Plan | |
| How to Evaluate the Plan | |

**Goal 3. Set aside money for retirement**

| | |
|---|---|
| How to Achieve the Goal | |
| How to Implement the Plan | |
| How to Evaluate the Plan | |