

Budgeting and Emergency Savings

Questions and Concerns:

- I do not know where my money is going.
- I have not managed for expected and unexpected expenses such as car repairs or health care deductibles.

Prior to preparing a budget or cash flow statement, one should understand their financial goals and how much it will take to accomplish those goals. An athlete sets goals to know what type of training is necessary to accomplish that goal. The same goes for individuals who wish to accomplish their financial goals. They understand what their most important financial goals are and act on accomplishing those goals. Preparing a monthly cash flow statement is similar to a homework assignment. The net worth statement at the end of six months is your semester grade. Understanding the relationship of income and expenses is not only beneficial to spenders but also to thrifty individuals.

I do not know where my money is going.

A cash flow analysis is perhaps the most insightful and meaningful step to understand your finances. The concept is simply tracking all of your income and expenses and sum them up into various categories. Although, on the surface this appears to be an easy concept, in reality it is a difficult and emotional task to execute. Many are paralyzed on where to begin. From an emotional stand point, you expose yourself to your own spending behavior. Worse, if you have a significant other, you expose your spending habits to them as well. However, if you are committed to accomplishing your goals, the solutions (adjustments to income or spending) will ensue.

Writing Down Your Daily Expenses -The good news is that is all you need is a pencil, paper and the ability to add/subtract to create a cash flow analysis. The first step is to identify and list every expenditure daily. This literally means daily writing each expense type and amount spent on, let's say, a yellow pad. The information for the expenditures list can come from receipts, your credit card statement, checking account register, bill pay or checking statement. Tracking expenditures takes a tremendous amount of discipline and the need for constant reminders. Use the calendar on your phone or computer to provide daily reminders. Below is an example of a list which accountants call a journal entry:

Date	Amount	Place: Purpose
8-1-12	8.00	City of Santa Fe Parking: Parking
8-1-12	3.59	Starbucks & CaffeLatte
8-1-12	8.53	Lunch Box: Lunch
8-1-12	2.25	Vending Machine: Soda & Snack
8-1-12	102.51	Walmart: Groceries ^(52.56) & Car Battery (50.00)

This is a tedious task and after a week, you will note spending behavior changes to avoid jotting down expenditures. For example, you will not want to go to the snack machine or coffee stand because that will mean accounting for another expense or explaining that expense to your significant other. You may note other behaviors such the amount of trips to the grocery store in a week. This may cause you to plan your meals more effectively to save time as well as the cost of fuel to drive to the store.

Summing Up and Categorizing Your Expenses - The next step is to sum up the various listed expenses into categories over the course of a month. You can establish and name your own categories. Having dinner outside the home can be labeled “Eating Out”, “Dining” or “Restaurant Expense”. For example, if you have to park your car downtown four times a month at \$8 per day your monthly transportation parking expense would be \$32.

Formatting Your Categories - There are generally two ways income and expense categories can be formatted: Fixed/Variable expenses or Major Class/Minor Class expenses. The Fixed/Variable Expenses separates the fixed expenses such as loan payments, auto payments and insurance payments that you do not have control over on the monthly payment amount. The variable expenses are expenses that you do have control over such as dining, entertainment and travel. The Major Class/Minor Class lumps all expenses into major expense classes and minor subclasses. For example the four major expense classes could be Home, Personal, Transportation and Other. The minor classification could be Home: Mortgage, Home: Utilities and Home: Repairs. Which format you choose is a matter of personal preference. The Appendix illustrates the two cash flow analyses.

Adjustments to your cash flow – For payments that are due periodically, such as auto insurance payments premiums due every six months, you should either 1) transfer a monthly amount to a savings account or, 2) have the insurance company bill you monthly. If you shopped at a major mega store for groceries and a car battery, you should split the expenses into the appropriate categories. At times it becomes a toss up to where to classify an expense. For example, buying a coffee may be classified either as a “personal other expense” or “dining” category. Accountants run into this often in defining the type of expense. Overall it is more important to be consistent than to struggle where to categorize that expenditure.

It is recommended that a cash flow analysis should be done for at least two months. The first month will help you understand your spending habits and to make spending adjustments. The second month is to measure progress on the adjustments.

Cash Flow Analysis Tools – Obviously the cash flow analysis can be done manually. One can also create a spreadsheet program to provide visuals and assist with the math. Also there is personal money management software that downloads account activity from your banking and credit card accounts. The set up can be cumbersome and there is a bit of a learning curve but many find these software programs helpful. In addition, several banking institutions have spending and cash flow analysis tracking on their checking accounts.

I have not managed for expected and unexpected expenses such as car repairs or health care deductibles.

An emergency savings or “rainy day fund” insures against minor financial setbacks. Sometime this is to cover anticipated expenses such as replacing tires, a roof, or other necessary non-monthly expenses.

Other times it might be used for unexpected deductible expenses for insurance. Such savings provides two benefits, 1) you can avoid financial setbacks and the need to borrow at a high interest rate and 2) you can increase your insurance deductibles. For people who are healthy and are safe drivers, a higher deductible usually means lower insurance premiums. A payroll deduction to a savings account is the best way to establish and maintain such a savings account. Most banks also have an automatic transfer from checking to savings. This automatic transfer can be set to transfer after a payroll deposit.

Conclusion

Once you complete a one month cash flow analysis, you will realize many things regarding your spending habits. It allows you to think of what is most important in your life. For many, they adjust their spending habits. For others, they realize that they need to adjust their financial goal expectations. Most everyone appreciate this exercise because it gives them the knowledge to make financial decisions that are important to them. Budgeting and building an emergency savings dovetail together to stabilize one's situation. Also, some people establish an additional savings account designated to accomplish various goals. Committing to this process, you will find things fall into place.

How can a financial planner help in the budgeting and cash flow analysis?

In order to help clients accomplish their financial goals, most financial planners require a cash flow analysis. A financial planner knows that this is a difficult but important task. Although the financial planner may act as a sounding board, the ideas and commitments best come from the client. After all, it is an individual's life not the planner's. Suggestions by a planner are often limited to modifications that do not change the life style such organizing meals and reducing travel to stores.

In addition, some financial planners often set up the money management software to help clients track their budgets. They provide training for the first few months until a client becomes proficient in running the software. This helps the household run more like a business.

In regards to the savings plans, the planner will help establish the various savings plans to accomplish savings goals such as emergency, vacation, and car repair/purchase.

DISCLAIMER

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Appendix: Cash Flow Analysis Comparison of the Fixed/Variable and the Major/Minor Category Formats

Monthly Fixed/Variable Format		Monthly Major/Minor Category Format	
Income		Income	
Salaries (Take Home)	5,000	Salaries (Take Home)	5,000
Other Income	50	Other Income	50
Total Income	5,050	Total Income	5,050
Expenses		Living Expenses	
Fixed Expenses		Home Expenses	
Mortgage	800	Home: Mortgage	800
Auto Loan	300	Home: Utilities	200
Auto Insurance	125	Home: Improvement	150
Student Loan	200	Home: Maintenance	100
Savings	200	Total Home	1250
Subtotal Fixed	1,625	Personal Expenses	
Variable Expenses		Personal: Groceries	
Groceries	600	Personal: Dining	800
Utilities	200	Personal: Grooming	80
Auto Fuel and Service	400	Personal: Clothes	100
Dining	800	Personal: Health & Medical	80
Entertainment & Travel	500	Personal: Hobby	150
Clothes	100	Personal: Entertain & Travel	500
Grooming	80	Total Personal	2310
Hobby	150	Auto Expenses	
Home Improvement	150	Auto: Loan	300
Home Maintenance	100	Auto: Insurance	125
Education	100	Auto: Fuel & Service	400
Health & Medical	80	Total Auto	825
Gifts & Charity	100	Other Expenses	
Taxes & Professionals	30	Other: Student Loan	200
Other Expenses	80	Other: Gifts & Charity	100
Subtotal Variable	3,470	Other: Taxes & Professionals	30
Total Expenses	5,095	Other: Education	100
Net Gain or Loss	(45)	Other: Miscellaneous	80
		Total Other	510
		Total Living Expenses	4895
		Savings	200
		Net Gain or Loss	(45)