

Budgeting Basics

A Financial Make-over



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Summary

Rachel exits college with a whopping student loan and heavy credit card debt. Excited to be in the grown-up world at last, she lands a job, rents her first apartment, leases a car and runs smack into the real world.

That \$30,000+ salary once seemed like megabucks, but now Rachel discovers that debt, taxes, everyday expenses, and a few unexpected bills can turn a tidy sum into a hole in the wallet.

Thanks to her friendship with a financial planner-in-training she learns the value of preparing a budget and sticking to a spending plan.

Rachel's lessons can help students learn:

- How to prepare a basic budget, no matter how small the income
- How to track expenses; keeping a spending diary
- How to organize financial records
- How to audit spending habits and discover expensive "blind spots"
- How to plan for the unexpected and maintain a safety net
- How to put all the pieces together in a budget to meet personal goals
- Why not default on a student loan
- Percentage guidelines for spending
- Ways to save – such as an automatic payroll deduction plan
- Cost-cutting ways to reduce spending

Life After College

Rachel finds her expenses continue to add up after departing from college, despite having a job.

She finds that she needs a financial whiz kid, luckily for Rachel a yoga student of hers is just that! Tony and Rachel conjure up a bartering system. He gives her financial planning sessions in exchange for yoga sessions.

Rachel's first assignment is to list her needs vs. wants. Her needs are shelter, food, health insurance, transportation, cell phone, and internet. Wants are extras, like a loaded MP3 player, a new laptop, eating at restaurants with friends.

Now she is ready to begin tackling the job of writing a budget with Tony's help.

Rachel is asked to list her assets. She is asked to review the most recent statements from her checking and savings accounts. Tony asks if she holds any real estate, brokerage, retirement accounts, or does her employer offer a matching contribution to her retirement account. If they do it is like a bonus, as the company is awarding money to an account without any extra effort from the employee.

Rachel claimed zero withholding allowance on her taxes, thinking the income tax refund will be a bonus. However, in effect she gave the government an interest free loan. That money could have earned interest for Rachel, instead of the government!

Getting A Handle On Your Spending

Rachel is asked to take her monthly income and subtract the money withheld from her paychecks; then she'll know her take-home pay, also known as spendable income.

Rachel is then prompted to outline her fixed expenses that remain the same each month, like cable and web fees, basic phone service and insurance.

Rachel's Fixed Expenses

Withholding for Social Security, Medicare, Federal and State taxes	\$550
HMO	\$ 85
IRA (5%)	\$125
Rent/Utilities	\$800
Car payment	\$200
Car insurance	\$100
Student loan repayment	\$130
Credit card minimum payments	\$100
Cell/Internet/Basic cable	\$ 99

Many people use computer software dedicated solely tracking their money, provided that the user inputs everything, such as car payments, student loan repayments, credit card balances and so forth. This is a great tool to provide a neat visual picture of your spending habits.

In addition to an electronic system, it is best to always have a physical filing system for your financial papers. There is not a set organization method. Use categories that work best for you. It is an easy task to do, while you are watching a movie, listening to your favorite tunes or maybe even talking on the telephone...

Organizing Financial Records

After Tony's next yoga session with Rachel he reviews her organized receipts and financial records. He suggests further ways for Rachel to cut down on spending, such as getting a roommate. Spending more than a third (33%) of one's monthly take-home pay on rent or mortgage payments can put a real strain on one's budget. Tony even suggests that Rachel could move back home to really save money. Rachel isn't too excited about this plan, and opts for a roommate.

Since Rachel decides she'll get a roommate to save on money and put it towards other needs, Tony decides to look at her car lease. He sees the lease on her car costs \$200 a month, her auto insurance is \$100 a month.

The car lease requires Rachel to have ample coverage to protect her in case of an accident. In addition, she must feed her car with gas and oil. That adds another \$500 just to get around. It is important to know that experts recommend spending about 18% of your income on transportation. Rachel is spending more than double that! Tony explains that a purchase is a wiser choice than a lease. When she pays off the purchase the car belongs to Rachel, not the car dealership. With that added advantage she can enjoy the car for a few more years without car payments and a high insurance premium.

Good Debt vs. Bad Debt

Rachel pays \$130 a month for her college student loan. Tony reminds her that a student loan is good debt, even though it carries an interest rate that is much lower than all of her credit cards. Rachel points out that she is carrying \$4000 in credit card debt, which continues to grow each and every month. Unfortunately, Rachel is only making a payment of \$100 per month, the very bare minimum.

Tony finds that based on her interest rate—it will cost her over \$2300 to pay off that debt over five years. That is just the interest! If she takes a little over two years to pay off the \$4000 credit card debt, her interest costs will be only \$842. Paying the debt off in two years will make a huge impact on her finances,

For Rachel to take the challenge to pay off her credit card debt in two years she will need to trim other parts of her budget. Tony wisely suggests that she pay extra on the card with the highest interest rate and pay the minimum due on the other cards. Rachel will dig herself out of the credit card debt hole. Rachel decides independently to increase her payment by \$100 and to take on extra yoga classes for more income.

To manage Rachel's money more effectively, Tony asks her to keep a financial diary of all of her spending that varies from month to month, such as food, clothing, salon services, health costs, money spent on her pet or hobbies. She is instructed to save receipts from her credit cards and cash expenses. That way they can account for her spending the next time they meet.

Rachel's Spending Habits

For the next two weeks Rachel tracks all of her spending. It takes time away from other activities, but it is important for Rachel to see why her salary is disappearing so quickly. Everything is documented from filling up her gas tank, to the expensive tea from a fancy coffee house. Don't forget she needs to eat, so there are grocery expenses, too. Rachel has the dream of unlimited wealth, so she pays for lotto tickets. Fun is a requirement for Rachel so she downloads music, goes out for dinner with friends and family and she must check out the latest band. Rachel is also very feminine so she needs to have her hair done, manicures, pedicures and new clothes and oh so much more.

Rachel asks Tony to give her guidelines on how to spend in each category. He suggests the following:

Food:	16%
Entertainment:	6%
Clothing & Personal:	7%

Rachel finds that she can save money by eating at home. She can even brew her own tea for only 35 cents a day. She continues to crunch the numbers to find out that she can only afford \$30 a week for fun/entertainment. She decides to stay within that, but struggles with the clothing allowance.

If Rachel stays within the guidelines, she would be better off for emergencies, like if her dog needs a surgery or for those happy occasions when a friend gets married.

After Rachel cleans up her credit card debt, she can develop a spending plan where she implements a savings plan, by putting 10% of her take home pay into a saving account. Rachel is afraid this may be more difficult than it sounds. Tony suggests that Rachel ask her employer if the company has an automatic payroll deduction. If they do, her employer can automatically put the money in a savings account as part of its direct deposit program. The automatic deduction would mean Rachel would not see the money, therefore wouldn't be able to spend it.

Trimming The Fat

When Rachel takes a serious look at her spending, she finds that she could make additional trimming. She finds cheaper car insurance on the internet that is reputable, too. She's cut down on getting her hair done every five weeks to six weeks. She completely cuts out the expensive manicures and pedicures until she is out of credit card debt. Rachel finds that she can go to her local public library for books, cds and dvds; which saves a lot of money! Instead of eating out at lunchtime, Rachel prepares a bagged lunch to take to work; which in many respects can be healthier, too. She's even found ways to cut down on her grocery spending by buying gallon-sized generic products at discount stores and joining an organic food co-op. Rachel even decides to allow for a new category in her budget, charitable contributions.

To make a budget work for you, compare your monthly estimates with your actual spending.

Rachel finds that she has trimmed her budget as much as she can and can hardly imagine cutting it anymore. Tony warns her that cutting back too severely, especially on food and fun, becomes like a starvation diet. You're likely to gorge and perhaps even binge - which can be unhealthy for the wallet.

With Rachel's budget up and running, she can both spend and save. Rachel finds the flexibility to accomplish her financial goals.

Tony sees Rachel about two years later and notices her new car. He asks her how she got it. Rachel explains that when her lease expired, she purchased a two-year-old car with low mileage. In addition it is a hybrid so she is saving on gasoline all the while helping the environment which is important to her.

After two years her credit card debit is more manageable, too. The combination of earning more and spending less has helped keep her budget on track.

The time-tested budgeting system worked for Rachel and can work for you!

Review

- List needs vs. wants prior to setting up a budget
- Thoroughly review fixed expenses
- Keep a spending financial diary on daily expenses
- Review your diary and trim the financial fat
- Write down your personal budget
- Understand good debt vs. bad debt
- Always pay off high interest rate credit cards first
- Align spending with suggested guidelines
- Stick to the budget!

Questions For Discussion

1. What financial mistakes did Rachel make after she first graduated?

She committed herself to an apartment which was too expensive for her income. She leased rather than purchased a car that was too expensive for her. She had no savings plan and couldn't meet unexpected expenses.

2. What is a budget and why is having one a good idea?

A budget is a written spending plan. It will improve management of one's income.

3. When is establishing an Individual Retirement Account (IRA or 401K) a good idea?

When an employer matches personal contributions to a retirement account, it's like a bonus or automatic raise.

4. Rachel set up a filing system. What paper work did she save?

The auto section included her lease agreement, registration and insurance, and warranties. The banking section included transactions with a teller, ATM transactions, bank fees, deposits, receipts, online banking transactions, recurring automatic payments, transfers of money between accounts. The credit card section included monthly statements and individual receipts. Other sections include: student loan records, health care materials, housing expenses, salary stubs, and past tax returns.

5. How did Rachel trim spending?

She shopped the Internet for a better price for car insurance; she found a bank with free checking and ATMs on her way to work. She got hair cuts less frequently, went to the library for books and DVDs, took lunch to work, bought large generic sizes, and joined a food co-op.

6. Why did Tony suggest that Rachel avoid cutting her budget too severely?

A person who allows too little for food and fun is likely to stop following the budget and overspend.

7. Do you plan to prepare a budget? If not, why not?

Common excuses include:

- *Too busy*
- *Will do it later*
- *Too tedious*
- *Meant to, but I forgot*
- *Can't find all those records*
- *Budgeting takes too long*
- *Other people say budgeting doesn't work*

Suggested Activities

1. Plan a budget according to the procedures described in the video.
2. Keep a financial diary for two weeks, using the hand-out in this guide. Prepare a report telling the class what you learned.
3. Prepare a budget for a variety of situations:
 - A person living alone who has completed a two year tech school program and earns \$25,000 per year.
 - Two persons sharing an apartment working at minimum wage jobs.
 - Someone attending college and living in a dorm.
 - Someone with children.

Budgeting Basics

Multiple Choice Worksheet

Circle the best available answer for each of the following:

1. A budget is:

- a) spendable income
- b) a well-written spending plan
- c) your assets
- d) take home pay

2. To withhold more income in order to receive a larger tax refund is:

- a) a 401k plan
- b) a fixed asset
- c) giving the government an interest free loan
- d) an H & R Block plan

3. Spendable income is:

- a) the amount left after withholding taxes and FICA
- b) fixed income
- c) clothing allowance
- d) a spending plan

4. Housing should be what percentage of your budget:

- a) 80%
- b) 100%
- c) 15%
- d) 33%

5. An emergency fund should have how much in savings:

- a) two weeks of spendable income
- b) a year of FICA
- c) two months of your 401K contributions
- d) 3-6 months of fixed income to cover your expenses

6. An easy way to save money without spending is to:

- a) keep it in your checking account
- b) place it under your mattress
- c) ask your employer to automatically direct deposit into a savings account
- d) give it to your best friend

7. A student loan is:

- a) an IRA
- b) good debt
- c) a spending plan
- d) bad debt

8. When purchasing a car it is best to:

- a) put 20% down
- b) buy a used car
- c) to buy one with low mileage
- d) all of the above

9. To get out of credit card debt:

- a) pay off the low interest rate credit cards first
- b) put all your fixed expenses on the credit card with the most available
- c) pay off the highest interest rate card first
- d) none of the above

10. A budget is only needed when:

- a) you don't live with your parents
- b) you have a job
- c) you get into credit card debt
- d) always

Budgeting Basics

Multiple Choice Worksheet *Answer Key*

Circle the best available answer for each of the following:

1. A budget is

- a) spendable income
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- d) take home pay

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10. A budget is only needed when:

- a) you don't live with your parents
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- d) always**

Budgeting Basics

Quiz

Match the words in the first column to the best available answer in the second column.

- | | | |
|-------|---|---------------------------|
| _____ | an IRA or 401K is like what from an employer | 1) discontinue the budget |
| _____ | this includes money in checking and savings; real estate; brokerage accounts; retirement accounts | 2) needs vs. wants |
| _____ | this percentage of your income should go towards transportation | 3) spending |
| _____ | cutting your budget too severely will likely cause you to | 4) bad debt |
| _____ | when categorizing your budget be sure to categorize your | 5) bonus |
| _____ | one of the first steps in creating a budget is to define | 6) same each month |
| _____ | fixed spending is the amount that remains the | 7) assets |
| _____ | credit card debt is | 8) 18% |

Budgeting Basics

Quiz *Answer Key*

Match the words in the first column to the best available answer in the second column.

- | | |
|----------------------------|---|
| 5) bonus | an IRA or 401K is like what from an employer |
| 7) assets | this includes money in checking and savings; real estate; brokerage accounts; retirement accounts |
| 8) 18% | this percentage of your income should go towards transportation |
| 1) discontinue your budget | cutting your budget too severely will likely cause you to |
| 3) spending | when categorizing your budget be sure to categorize your |
| 2) needs vs. wants | one of the first steps in creating a budget is to define |
| 6) same each month | fixed spending is the amount that remains the |
| 4) bad debt | credit card debt is |

Your Fixed Expenses

Withholding for Social Security, Medicare, Federal and State taxes	\$
HMO	\$
IRA (5%)	\$
Rent Utilities	\$
Car payment	\$
Insurance (car, medical, life)	\$
Student loan repayment	\$
Credit card minimum payments	\$
Phone, Internet, Basic Cable	\$

Flexible Budget Items

	Estimated	Actual
Clothes	\$	\$
Food Groceries and eating out	\$	\$
Transportation Gasoline, car washes, maintenance, taxis, public transportation	\$	\$
Medical and dental expenses Co-pays, prescription drug costs, over-the counter medicine	\$	\$
Home expenses Furnishings, maintenance, painting, kitchen gadgets	\$	\$
Bank fees Unexplained withdrawals, ATM user fees	\$	\$
Personal care Salon services, laundry, cosmetics, gym membership	\$	\$
Pop-ups Pet expenses, events	\$	\$
Entertainment/ Recreation Hobbies, sports equipment, vacations, tickets to events, music, movies	\$	\$
Gifts/Contributions Wedding expenses, birthdays, Church and charitable donations	\$	\$

Glossary

Barter	To trade goods or services without the exchange of money.
Budget	A written record of income and spending; a plan for managing money.
Fixed Expenses	Costs you must pay at specific times, no matter what.
Flexible expenses	Costs that vary, depending on events.
Goals, short term	Smaller goals, things possible to accomplish in a short time, around six months to a year.
Goals, long term	Larger projects that take longer than a year to achieve.
Income	The total sum of money received from all sources.
Income tax	A tax that federal and state governments collect based on money earned.
Individual Retirement Account (IRA)	A private retirement account.
Interest	A fee paid to borrow money. The original amount lend is called the "principal;" the percentage of the principal which is paid over a period of time is the "interest rate."
Internal Revenue Service (IRS)	The government agency responsible for collecting federal taxes.
Lease	An agreement to use or to occupy personal property for a fixed period of time, in return for a payment with a fixed interest rate.
Medicare	Publicly funded health insurance program generally for the elderly and disabled.
Periodic expenses	Expenses that come up occasionally.
Social Security	A fund managed by the government to which workers contribute through taxes. It pays benefits to people who are retired or disabled, or who are survivors of a deceased worker.
Spendable Income	Amount remaining after deducting taxes and FICA from income.
Student loans	Loans offered to students to help pay the costs of professional education. Loans usually carry lower interests than other loans; usually issued by the government.
Receipt	A document given to a consumer at time of purchase; acts as proof of purchase.
Taxes	The money the government collects from citizens.
Withholding	Deduction of money from an employee's wages by an employer, for projected income tax.