

Chapter 1

Budgeting and personal financial forecasts

Aims

In this chapter, you will:

- define what is meant by a budget;
- explain the circumstances in which a budget might be useful;
- understand what is meant by effective financial planning;
- understand the importance of flexibility within the plan;
- understand that the financial choices you make now will impact on the future;
- understand how planners need to make choices linked to variables and their own wants, needs and attitudes.

Learning outcomes

In this chapter, you will:

- be introduced to the concept of budgeting;
- learn how to construct a budget;
- draw up a budget (financial plan) for your own personal circumstances;
- learn about the dynamic variables that affect a budget;
- learn how a budget should be balanced in terms of time periods, spending and saving within the framework of personal circumstances.

Introduction

This text looks at some of the same areas that you may have already studied for the Certificate in Financial Studies (CeFS). The explanations and examples used in the Diploma in Financial Studies (Dip FS) are, however, much more rooted in the real world. The difference? The real world is a world of change, a world of variables, in which many factors can affect future plans.

There are three main areas in which change takes place, as follows.

1. There can be change in what are called 'macro' factors. These are the national and international variables that are beyond your control. They include interest rates, foreign exchange rates, changes in taxation and allowances from government, and changes in businesses and business models. You can allow for these changes only by predicting what might happen in the future. For example, you may decide that you think, because of the information that you have, that the stock market will improve, but that interest rates will fall. You may therefore decide to take your money out of the bank and buy shares. If you are wrong, however, you are likely to lose money. If you are right, but fail to have the confidence to move your money, then you have still lost. In the real world, you will have to be making these decisions and judgements constantly.
2. There can be changes in your own personal circumstances. You may stay on in education and build up debt through student loans; you may decide instead to go out to work and save. You may marry, have a family, get a better job or promotion, inherit money and suffer losses. All of these factors will affect your ability to budget and keep your future finances on track.
3. There could be changes in the products offered by the financial markets. A mortgage product (which you take out in order to buy a house) may look attractive at the time, but then be replaced by one that is better value. You may find, however, that you are unable to change without suffering some sort of penalty. As market factors – and businesses within the financial services market – change, there will always be new products replacing old ones – and new decisions for individuals to make regarding them. These decisions are made easier – or at least more informed – if you have learned to use certain key tools to forecast what might happen to each of these groups of variables in the future.

1.1 What is a budget?

For a business, a budget shows its planned income and expenditure over a period of time. It is a forecast of what might be spent (expenditure) and what might be received in income (sales revenue and other income sources). It allows the business to know whether it will be able to afford to pay its staff and pay suppliers, or will need to borrow for that particular period. A key feature is that it is a forecast – that is, it is looking at the future – and therefore will be more or

less accurate depending on the accuracy of the information that has been used to compile it.

For a government, the budget is an estimate of future income and expenditure, allowing it to see how much it needs to raise in taxation or to borrow against shortfalls. For an individual, such as yourself, a budget is very similar. It is an estimate of what income – from various sources – you might receive in a specific future time period set against the expenditure that you expect to have to make in that time period. It allows you to plan purchases and borrowing, and even to set aside money for unexpected events (these are called ‘contingencies’).

Activity 1.1 Your own budget

Draw up a simple budget for yourself for the next six–eight weeks. Make sure that you plan for all income and expenditure. What sort of contingencies do you think might arise in this time? What sort of contingencies do you think might arise in the space of a year?

1.1.1 Flexible financial planning

Financial planning means planning future expenditure and deciding how this will be financed. Someone’s anticipated future expenditure will reflect his or her needs, wants and aspirations. How people decide to finance this expenditure will depend on their anticipated future income, and their attitudes to savings and borrowing. For example, people often want to buy birthday presents for family and friends, or to celebrate a religious or secular event. Planning can enable them to make sure that they have enough money to do so, and tell them how much they can afford to spend.

When planning spending, people need to bear in mind their overall financial position – that is, whether income tends to be more than expenditure or vice versa. A static plan is one that does not change once it has been drawn up. Flexible plans – also known as dynamic plans – change as a person’s financial and life circumstances change. The aspect of flexibility should be taken into account when the plans are being drawn up.

1.1.2 Why budget flexibly?

The future is uncertain, but what is certain is that your situation will change. In the near future, you may, for example, become a student away at college or university. This would mean a number of life changes: you may leave home, rent a flat with others and therefore become responsible for your own bills, whilst your income may come from different sources – student loans, part-time work and, if you are lucky, parents. Later, you will have income from employment, and may use this to buy a car, a house or other goods. You may enter into contractual arrangements, requiring you to make regular payments such as satellite television, mobile phone contracts or credit agreements. Once you have responsibilities, you may want to recognise possible contingencies and take out

insurance against the risks of them happening – this is one way in which you can make sure that your budget can meet contingencies such as accidents, fire or theft.

1.1.3 Variables

Other life changes – promotion, marriage, children, bereavement, job loss – may all bring different issues to a budget. Sometimes, they mean unexpected income (perhaps an inheritance); sometimes, they mean unexpected expenditure. Budgets need to take account of such factors by being sufficiently flexible to change if need be. An inheritance might, for example, make it possible to pay a debt off earlier than had been planned. But some types of debt come with a penalty attached for early repayment. This means that, before taking out such a product, you would need to judge how likely you were to want (or be able) to pay it off early. This will be down to your own personal circumstances. Another major variable will be the rate of interest. Interest rates are set, monthly, by the Bank of England's Monetary Policy Committee (MPC). They are set to help the Bank to control the economy – especially in terms of inflation (price rises). Sometimes, the Bank will raise interest rates; sometimes, it will bring them right down. This will affect both savers and borrowers. For savers, a lower interest rate might make other investments more attractive, for borrowers, lower rates could encourage them to borrow more, or mean that they can pay off debt more quickly.

Some products (as you will see in Unit 2) come with a fixed interest rate, whilst others are variable. Again, it is up to you to decide whether you think that rates will go up or down in the future, and therefore what sort of savings and debt vehicles you prefer. Some products have guaranteed returns – but such guarantees are only as strong as the bank or other financial institution that is making them. The government has put in measures to cover some losses that investors might make if a bank were to collapse – but not all of them.

Sometimes, institutions will help you to make the decisions because of the products that they offer. For example, some banks offer a 'sweep' service for savings. You can instruct the bank that any amount over a set sum that you are in credit at the end of the month is 'swept' into a savings account. In months in which there might be extra expenditure, this account can then be used to make up the difference.

Activity 1.2 The importance of a flexible approach to planning

Why do you think a flexible financial plan is a more useful tool than a static one?

Consider your current needs, wants, income and savings. Write down how these have changed over the last three months and how they may change in the next three months.

1.1.4 The characteristics of a flexible financial plan

A flexible financial plan should be:

- *balanced between different time periods* – that is, the plan should look at income and expenditure in the short term, medium term and long term, and there should be a good balance between these periods. For example, some people may have a definite weekly plan, a less-defined monthly plan, and an outline plan for the whole year. They may also have a plan for ‘the future’ that is quite vague, but which requires some action now, such as small, regular savings. Balance between spending and saving is very important; The plan should be:
- *informed* – like any other plan, a dynamic financial plan must be based on accurate information as far as possible. For example, someone aiming to make a purchase financed by a loan must find out how much the monthly repayment figure is likely to be, while planned spending should be based on the actual price of the goods someone wants to buy;
- *able to adapt to circumstances* – the plan might include several versions that would fit different situations. For example, someone aiming to take out a loan should include in the plan several different monthly payment figures to take account of interest rate changes. They may be able to afford the repayments at 6 per cent interest – but not at 8 per cent. Or they might estimate their financial circumstances if they were to work an extra shift, or to share their flat with one fewer person. These are often called ‘what if’ calculations;
- *fluid* – a dynamic plan must change to suit the changing circumstances in the life and situation of the person making it. For example, school students are likely to have greater income at certain times of the year, such as during the summer holidays, if they have a temporary job. Expenses may also be higher at certain times – for example, when going on holiday or buying what they need when they leave home for college or a flat share; and
- *realistic* – the person drawing up the plan should aim for a balance between being optimistic and pessimistic about the future. For example, they might consider saving in case an emergency happens, eg having to replace a car exhaust or being made redundant.

Activity 1.3 Angharad’s financial plan

Angharad is at school. She works as a waitress on Saturday evenings and at Sunday lunchtime in a nearby hotel.

She writes down the following financial plan.

Income

About £35 per week (£10 allowance, and two three-hour shifts @ £4.25 an hour)

Spending

£5 to Mum towards my food

Clothes and make-up: £10

Going out: £10

Music downloads: £5

Saving: £5

Over summer holidays

Go on holiday

Get more shifts at hotel

Long-term plan

Get a new smart phone



Analyse how effective Angharad's plan is, using the characteristics of a flexible plan described above.

1.2 The objectives of a budget (or financial plan)

In this section, we will explore why people draw up financial plans and how the planning process helps them.

- *To budget* The amount of money that someone spends is determined by their income, so drawing up a plan helps them to see how much is available for spending or saving.
- *To decide on priorities* Everyone's income is limited and everyone has to choose between alternative ways of spending it. Drawing up a plan helps people to see which goods and services are more important to them, and which they can do without.
- *To avoid getting into financial difficulties* People who find that their planned spending is greater than their income will either have to give up certain essential or desirable items (needs or wants), or they will have to borrow. If they borrow more than they can afford to repay, they will be in even greater trouble. For example, anyone who buys on hire purchase and does not keep up the repayments will not only lose the item that they 'bought', but might also be taken to court by the company that made the loan.

- *To achieve their life aspirations* For example, a young person who wants to buy a house one day needs to know how much they are likely to be able to save towards a deposit and how much they could afford to spend on monthly mortgage repayments at different salary levels.
- *To be aware of, and manage, their risk* Different people have different risk profiles. It is this profile that helps them to decide on how much risk they are willing to accept. For example, do they want to keep their savings in a building society account, or are they willing to risk buying shares in the hope of getting a higher return? Do they want to spread their risk, eg placing most of their money in a safe savings account with a lower rate of return and some in more speculative investments that could offer a greater reward at a higher risk? Drawing up a financial plan shows them how much money they have available and what expenses they need to meet. This knowledge helps them to decide on how much risk to take.
- *To have financial control* Once someone has a financial plan, they can compare actual income and expenditure against budgeted income and expenditure. If there is a discrepancy, the planner has to decide whether to change their actual income and expenditure, or to change the plan to suit their real circumstances. They can also monitor how savings are growing towards targets and how debts are being managed. They can use this information to make decisions about future spending, savings and borrowings, such as taking steps to reduce overall debt or to save towards something they want.
- *To be better consumers* Nowadays, consumers are constantly targeted by marketing campaigns for consumer goods and services, and for the financial products that can help them to buy those goods and services. Some people are persuaded to spend money on things that they do not really need; some get into financial trouble because they find that they cannot pay off all of their borrowing. Making a financial plan puts consumers into a strong position because they think more carefully before embarking on new expenditure, borrowing or saving. For example, using their plan, they will analyse how a potential loan fits into their income and expenditure pattern, and will make a decision based on what they need and what they can afford. Further, a key part of planning is making realistic decisions, based on up-to-date information. Keeping up to date with trends in the market enables consumers to make better choices between financial suppliers.

Activity 1.4 Deciding on priorities

What do you want to achieve from your own plan?

For example, you might want to reduce your debt, save for a new mobile phone, know what you can spend each week or month and avoid financial difficulties.

1.3 Self-awareness

Before drawing up a financial plan, you need to know yourself. Planners need to have a good idea of their needs, wants, priorities, attitudes and aspirations, so that they can develop a personal financial plan that reflects their priorities. They need to be aware of any financial constraints that cannot be changed, because they will have to work around them. They also need to think about where they are in the life cycle and what life events they may encounter.

1.3.1 Attitudes to financial products

The following are some questions that individuals can ask themselves to work out what characteristics their personal financial plan should include. These characteristics will apply whatever their level of income and expenditure.

- a) *What are your main needs and wants in life? Are you satisfied with a basic level of consumption or do you like your luxuries? Do you have any special needs that you must finance whatever happens?*
- b) *What is your attitude to spending money? Are you easily tempted into making purchases or are you careful? When you want or need something, do you feel a strong desire to have it now, or are you willing to wait until you can afford it?*
- c) *What is your attitude to saving? Do you feel safer if you have a bit of money put away? Do you feel tempted to spend the money that you have saved, or does it give you satisfaction to see your savings grow?*
- d) *What is your attitude to borrowing and being in debt? Does it bother you if you owe money? Do you worry about how you are going to pay it back? Or do you see it as a normal way of affording something that you couldn't buy otherwise?*
- e) *What are your aspirations? Do you hope to improve your standard of living as you get older? Are you impatient to start earning as much as possible, or are you willing to invest time in further or higher education?*
- f) *What is your attitude to risk? Are you happy to risk your money, even if you don't have much, in the hope of gaining more? Or does it worry you to think that you might lose what you have?*

Of course, everyone's individual profile is slightly different, so we cannot fit everyone into only two or three categories.

Activity 1.5 Attitudes

Jamie, Colleen, Faisal and Gareth are in Year 13 at school. They all have different ideas about their future. Here is how each is thinking.

Jamie: Life is too short to make long-term plans. I'm going to travel as soon as I leave school. I haven't got any savings, but I'll work my way round the world. Buy a house? I don't know – I'll see. Savings scheme? No, you're only young once. I intend to enjoy myself while I can, and I'll think about savings and my retirement when I'm older.

Colleen: I'm going to university to study chemistry and then I'm hoping to get a good job. I have some money saved to help me through my studies, so I shouldn't have too much debt when I graduate. My aim is to buy my own house and to save for my future. I don't really care whether I have a car or go on holidays – I want to build up some security for when I'm older.

Faisal: I've got a job lined up with a software company. My aim is to work for them for a few years to learn the ropes. Then I want to start my own business. I'll need to borrow quite a lot of money, but it will be worth it. I don't mind taking the risk, because I feel very positive and I'm sure I'll be successful. As a Muslim, however, there are special rules about what and from where I can borrow, and I will need to take these into account. I will also save with a Muslim institution.

Gareth: I want to get a job as soon as I leave school, although I have nothing definite yet. I want an office job locally. I know that I will need to start at the bottom and work my way up gradually. My aim is to live at home, but to pay my parents rent. Once I've saved enough, I'd like to rent with some friends.

Analyse the attitudes of each friend using the characteristics outlined in section 1.3.1 above.



1.3.2 The financial life cycle

Whatever the type of person involved, a financial plan needs to take into account the planner's current position in the financial life cycle. Needs and attitudes are

different at various stages in life and when various life events occur. These different needs and attitudes affect the way in which people arrange their finances. You came across life stages in CeFS Unit 1.

Activity 1.6 Life events

What are the life events that can happen to people at different ages? Are these going to be the same, or different, depending on the person's background and culture?

How does each event affect a person's needs, wants and aspirations? What does this mean for their likely incomings and outgoings?

1.4 Constructing a budget

Although people are likely to keep the key points of their plan in their head, the details need to be written down and regularly reviewed. Before you can construct a budget, you need to be able to predict what income you are likely to receive over the budget period and what expenditure you may have to make. Before you can do this, you need to remind yourself of the possible sources of income and expenditure.

Income is money that you receive. Sometimes, it is money that you have earned; sometimes, it is given to you – or made in other ways – this is called 'unearned income'. When you studied for the CeFS qualification, you looked at the types of earned and unearned income.

We should also remind ourselves of the major types of expenditure. This is usually divided into two parts. Expenditure over which you have a choice is called 'optional, or discretionary, expenditure', and that which you must spend is called 'compulsory, or mandatory, expenditure'.

1.4.1 Cash flow

A cash flow is one way of recording and keeping track of your incomings and outgoings. A cash flow is a table that lists all income and all expenditure for a given time period, and then measures the difference. Both a deficit and a surplus are carried onto the next time period.

A **deficit** arises when spending is greater than income, so that the cash flow balance is a negative number – ie the planner owes money.

A **surplus** arises when income is greater than spending, so that the cash flow balance is a positive number – ie the planner has money left over.

Cash flow refers to the cash coming into and going out of a person's life, and comprises two aspects. The first is the overall difference between total income and total expenditure over a period: for example, a week or a month. The second aspect is the timing of the inflows and outflows. A person may have an overall surplus for a 12-month period, but income may not come in regularly. Despite this, however, expenses are likely to have to be met every week or every month. For example, school students and self-employed people have a monthly income that is not always the same. Such people have to save some of their income in good months to pay their expenses in lean ones.

It is important that people budget so that they always have access to cash for at least their basic expenditure, such as food.

Activity 1.7 Quotation and discussion

To quote Mr Micawber, a character in Charles Dickens' book, *David Copperfield*:

Annual income twenty pounds, annual expenditure nineteen pounds, nineteen shillings and sixpence, result happiness. Annual income twenty pounds, annual expenditure twenty pounds, ought and sixpence, result misery.

What do you think Mr Micawber meant? Remember that this was written in the 19th century. What has changed since then? Do you think that it applies today?

1.4.2 Mandatory and optional expenditure and savings

When drawing up a financial plan, planners should distinguish between mandatory expenditure (spending on items that must be paid) and optional spending (spending on items that they could do without). Different people have different views on what constitutes a necessity or a luxury, depending on their lifestyles and attitudes. Everyone has to eat, but while some can get by on £20 a week in the supermarket, others might spend £200. Most of us have a list (either mental or written) of our main items of expenditure in order of priority. The items at the top of the list are those that we cannot give up, while those lower down are those that we could manage without if we had to. Everyone has limited resources and we all have to make choices as to how to spend these resources.

We can also distinguish between mandatory and optional savings, eg someone who is a full-time employee in a firm in which there is a pension plan may be obliged to pay into this.

We will explore the idea of mandatory and optional spending in more detail in section 1.8 below.

1.4.3 Steps in constructing a cash flow

A cash flow can be written as a table, with headings as follows.

	Week 1	Week 2	etc
Income			
Source 1, eg wages			
Source 2, eg allowance from parents			
etc			
Total in			
Expenditure – mandatory			
Item 1, eg rent			
Item 2, eg transport			
etc			
Expenditure – optional			
Item 1, eg entertainment			
Item 2, eg clothes			
etc			
Total out			
Balance – surplus or (deficit)			
Balance from last time period			
Closing balance			
Running total in			
Running total out			

The steps involved in constructing a cash flow are as follows.

1. Identify and list all sources of income. These sources include wages, allowances from parents or guardians, state benefits, interest on savings and investments, and money received for birthdays or other celebrations. It is helpful to list regular wages separately from wages that are earned less frequently. This makes completion of the cash flow easier. For example, school students may wish to list wages from a regular Saturday job separately from wages earned during the holidays. People in full-time employment may prefer to have one entry for their regular salary and other entries for second jobs, such as bar work or freelance assignments.
2. Identify and list all items of expenditure. It is helpful to list all mandatory items first and then the optional spending items. This makes it easier to see what expenditure has to be met and what can be changed when you are using the cash flow to manage your funds.
3. Decide on the time period that you will use in the cash flow (for example, per week or per month). It is useful to choose the length of time between receiving your regular sources of income. So, a school student who receives a weekly allowance may use a week as the time period, whereas

someone with a full-time job who is paid monthly will use one month as the time period. The cash flow should have enough columns to record incomings and outgoings for the short and medium term. How many time periods this means will depend on the individual. Some people find it very difficult to plan more than three months in advance, while others are comfortable with a year.

4. Fill in the figures for all of the various income sources and types of expenditure for each time period. At this point, the figures are expected incomings and outgoings. As we have already discussed, some of these items will be easier to complete than others. Some optional spending really amounts to 'whatever is left over at the end of the week', so this amount will be a guess when you first start using your cash flow. Similarly, some items of future income may be uncertain at the moment, such as wages from a seasonal job picking fruit. Put in your most realistic estimate for now.
5. Calculate the total income and total expenditure for each time period, and write in the appropriate field.
6. Now focus on the balances. Calculate the balance for your first time period. This will be either a surplus or a deficit. Put minus amounts in parentheses – that is, in brackets like this '()'. The balance from the last time period is zero. Your closing balance is therefore the same as the surplus or deficit for this time period. Now work out the balances for each time period. You carry forward the closing balance from one column to the 'balance from last period' cell in the next column. Be very careful to mark deficits with parentheses, so that you know either to add or subtract the figure. For example, this week's balance is a surplus of £5. Last week's closing balance was (£3), so this week's closing balance is £2.

Activity 1.8 Cash flow entries

Choose a time period for which to manage your own finances, such as a week or a month.

Complete the first column in the cash flow with the income that you expect to receive and how you plan to spend it.

Now complete the next column with your actual income and outgoings for the time period.

Activity 1.9 Analyse your cash flow entries

Can you identify how you spent every penny of your income?

What implications does this have for creating an effective financial plan?

1.5 Keeping a record of the plan

It is important to keep a record of a financial plan. Different people will do this in different ways and each will come across some problems from time to time.

- Organised people who like writing things down may undertake a detailed plan, such as the one that we drew up in section 1.4.3 above. As these people live through the time periods they have planned, they can record the actual amounts coming in and going out. This will highlight which planned amounts were unrealistic and need to be changed. Using tools such as Excel, or a pencil and eraser, makes revising the plan easy to do. Revising the figures is a normal feature of budgeting and it shows clearly the need for flexibility in the plan. Someone who uses detailed information in their plan is in control of their finances.
- People who are less organised may simply jot down a few figures on the back of an envelope every week or month, to see how much they have spent and how much money they have left until they receive their next allowance or salary payment. Some planning is going on here, but it is not very detailed and leaves quite a lot to chance.
- People who do not forward plan may just do a few mental calculations or simply ask the bank for their current account balance when they think of it. This is rather 'hit and miss'. Emergencies are more likely to happen and will not be foreseen, so these people have to do a lot of what we might call 'firefighting' – that is, dealing with problems as they occur and not anticipating them.

Activity 1.10 Accounting for savings on a cash flow

Do you consider past and existing savings to be part of your future income? How would you recommend savings be written on a cash flow?

What are the advantages of including several weeks or months on a cash flow?

Activity 1.11 Revising written cash flows

Jake tells you that making a written plan is a waste of time. This is because you have to spend time reviewing, and possibly changing, the figures later, when you know the actual incomings and outgoings.

What are the advantages of making a written plan, reviewing and changing it as needed?

Consider how a written plan helps you to meet your needs, wants, attitudes and aspirations when identifying advantages.

1.6 How to plan

One of the central elements of a financial plan is time: circumstances change over time and these changes must be incorporated into the plan.

1.6.1 Time periods

Over what time period should a financial plan be drawn up? The examples of cash budgets through which we worked earlier were drawn up within a short time period – that is, several weeks or months. It is useful to base a short-term plan on how often the planner receives regular income. So school students who receive a weekly allowance from their parents and are paid weekly by a part-time job will set their short-term plan at one week. People who are employed and paid monthly are likely to set their short-term plan at one month. These time frames highlight the key financial decision in planning: what do I receive and how am I going to use it?

A number of short-term time periods make up the medium term. What is considered a medium- or long-term planning period will vary from person to person, depending on their circumstances and perspectives. For example, students in their last year of school might see the school year as the medium term and everything after that as the long term. People in full-time employment may view the next few years as the medium term, with the long term happening in five or ten years' time, or even longer. There is no universal definition of short, medium and long terms. The key is to find the time periods that are meaningful to the planner's circumstances.

Activity 1.12 Perspectives on time

What do the following phrases mean to you, personally?

- a) Short term.
- b) Medium term.
- c) Long term.
- d) Very long term.

Many people base their medium-term financial plans on one year, because a year is a 'complete' period in which all regular events happen, eg religious and secular events, such as Christmas, Divali, birthdays and holidays.

Long-term planning is done over several years – a five-year plan is a popular period. A young person may expect several quite dramatic changes over the next five years – for example, getting a job, going to college, getting married, entering into a civil partnership or moving in with someone, being promoted at work, maybe even buying a first house and having children, among other things. All of these events make a difference to that person's financial needs, wants, attitudes and aspirations, and can be incorporated into a long-term plan.

It is harder to plan for the long-term, because there are so many unknown variables. There are personal factors, such as changes in a person's wants and aspirations, or changes in their needs – for example, leaving home to rent with friends. There are factors over which they have only limited control – for example, only being able to work at certain times to fit in with studies, or a shortage of local job choices. And there are factors over which they have no control – for example, interest rates might be low now, but they could rise or fall in the long term. This does not mean, however, that planners should not take the longer period into account.

Someone could have a long-term contingency plan whereby they aim to build up an amount of savings over the next five years that they will use for whatever might happen. If they don't need it to deal with unexpected events, then they can use it for something exceptional – whether this is an expedition to the Amazon jungle or a large wedding reception! This long-term plan is the result of the surpluses that they have built up over five medium-term annual plans. This is only one example, but it shows how people can keep the longer term in mind while living their everyday life.

And what about the really long term? By this, we mean 20 years or more. In 20 years' time, today's young people may be concerned with the education of their children, moving to a bigger house and, eventually, retiring from work. It can be difficult for a young adult to incorporate their old age into their current plans – retirement seems to be so far away, and many people in their teens and 20s find it impossible to give up things that they would like to buy now so that they can have a pension in later life. But the years pass and suddenly they could find themselves in their 50s without any savings. To avoid this, many people will make pension arrangements as soon as they find a regular job. For example, they may choose to pay into a pension or life assurance scheme by making regular direct debit payments out of their bank current account.

1.6.2 Pensions

Pensions are long-term investments that are intended to help people financially in retirement. They may provide a lump sum, a regular income, or a combination of the two. When you are only 16 or 17, saving for the long term may not be very appealing – most pensions can't be accessed before a person reaches the age of 50 (an age that is due to increase to 55 in 2010) – but it is essential in making sure that you have a secure long-term financial future.

Occupational pensions (that is, those provided through employment) are either salary-related or money-purchase schemes.

- Salary-related schemes are based on your salary and the number of years for which you've worked. You will be required to make a regular contribution and will often have the chance of increasing your pension by buying extra contributions (known as 'additional voluntary contributions', or AVCs).

- Money-purchase schemes are based on how much you have paid in and how well the money has been invested, so are more risky than salary-based schemes.

Occupational pensions usually mean that there are benefits available to your spouse or civil partner and other dependants, should you die. You are also still entitled to the benefits that you had built up even if you leave the company.

Stakeholder pensions allow for people earning an average salary who are not part of a company pension scheme to build up their own pension. They suit the self-employed and will also be offered by companies with five or more employees who do not run a company pension scheme.

Personal pensions are pensions that you set up yourself – perhaps because you are self-employed (there's no employer to give you an occupational scheme), or because you move around from job to job and cannot build up a reasonably sized pension with a single employer. A specialist financial services provider, such as a life insurance or pensions company, runs a personal pension plan, not an employer.

There are also tax advantages with pensions, but these can change as taxation rates change. The amount of taxable income that you have is reduced by the amount going into the pension plan as an incentive for people to save in this way (this is known as 'tax relief').

The websites of pensions providers provide online forms that you can fill in to create a personal pension plan.

1.6.3 A financial plan with interlocking time periods

Short-term, medium-term, long-term and very long-term plans all lock into each other. The short-term plan, in particular, should be adjusted to accommodate future needs, wants and aspirations. For example, suppose that a short-term plan is based on one week. During this one week, the planner aims to take on a summer job and save as much as possible. Several weeks make up the medium-term plan. Part of the medium-term plan is to go on holiday at the end of the summer – but not to spend all of the money saved so far. Some of these savings are needed to buy winter clothes later in the year.

Activity 1.13 Interlocking time periods

Consider how you mentally divide up the coming year.

What time periods do you use and how do these interlock? For example, does your income and spending vary between term time and holiday time? How will you finance big expenses, such as presents, new trainers, clothes and entertainment? Do you have cultural or religious obligations? Do your plans for next year influence your financial behaviour now?

1.7 Reassessing a situation in order to fulfil longer term goals

Different people have different approaches to setting themselves goals and achieving aspirations. If, however, someone has a longer term goal that requires money, it is best to plan for it rather than to leave things to chance.

The key is to act now to make some provision for the future. Individuals do not know what will happen to them in the future, but if they have some money saved or a plan to work their way out of debt, their life choices are less constrained by their finances.

Activity 1.14

The following people have set themselves long-term goals.

- **John** is aged 20 and has just started work as an office assistant in a solicitor's office. He wants to achieve promotion and earn more money, because his ambitions are to own a big house with a swimming pool, to have a new car every year and to take holidays in exotic destinations.
- **Corinella** is aged 22 and has a university degree. She has just started a job at a bank and intends to complete the professional examinations over the next four years. Her ambition is to become an executive manager within the bank.
- **Raza** is aged 23 and has finished professional accountancy examinations. His only real ambition is to settle down and start a family. When he does, he and his family will stay with his parents for a while. He would also like to undertake a religious pilgrimage in the next two years.
- **Mark** is aged 18 and has just left school. He is about to start work at a nearby golf club, but his main interest in life is football. He supports his local team and his ambition is to go to every World Cup until he is too old to travel.
- **Maria** is aged 19 and works in a local government office. She is getting married next year, and her ambitions are to have four children and lots of grandchildren.
- **Rob and Trudi** are both aged 23, and have been married for two years. They don't want any children yet, but their goal is to set up an orphanage in Africa.
- **Kevin** is aged 24 and is unemployed. He has never worked because he cannot find a job that suits him. He still lives with his parents and has no ambitions beyond going out with his friends on a Saturday night.

Consider the extent to which the ambitions of the above people will affect their financial planning now – that is, what financial sacrifices they might have to make. What capital sums might they need? How realistic do you think their ambitions are? What reassessments might they have to make along the way?



1.8 Choices and their implications

In this section, we shall look at some of the choices that people have to face when drawing up a financial plan. We are going to consider saving, spending and borrowing separately, but choosing one does not necessarily preclude the others. Many people do all three to varying degrees, and balancing the three and imposing limits on each is often at the heart of the choices that they make.

1.8.1 Spending

Everybody spends money and the option not to spend at all does not exist. Each of us spends money on that collection of goods and services that reflects our needs, wants and priorities, and each of us makes a slightly different choice. As we mentioned in section 1.4.2 above, spending is either mandatory or optional:

- mandatory weekly or monthly payments include basic food needs, rent or mortgage instalments, electricity, gas and telephone bills, train season tickets and petrol;
- optional regular payments might include snacks, magazine subscriptions and karate lessons;
- optional one-off purchases include clothes, entertainment and holidays.

Individuals control their optional expenditure, but we are all subject to the influence of the mass media, advertising, and the goods and services that we see for sale in shopping centres.

The total amount of money that someone spends each month is determined by three factors, as follows.

- *Income* Whether paid weekly or monthly, earned income is, to some extent, a given figure, paid after deductions for tax and National Insurance. Some people may have the opportunity to supplement their income by doing extra hours, overtime hours, or by taking a second job in the evenings, weekends, or holidays. So there is some element of choice. In addition, they may be looking out for a better paid job so that earnings will increase. And there may be income from other sources, such as allowances from parents, benefits, gifts, and interest or dividends from savings and investments.
- *The amount that they want to save* The more someone wants to save, the less they can spend. Saving means not spending and if someone has positive reasons for saving money, they will be motivated to cut back on spending. (This assumes that they are not financing their spending by borrowing.)
- *The amount of credit that they are able and willing to borrow* If someone wants to buy goods and services that cost more money than they currently have, they must borrow. Borrowing means that they are drawing on their future income to finance their present consumption. Borrowing does not necessarily mean that people are not saving, because they may be doing both.

1.8.2 Saving

As well as spending money, planners may have decided to save. Saving can be broken down into different time periods, as follows.

- *Short-term saving* might mean stretching their income over one or two months.
- *Medium-term saving* means putting a certain amount of money out of each income into a savings account. Saving in the medium term is usually done to finance some large item of expenditure that cannot be afforded out of current income – for example, a new mobile phone or a new computer. When they have saved enough, they will spend the savings. If it becomes easy to borrow money, a lot of people do not save up for this type of purchase, but borrow the amount instead.
- *Long-term saving* means putting aside money that will not be spent for a long time. One reason for doing this might be precautionary – for example, some savings in case of an emergency such as having to replace a fridge, a job loss, or illness. Another even longer-term reason is saving for retirement. Apart from getting a pension from the state, people depend on the money that they have managed to save during their working lives.

The extent to which anyone engages in medium-term or long-term saving depends on several factors, as follows.

- *How important they think it is to save* This will depend on their needs, wants, aspirations and attitudes, as well as their education and family

background. If parents have always encouraged their children to save, they are probably more into the saving habit.

- *The extent to which current income covers spending* If people earn just enough to cover basic expenditure, they are unlikely to save. but if they start to earn more, they might begin saving. As income increases, both consumption and saving increase.
- *The extent of their demand for consumer goods and services now* Once they have covered basic spending, they can choose between saving money or buying more products or more expensive ones. What they spend, they cannot save, and vice versa.
- *The levels of current interest rates and how they might change in the future* High interest rates make saving more attractive and borrowing more expensive so less attractive. Lower interest rates may mean that a person begins to look round for alternatives that bring greater rewards, or may decide that it is better to spend (or borrow) now while rates are low, rather than to save.

1.8.3 Borrowing

There are many different types of borrowing. Which options are available to any one person depends on their circumstances. Which they select, if any, depends on their needs, wants and attitudes. Some of the options are:

- *credit cards*, which allow people to spend more than they currently have by borrowing from future income;
- *overdrafts*, which mean that people can exceed their income by letting their bank current account become overdrawn, as long as they have had prior approval from the bank and they do not exceed the limit agreed;
- *personal loans* to finance the purchase of a consumer item, such as a car;
- *hire purchase arrangements*;
- *mortgage loans*, which most people use to buy a house.

The amount that someone is able to repay is related to their income. If they have a mortgage, personal loan or hire purchase arrangement, they will have to make monthly repayments of principal and interest – these amounts must be fitted into their budget. Borrowing means financing a current purchase by drawing on future income, so it is vital to make sure that repayments can be met out of this future income. The amount that someone is able to borrow will be linked to their ability to repay. This can, however, be a problem for people on low incomes, who are likely to be charged more for their borrowing because they are a greater risk for the lender.

We will be looking at debt and borrowing in more detail in Chapter 3.

The fact that someone is borrowing money does not necessarily mean that they are not saving; they may be doing both. But the more they borrow, the less they can save, because of the repayments that they must make.

1.8.4 Planning a mixture of spending, saving and borrowing

There are various ways in which to combine spending, saving and borrowing, including:

- all income spent, so no savings, but no borrowing either;
- all income spent and borrowing on top of this, but no saving;
- not all income spent, so some saving, but no borrowing;
- not all income spent, so some saving and borrowing as well – that is, all three together.

Activity 1.15 The balance between spending, saving and borrowing

Angharad: I'm making a new plan that increases my level of saving so that I can afford to go on holiday with Mai. At the moment, I spend £30 and save £5 each week. I have £25 saved already and I need £100. There are six weeks until we go away. If I increase my savings to £8 a week, I should be able to save another £48 and my Mum will lend me the rest. I'll pay her back from my holiday job earnings.

Saroop: I've saved £45 towards my football boots. My eldest brother will lend me the rest of the money I need – £75. He wants me to pay him back in three monthly payments of £25, starting next month. At the moment, I save £15 and spend £25 each week.



Analyse the balance between spending, saving and borrowing for each of these two school students:

- a) now;
- b) in two months' time.

1.9 A surplus or a deficit?

People who budget for expenditure to be less than income will have a surplus and can save this; people whose income is less than their expenditure will have a deficit and will be borrowers. When planning out your finances, you need to consider with which of these you feel more comfortable and which suits your particular circumstances.

1.9.1 Planning for a surplus

People who do not like borrowing and prefer to have some money behind them, need to save. This might mean trying to increase income or to cut costs, or both. This approach has several implications.

- These people can use a credit card, as long as they make monthly repayments in full.
- They need to steer clear of overdrafts, personal loans and hire purchase agreements. If these people want to buy consumer goods, they should save up for them, only buying when they can afford them.
- But these people must realise that the only way that they are going to buy a house or a flat is to take out a mortgage; they will never be able to save up such a large sum, and house prices will probably increase while they are saving in any case. They may, of course, decide that they would rather rent than buy.

1.9.2 Planning for a deficit

People who want to use credit to purchase goods and services may have several borrowing options open to them. We have already touched on these and we will look at them in more detail in Unit 3. Bear in mind that the more someone borrows, the higher the monthly repayments will be and the more they are drawing from their future income. In addition, they should plan for some increase in expenditure in the future.

Borrowing money does not necessarily mean that people have a deficit on their monthly plan. If the total amount of the repayments is easily payable out of monthly income, borrowers do not have a cash flow deficit – and they have the benefit of the use of the goods immediately, rather than waiting to save up for them.

Activity 1.16 Planning for a surplus or a deficit

Saroop (see Activity 1.15 above) doesn't like the idea of having a deficit. Does he need to have a deficit while he is paying his brother's loan back?

1.10 Balance within the plan

One of the threads running through this course is the concept of balance. It is necessary to achieve some balance when deciding on a course of action. The following are some examples of the types of financial decision that require some balance.

- Should I live for today, tomorrow, or the day after tomorrow? Some people make no plans at all and just buy what they can afford at the moment, while others go to the opposite extreme, and plan every bit of income and expenditure for years to come. To a large extent, the answer to the question is a matter of personality. The balanced approach is when people do a bit of both – that is, make plans that are flexible enough to allow for unexpected events, such as emergencies or spotting a bargain in the shops.
- Should I spend all of my income on having a good lifestyle, or should I just buy the bare necessities now and save all the rest of my income for my future? What is a balanced approach is a matter of personal outlook and attitude to life.
- Should my finances be flexible or fixed? Should I leave my spare cash in an instant access bank account or should I tie myself into a long-term scheme, such as a life assurance policy? Some people want to have their money where they can get hold of it immediately if they feel that they want to spend it; others want to get the higher rewards promised by longer-term savings schemes. Again, some balance is needed and savings can be made in a variety of different schemes, some of which are more flexible than others.
- Should I take risks or play for safety? Shall I invest my spare £1,000 in the shares of a likely looking company and hope that they will increase in value, but take the risk that the company might fail? Or shall I put the money into National Savings certificates, which will always pay out, but which won't be so profitable? A balanced solution is to put your money into different types of savings and investment, and always to spread them around so as not to put 'all of your eggs into one basket'.

In the end, everyone will have a different attitude to the above questions and so each person will choose a different financial profile.

1.11 Making a plan realistic

An individual's financial plan reflects their needs, priorities, personality and attitudes. People may seek help while drawing it up – whether from another person, organisation, or texts such as this one. But in the end, the decisions that determine what they put in the plan are theirs and should be based on realistic assumptions about their financial behaviour.

Planners may recognise, however, that there is a difference between what they think they should aim for and what they are capable of achieving. For example, some people might not be very good at saving, but at the same time realise that they need to save to fund their hopes for the future. Planners should try to

achieve a balance between the perfect world and the actual outcome. So they may feel tempted to spend all of their income, but because they realise the value of having some savings, they might decide to put a little bit away each month. It is unlikely that people will go against their true nature and give up their current lifestyle altogether in order to save large amounts. But if they have something really important to save for – such as the deposit on a house – they might give up clothes and going out for a while in order to achieve that goal. Other people may prefer to save up to pay for expensive items, but decide that using some credit is the best way of managing their money – for example, to buy a reliable car to get them to work. The important thing is that the decision should be made by the individual and not by someone else.

We will look at getting financial advice and making decisions in Chapter 2.

Making sure a financial plan is realistic also means that planners need to keep a check on it as the months pass, to see if they are keeping to it and, if not, to find out why not. If they are saving less than they had hoped, why? Are they spending less? Do they know where their money went?

1.12 Contingency planning for unforeseen circumstances

As we have already said, a flexible financial plan is one that needs to evolve as an individual's circumstances change. A person's lifestyle changes every so often – for example, going to university, getting a first job, getting married, travelling or having a child. To some extent, all of these events can be planned for. But unforeseen events also happen and these should also be included in a financial plan, or at least taken into account. This is called 'contingency planning' and it usually refers to undesirable or unfortunate events. Of course, there can be good surprises too.

The following are some examples of the types of event that might arise (and you can probably think of more).

Favourable events

- A salary rise or promotion at work.
- Winning money on the lottery.
- An increase in the value of an asset, such as a house.
- Paying off a personal loan.

Unfavourable events

- Losing a job or receiving a pay decrease.
- An increase in the rate of income tax.
- Becoming ill and having to stop work for a period.
- Major car repair costs.

Activity 1.17 Contingency planning

Make a list of other examples of favourable and unfavourable events that could occur in your personal situation.

Chapter summary

Key words: flexibility, choice, balance

- Financial plans should be flexible and dynamic – that is, they should take into account anticipated changes in both income and expenditure.
- A flexible financial plan is balanced between different time periods, informed, adaptable, fluid and realistic.
- People draw up financial plans to budget for the future, to decide on priorities, to avoid getting into difficulties, to achieve their aspirations, to manage risk, to be in overall financial control and to be better consumers.
- People need to be aware of themselves, their attitudes – for example, their main needs and wants, their attitudes to spending, saving, borrowing, risk and to life in general – and their aspirations in order to create an effective plan.
- Drawing up a financial plan involves gathering information about cash flow – that is, the expected weekly or monthly balance after expected expenditures are deducted from expected incomes. It is useful to keep a record of the plan.
- A flexible plan needs to consider changes over time and to distinguish between the short, medium and long terms. Plans have to be reassessed as circumstances change.
- People make choices about spending, saving and borrowing, and they decide on different mixtures of these. Some planners budget for a surplus and others for a deficit that is financed by borrowing.
- A financial plan should be balanced between different time periods, between spending and saving, between being tied down and being flexible, and between taking risks and playing for safety.
- People should make sure that their financial plans are realistic and should make contingency plans for unforeseen circumstances.

Suggested responses to activities

There are no correct or incorrect answers to some of the activities in this chapter. These are activities designed to help you work out your attitudes towards risk and taking control, and responsibility to others. When thinking about your answers, bear in mind that financial plans need to be flexible, because life changes, and that each financial decision leaves its own footprint.

Activity 1.1 Your own budget

You should be sure to take into account all three types of variable – that is, macro variables, your own situation and changes in products.

Activity 1.2 The importance of a flexible approach to planning

A flexible financial plan is a more useful tool than a static one, because income and expenditure may vary from one week to another, and a flexible plan can adapt to these changes. Also, a flexible plan can be changed if actual spending is different from expected spending. A flexible plan can include the following:

- what to do if spending or income is greater or less than expected – for example, if there is money left over at the end of the week, what the planner intends to do with it (save or spend);
- anticipated changes in circumstances, such as different income at different times of the year or more spending at certain times;
- allowances for ‘what if’ circumstances, such as getting fewer or more shifts in a part-time job, or finding out that a mobile phone accessory costs more than originally estimated;
- disaster or contingency planning – for example, what to do if the planner loses a part-time job or needs to pay a large, unexpected bill.

Activity 1.3 Angharad’s financial plan

a) *Balanced between different time periods*

Angharad’s plan does include the short, medium and long term. It is biased towards the short-term. We would expect her medium- and long-term plans to be less detailed. But she is planning some big expenses and may not be able to pay for them if she does not consider what she can do now to achieve her aims.

Angharad has planned her current situation in some detail with a weekly budget. She does not identify a particular goal for her savings, so these funds may be for emergencies, presents, or her holiday. She only has vague plans for the summer holidays, but she has identified that extra shifts at work will help her pay for a holiday. This seems to be her medium-term plan. She is more likely to realise her long-term plan if she decides when she wants to be able to buy the mobile phone. For example, does she intend spending all of her income from the summer job on her holiday? Or does she want to save money towards her new mobile phone?

b) *Informed*

Angharad has used estimated figures for her short-term plan, although she seems to have the information to be able to use accurate ones. Her income from the hotel is £25.50 (because Angharad is only taking home £25.50 per week, she will not have to pay income tax). With the allowance from her parents, she has £35.50 per week.

In relation to her medium-term plan, nearer the time of the summer holidays, Angharad will need to find out what extra shifts she can get at the hotel and how much her holiday might cost. Then she will be able to calculate how often she needs to work to be able to afford her holiday.

Regarding her long-term plan, Angharad needs to find out how much the mobile phone she wants will cost. This price might make a difference to how much work she wants to get during the school holidays. For example, if the new mobile costs £80, saving £5 a week means saving for 16 weeks, or four months, to get it. And that assumes that she has no other demands on her savings in the meantime.

c) *Adaptable to change*

Angharad would find it useful to work out the costs for several different holidays and calculate how many shifts at the hotel she needs. She may not be able to get all of the shifts she wants.

d) *Fluid to accommodate life events*

At the moment, Angharad's plan does not take account of birthdays, Christmas, etc. She is likely to need money to spend on other people. There is also the possibility that she will receive gifts during the year.

e) *Realistic*

Angharad needs to keep a careful record of her actual spending and compare it against her plan. £5 per week for clothes, for example, may not be realistic. The timing of her spending might also be important. For example, does she give her mother £5 as soon as she is paid? Or does her mother get £5 at the end of the week only if Angharad still has it? By comparing planned and actual spending, Angharad can revise her plan as needed to make it more realistic.

Activity 1.4 Deciding on priorities

The answer to this activity will be personal and may be the subject of group discussion.

Activity 1.5 Attitudes

	Jamie	Colleen	Faisal	Gareth
Needs and wants	Satisfied with basics	Willing to live frugally now	Wants to earn his living now	Lives within his means
Attitude to spending money	Will spend what he has	Better to save than spend now	In support of his life goal	Wants to pay his own way; not aiming for luxuries
Attitude to saving	Later	Feels safer with savings behind her	Prefers Muslim bank	Saves so that he can afford independence
Attitude to borrowing and being in debt	Work to meet living expenses; unsure about taking on a mortgage	Built up savings to avoid debt; will borrow to be able to buy a home	Will borrow money if he has to, but only from certain sources	Avoids debt; wants to pay rent to his parents
Attitude to life in general	Live for today, worry about the future tomorrow	Looks to the future; cautious	Willing to take a risk	Realistic; start at bottom and work his way up
Aspirations in life	Travel as soon as possible	Invest in her education; buy a home and have financial security	Impatient to start earning; wants own business.	Wants to start earning as soon as possible
Attitude to risk	Live for today	Willing to take on a mortgage to get financial security in the future	Will take risks if he believes they are justified	Low risk-taker

Activity 1.6 Life events

The life events that you may have considered include the following:

- leaving home;
- renting somewhere to live with other people;
- starting full-time work;
- getting a part-time job;
- going into further education;
- going travelling;

- buying assets, such as a car or a home;
- experiencing unforeseen circumstances, such as an accident, theft, job loss, etc;
- falling in love;
- getting married or entering into a civil partnership;
- starting a family;
- getting divorced;
- starting a business;
- being made redundant.

Are these going to be the same, or different, depending on the person's background and culture?

The UK is host to people from many different backgrounds and cultures. Some may not agree with the idea of borrowing at all; some do not like the idea of charging or paying interest; some are in close-knit communities within which it is the norm for extended families to provide any financial support that is necessary. To give yourself a wider viewpoint, you should find out about at least two different cultures or backgrounds.

How does each event affect a person's needs, wants and aspirations?

People will reassess what they need to pay for and possibly reduce the amount spent on wanted items. For example, moving into a rented flat with friends, or going to university will be the first time that some people have been responsible for planning what they will eat and buying their own food. Other essential items, such as toilet rolls, cleaning materials and toiletries, need to be bought on a regular basis too. These people may need to spend more money on these items and reduce the amount that they previously spent on wants such as CDs, clothes and going out.

What does this mean for their likely incomings and outgoings?

Priorities are likely to change. How much income someone earns may vary over time and what they choose to spend their money on will change. For example, when you buy a car, you need to buy insurance and pay road tax, as well as (perhaps) repay a car loan and pay for petrol. There will be regular expenses, such as servicing and MOTs, as well as unexpected expenses, such as buying a new tyre or repairing damage. People may be willing to reduce spending on other items, such as clothes and entertainment, to pay for the car expenses.

Activity 1.7 Quotation and discussion

What do you think Mr Micawber meant?

You shouldn't need to 'translate' the money in order to see the meaning – just realise that, in the first instance, Mr Micawber has saved sixpence, and that in the second, he owes sixpence. He means that even a small surplus is a good thing and even a small deficit a very bad thing. (The figures are accurate for the time that Dickens was writing, when an annual income of £20 would see a

person reasonably comfortably off.) Small surpluses can grow into substantial savings, while small deficits can grow each month into large debts.

What has changed since the 19th century?

We no longer have debtors' prisons as they did in Charles Dickens' day. These days, people who owe more than they can repay forfeit their goods to the bailiffs and might become bankrupt. What we do have today is much better sharing of information between companies that offer loans. People who do not repay will find it very difficult, if not impossible, to borrow more.

Do you think that it applies today?

Although financial products may be more complicated today, Mr Micawber's words of advice are still true.

Activity 1.8 Cash-flow entries

You might find it useful to note down all of your income and outgoings for one week. This will help you identify all of the different ways in which you spend money – for example, taking the bus to the shops at the weekend, or buying chips on the way home from the cinema.

Activity 1.9 Analyse your cash-flow entries

Accounting for every penny

It is very unusual for someone to be able to account for every penny that they have spent. There will be a few pounds or pence here and there spent on items such as a drink, newspaper, chocolate bar, or extra bus journey that we do not consciously plan or remember. This is sometimes called 'fritter money'.

Implications for an effective financial plan

An effective financial plan needs to take into account that everyone needs some fritter money every week. Effective planning also means that intending to allocate a certain amount for savings, rent and food, clothes, going out, etc, is not enough. It is a good idea to put this money in a place in which it cannot be frittered – for example, having a standing order set up to take money out of a current account and put it into savings. This is why people often set up direct debits to pay bills as soon as they receive their salary, or use different jam jars to divide up their cash for different uses.

Activity 1.10 Accounting for savings on a cash flow

Do you consider past and existing savings to be part of your future income?

You can make future expenditure from your savings. In that way, they are a form of incoming cash in the future.

How would you recommend savings be written on a cash flow?

We recommend that you add a running total for savings at the bottom of your cash flow, so you can see the balance grow. Some people are motivated to

continue to save, or even to save more if they can see the amount growing; other people might find that the temptation to spend savings is greater if they see the amount that they have on a regular basis. These people prefer to put their savings into a suitable account and forget about them.

What are the advantages of including several weeks or months on a cash flow?

You can see how one time period affects the next ones. Remember Mr Micawber in Activity 1.7 and the knock-on effects of a surplus or a deficit? There will be irregular incomings and outgoings, such as birthday money or larger purchases, that will be spent or saved for over several time periods. A cash flow over the medium and long term enables people to track and control their money over several weeks and months.

Activity 1.11 Revising written cash flows

Some of the advantages of making a written plan, and reviewing and changing it as needed, are that:

- it helps you to meet your needs, wants and aspirations;
- it means that you can get the most out of your money;
- it enables you to alter your spending habits as your circumstances change;
- it helps you to plan for big items of expenditure;
- it means that you can reduce the need for borrowing, if that's what you prefer, by saving up over several weeks or months;
- it gives you control over your money;
- it keeps your plan realistic as you compare planned with actual incomings and outgoings;
- it helps you run 'what if' calculations – for example, it can help you to decide if it is worth earning more now, so that you can get what you want sooner, or how much you can afford to repay when you are looking for an appropriate loan;
- when you borrow money, it helps you to minimise the amount of interest and charges that you will pay by keeping track of repayments.

Activity 1.12 Perspectives on time

The answers to this are personal and can be the subject of group discussion.

Activity 1.13 Interlocking time periods

The answers to this are personal and can be the subject of group discussion.

Activity 1.14

	Affect on planning now	Capital sums	How realistic are ambitions?	Possible financial reassessments needed
John	Needs to save towards his dream lifestyle	Large – his wish list includes a large house, swimming pool, new cars and exotic holidays	These dreams do not seem very realistic in the short term	John may need to set his financial sights a little lower and build up to his desired lifestyle
Corinella	She is investing in her future by getting professional qualifications	This depends on whether or not her employer will assist her	It may be a realistic ambition for the long term	She may need to reassess her chances of promotion and decide if this is what she really wants as life events occur
Raza	Has invested in the future by qualifying	Small at present, but will be looking for a house eventually	Very modest, so very realistic	May have to put off the pilgrimage until he can afford it in the future
Mark	He will need savings to go to every World Cup game	This depends on where the games are (travel, accommodation, food) and what the tickets cost	It could be realistic if he loves the 'beautiful game' this much throughout his life	He may have other priorities as time goes by, such as having a family and a home of his own
Maria	If she wants a big wedding, she will be saving already	Weddings and looking after children require significant sums	Could be realistic, depending on the lifestyle she wants	She may decide to reassess the number of children she wants; her kids may not be so keen to have her grandchildren

Rob and Trudi	They will need to save for their orphanage, and their travel and living expenses	There could be considerable expense, even if they get support from charities	It could be realistic, if they have financial backing and local support	They may reassess what they want when they have experienced the reality of their plans
Kevin	He does not seem to have any plans	Going out drinking does not need to cost very much	He has no ambitions at the moment	Hopefully, he will get a job or a place on a training scheme, and his future will seem worth planning for

Activity 1.15 The balance between spending, saving and borrowing

Angharad now

- Income – £35.50
- Saving – £8
- Spending – £27.50
- Borrowing – £0

Angharad is spending nearly 3.5 times more than she is saving. Of this expenditure, £5 is the amount that she gives to her mother, which she considers mandatory. If we look at what she considers her disposable income – that is, £30.50 – she is saving only 26 per cent. Angharad’s current plan is heavily biased towards spending.

Angharad in two months

- Income – £0
- Saving – £0
- Spending – £100
- Borrowing – £27

When she is on holiday, Angharad has no income and is making no savings. She owes her mother £27. She has no formal plans for how she will pay back this money as yet. Suppose that she gets no more shifts at the hotel and cannot find other work: Angharad will need to pay her mother back from her earnings of £35.50 per week. She could repay the loan (her mother is not charging interest) at £5 a week and not change her spending habits. She would be using the amount that she usually saved. This repayment would take her six weeks. During this time, she would not have made any savings. Angharad’s two-month plan is heavily biased towards spending and borrowing.

Saroop now

- Income – £40
- Saving – £15
- Spending – £25
- Borrowing – £0

Saroop spends 62.5 per cent of his income and saves 37.5 per cent. Of the £25 he spends, £10 is a mandatory payment to his mother. He is spending £15 on himself and saving £15. Before he accepts his brother's loan, he has no borrowing. Saroop's plan is therefore well balanced between optional spending and saving.

Saroop in two months

- Income – £40
- Saving – £15
- Spending – £25
- Borrowing – £50

In two months' time, Saroop has made one loan repayment (his brother does not charge interest), so he owes £50. At this point, he has borrowing that is just £10 larger than his weekly income. The next £25 repayment is due in four weeks and there are a number of ways in which he can finance it. If we compare his disposable income after his payment to his mother, he has £30 per week to divide between spending, savings and repaying borrowing. He needs to set aside £6.25 a week for the loan repayment. This is 20 per cent of his disposable income, giving him £23.75 to split between saving and spending. Saroop's plan is therefore well balanced between optional spending, saving and borrowing.

Activity 1.16 Planning for a surplus or a deficit

Saroop can make the £25 per month loan repayments out of his savings of £15 per week (£60 per month) and/or reduce his spending to ensure that he still has a surplus.

Activity 1.17 Contingency planning

The list will depend on your personal and cultural circumstances, but should cover the three areas – that is, macro changes, personal or life changes, and product changes.