

## 4-2

# Basics of Budgeting

## GOALS

- Identify the purpose of a personal budget.
- Prepare a personal budget.
- Describe recordkeeping methods used in the budgeting process.

## KEY TERMS

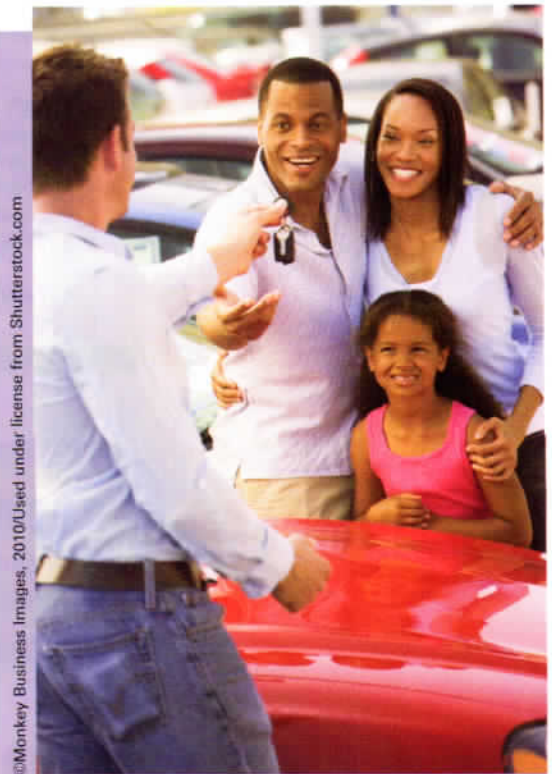
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## What Is the Purpose of Budgeting?

Budgeting is a critical part of managing your money. The purpose of a budget is to plan how you will spend and/or save money. A **budget** is a spending and saving plan based on expected income and expenses. A budget is similar to a cash flow statement because both are used to record income (cash inflows) and expenses (cash outflows). However, a **cash flow statement differs because it lists actual cash inflows and outflows to show how much money you have available on a certain date.** A budget lists **estimated income and expenses to help you create a financial plan.** Your goal is to create a financial plan that meets your daily and future spending and saving needs based on your expected income.

You may need to adjust amounts in a budget several times. By using **spreadsheet software**, such as Microsoft® Excel®, you can insert numbers and formulas to compute amounts and then easily change them later as needed. For example, what if your expenses go up by 8 percent? How will the budget be affected? What if the price of a car you are saving to buy goes up by 10 percent during the time you are saving for it? How much money will you need for the car? Allowing you to answer “what if” questions easily is one of the strengths of a spreadsheet program. When you change a number in Excel that is part of a calculation, all other amounts affected are updated automatically. Because amounts are calculated using formulas, math errors are eliminated (assuming, you initially entered the formulas correctly).

Using Excel, you can record your financial goals and then prepare the budgets that will help you achieve them. A sample budget created in Excel is shown in Figure 4-2.1.



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*How can using a budget help you plan your spending?*

**budget** a spending and saving plan based on expected income and expenses

**spreadsheet software** a computer program that allows you to insert numbers and formulas to compute amounts

Figure 4-2.1 Excel Spreadsheet

	A	B	C	D
1	<b>ALICE CHIN</b>			
2	<b>BUDGET FOR SEPTEMBER 20--</b>			
3				
4	<b>Income</b>			
5	Work (part-time)	\$300.00		
6	Allowance for doing household chores	15.00		
7	Lunch money allowance	40.00		
8	<b>Total Income</b>	<b>\$355.00</b>		
9				
10	<b>Savings</b>			
11	Deposit to savings account	\$100.00		
12				
13	<b>Expenses</b>			
14	Daily lunches	\$80.00		
15	Supplies	20.00		
16	Snacks	25.00		
17	Charitable giving	10.00		
18	Entertainment (movies and bowling)	120.00		
19	<b>Total Expenses</b>	<b>\$255.00</b>		
20				
21	<b>Total Expenses and Savings</b>	<b>\$355.00</b>		
22				

## CHECKPOINT ▶▶▶

How can you use a spreadsheet program to help you with budgeting?

## How Do You Prepare a Budget?

A budget should be designed to help meet financial goals, such as paying for current expenses and saving for the future. To create a budget, begin by looking at the amount you have available to spend or save. Then decide how much of that amount you will save and how much you will spend. You must also choose the items or services for which you plan to spend. Remember that a budget is a plan. Your actual income, saving, and spending may not be exactly as planned. You can compare your actual spending and saving to the budget to see how well you planned. This process will help you create better budgets in the future.

Figure 4-2.2 shows a sample budget. Look at each part of the budget as you read the steps for creating a budget in the following sections.

**Figure 4-2.2 Personal Budget**

<b>ANDREA MCCALL BUDGET FOR 20--</b>			
<b>Income</b>	<b>Weekly</b>	<b>Monthly</b>	<b>Yearly</b>
Work (part-time)	\$30.00	\$120.00	\$1,440.00
Allowance for household chores	10.00	40.00	480.00
Lunch money allowance	15.00	60.00	720.00
Savings account interest	.50	2.00	24.00
<b>Total income</b>	<u>\$55.50</u>	<u>\$222.00</u>	<u>\$2,664.00</u>
<b>Savings</b>			
Deposit to savings account	<u>\$ 5.50</u>	<u>\$ 22.00</u>	<u>\$ 264.00</u>
<b>Expenses</b>			
Gifts	\$ 5.00	\$ 20.00	\$ 240.00
Clothes and shoes	15.00	60.00	720.00
Loan payment to parents	5.00	20.00	240.00
Lunches	15.00	60.00	720.00
Entertainment/miscellaneous	10.00	40.00	480.00
<b>Total expenses</b>	<u>\$50.00</u>	<u>\$200.00</u>	<u>\$2,400.00</u>
<b>Total savings and expenses</b>	<u>\$55.50</u>	<u>\$222.00</u>	<u>\$2,664.00</u>

## STEPS IN PREPARING A BUDGET

To prepare a personal budget, there are four simple steps. You should keep good records so that your budget is both realistic and accurate. This way, you can make better decisions about how to improve the way you spend your money.

### Step 1 Estimate Income

You may have many different sources of *income*. Whether the money is earned or unearned, you should keep track of where it comes from and how often it is received. Because most budgets are prepared once a year, you should calculate income for an entire year. Locate the total estimated yearly income amount, \$2,664.00, in the budget in Figure 4-2.2.

You may receive income weekly, monthly, yearly, or on some other schedule. No matter when the income is received, it can be accounted for in terms of a monthly or yearly budget. If you receive income weekly, multiply the weekly amount by 4 to calculate how much that is per month. For example, \$10 received per week would be \$40 a month. (Rounding is okay as long as your total yearly amount is accurate.) If you receive income once a month, you can multiply it by 12 to get yearly income. When you look at the big picture—how much money comes in and goes out during an entire year—it may change the way you think about money.

### Step 2 Plan Savings

Pay yourself first—put money into savings before you consider other expenses. If you plan what you want to spend first, you may have no

money left for savings. Enter an amount that you would like to save. After entering expenses, you may need to adjust this amount. You might not be able to save as much as you want and still pay for all expenses. Plan to save some money, however, if at all possible. Savings allow you to plan for the future. You can identify items you would like to purchase at a future time with savings. Savings can also be used to pay for unexpected expenses that may come up. Locate the yearly savings amount, \$264, in the budget in Figure 4-2.2.

### Step 3 Estimate Expenses

*Expenses* are items for which you spend money. Clothes, lunches at school, and bus fares are examples of expenses. You may also make payments on an asset you purchase, such as a car. Other expenses are related to living costs and entertainment. Keeping track of what you spend will help you estimate expenses for the future. If you are trying to control expenses, seeing exactly how much you are currently spending for each expense can be helpful. Locate the expense amounts in the budget in Figure 4-2.2.

**variable expenses** costs that can go up and down each month

Costs that can go up and down each month are called **variable expenses**. An example of a variable expense is your gas and electric bill. When the weather is cold, the cost of heating your house will go up. Expenses can also vary due to changing prices. For example, as the price of gasoline rises, your transportation expense will also rise. The costs of food, clothing, and entertainment are also variable expenses. If you have less income or higher expenses than expected one month, you may need to decrease your variable expenses. You may choose to spend less on entertainment or take-out food. If you have more income or fewer expenses than expected one month, you might choose to spend more. For example, if you receive a gift of cash for your birthday, you can use the money to make an unplanned purchase, such as a new coat.

**fixed expenses** costs that do not change each month

Costs that do not change each month are called **fixed expenses**. Examples of fixed expenses are rent, insurance, and car payments. Renters typically have a lease contract stating a monthly rent amount that does not change for the term of the lease. Monthly car payments are usually fixed for the term of the car loan. Fixed expenses remain constant each month and must be paid even when income is less than expected. If income continues to be less than planned, a fixed expense may have to be eliminated. For example, if your income goes down because you lose your job, you may have to sell your car to eliminate the car payment you can no longer afford.

**charitable giving** the act of donating money or time to a cause in which you believe

Many people include charitable giving as a part of their monthly expenses. **Charitable giving** is the act of donating money or time to a cause in which you believe. You may donate through your church or a nonprofit organization. For example, you may donate money to the Red Cross to help earthquake victims.

### Step 4 Balance the Budget

Find the total of savings and expenses in Figure 4-2.2. This amount should be the same as the total income amount. When these amounts are the same, the budget is in balance. If your savings plus your expenses exceed your income, adjust your budget to make them balance. To do this, you will have to lower your expenses, save a little less, or increase your income.



## Focus On... PHILANTHROPY

After they have accumulated great wealth, some people give large sums of money to others. *Philanthropy* is a form of charitable giving that supports a societal cause, often over an extended period of time. *Philanthropists* want to leave the world a better place than they found it.

Philanthropy is the primary source of funding for the fine arts, the performing arts, and most religious and humanitarian causes. It also supports private (and some public) schools and universities. Many cultural institutions would not exist without the generosity of philanthropists.

Everyone has the opportunity to give something back. Many nonwealthy people also donate substantial amounts of time, effort, and personal resources to charitable causes. When you give of your

time, you are in fact giving the most valuable thing you have. Time is something that cannot be stored and cannot be regained once it is gone. It is in very limited supply for each of us.

Philanthropy is said to feed the soul of the nation. When those whose needs are greatest are given a hand, the entire nation benefits. We are all able to enjoy the richness of culture that results from sponsored events.

### Think Critically

1. Do online research to locate a charitable organization or foundation. Describe its purpose. How does it add value to society as a whole?
2. If you had the time and/or money, what charitable cause would you support? Why?

## PREPARING A BUDGET ANALYSIS

A budget is a plan for saving and spending. You should not expect income, savings, and expenses to be exactly as you planned in a budget. The differences between planned amounts and actual amounts are called **variances**. Looking at the variances in your income and spending amounts can help you plan better when creating budgets in the future.

Sometimes you will **earn or save more than you estimated. This is a favorable variance.** If you **earn or save less than you estimated, it is an unfavorable variance.** The reverse is true with expenses. If you spend less money than you planned to spend, this is a favorable variance; if you spend more than you planned to spend, it is an unfavorable variance.

Figure 4-2.3 shows budget variances—both in dollar amounts and in percentages. To compute the percentages for income and savings amounts, subtract the budgeted amount from the actual amount; then divide the difference by the budgeted amount. To compute the percentages for expense amounts, subtract the actual amount from the budgeted amount; then divide the difference by the budgeted amount.

By looking carefully at variances, you can see where you spent more or less than the estimated amounts. Any variance that is more or less than 10 percent of what you had planned should be looked at carefully. For example, Andrea had planned to spend \$60 on clothes and shoes for the month, but she actually spent \$70. That is \$10 more than budgeted, or a 17 percent difference. Andrea should think about why this happened. She may decide that she needs to revise the budget or change her spending habits. Analyzing variances will help you understand and better estimate your income and expenses.

**variances** the differences between planned amounts and actual amounts

Figure 4-2.3 Budget Variances

ANDREA MCCALL  
BUDGET VARIANCES FOR AUGUST

	Budgeted Amount	Actual Amount	Dollar Variance	Percent Variance
<b>Income</b>				
Work (part-time)	\$120.00	\$110.00	-\$10.00	-8% U
Allowance for household chores	40.00	50.00	10.00	25% F
Lunch money allowance	60.00	60.00	0.00	0%
Savings account interest	2.00	2.00	0.00	0%
<b>Total income</b>	<u>\$222.00</u>	<u>\$222.00</u>	<u>\$ 0.00</u>	0%
<b>Savings</b>				
Deposit to savings account	\$ 22.00	\$ 22.00	\$ 0.00	0%
<b>Expenses</b>				
Gifts	\$ 20.00	\$ 18.00	\$ 2.00	10% F
Clothes and shoes	60.00	70.00	-10.00	-17% U
Loan payment to parents	20.00	22.00	-2.00	-10% U
Lunches	60.00	55.00	5.00	8% F
Entertainment/miscellaneous	40.00	35.00	5.00	13% F
<b>Total expenses</b>	<u>\$200.00</u>	<u>\$200.00</u>	<u>\$ 0.00</u>	0%
<b>Total savings and expenses</b>	<u>\$222.00</u>	<u>\$222.00</u>	<u>\$ 0.00</u>	0%

**CHECKPOINT** ▶ ▶ ▶

How can budget variances be used to plan better budgets?

## What Are Recordkeeping Methods?

Keeping good records will help you prepare a better budget. Good information will also help you do a better job analyzing your budget. There are several methods you can use as you keep track of what you are earning, spending, saving, and investing.

### MANUAL RECORDS

You can keep logs or journals on paper that list types and amounts of income, savings, and expenses. **Manual records** consist of information recorded using pen and paper. You can manually compute your variances and make notations about what to change. You will want to keep these journals over time so you can compare them from year to year. It is important to keep these records in a safe and secure place. This will protect them from fire and other forms of damage. And just as important, it will keep them safe from misuse by others. Whether or not you keep all records manually, you can jot down your thoughts and make notations in *hard-copy* format, which you

**manual records** information recorded using pen and paper



## Success Skills

### DEALING WITH CONFLICT

Conflicts are bound to happen sooner or later. People you know will not be able to get along with each other. Maybe you will have a hard time working out a problem with another person. The ability to deal with conflict is an important personal skill—it will help you both in your personal life and in your work life.

When faced with a conflict, stop and take a ten-second time out. For those ten seconds, ask yourself, “What is happening here?” Listen rather than talk. Think about who is speaking and why that person is upset. Repeat a short summary of the problem or complaint to acknowledge that you understand the issue and confirm what you have heard.

If the person is upset or angry and not speaking rationally, suggest that you continue your talk later.

This will give you and the other person time to think about the issue. Resume talking when you are both calm and can speak in a courteous manner.

Focus on the problem, not on the person. Be objective. Do not let your personal feelings—whether you like or dislike the person—cloud your judgment. Look for positive ways to address the issue. Be willing to compromise, when appropriate, to reach a solution that will be acceptable to all parties. The next time you must deal with conflict, practice these skills.

#### Think Critically

1. Describe a past situation where there was conflict. What did you learn from the experience?
2. How could you have handled the conflict differently?

can transfer to your permanent or electronic records later. These notations will be useful in explaining spending and other actions you have taken.

## ELECTRONIC RECORDS

Many people prefer to keep **electronic records**, which consist of a *soft-copy* format of your financial information stored on your computer. The software package Quicken® is an example of an electronic recordkeeping program. The software will store the data and allow you to update and print reports. It will also allow you to reference financial information quickly.

You can also use spreadsheet programs, such as Microsoft Excel, for data entry and budget analysis. The program will allow you to compute variances in dollar amounts as well as percentages. You can set up worksheets and link them together.

Like manual records, electronic records should be protected from unauthorized uses and users. Passwords and **encryption**, which is the process of converting data to a coded form, will help protect your information.

hard copy = paper!

**electronic records** soft-copy formats of your financial information stored on your computer

**encryption** process of converting data to a coded form

## CHECKPOINT ▶▶▶

Why is it important to safeguard your financial records?