Personal Finance Take-home Reading

We've spent most of our time talking about the finances of a business. Now, let's spend some time talking about the basics of your personal finances. There is a lot to know about personal financial management, but we will just be talking about personal banking in this lesson.

Many of the financial principles and tools that you've learned for businesses apply to your personal finances as well. Just like a business, you should build a balance sheet for your personal life each year. This personal balance sheet will list all of your Current Assets (checking account, savings account, etc.) and your Non-Current Assets (personal belongings, cars, house, etc.). It will also list your Current Liabilities (credit card balances, portion of non-current liabilities due this year) and your Non-Current Liabilities (auto loans, student loans, home loans). You should track your personal Net Worth (Equity) on a regular basis to see how your financial condition is changing over time. Just like a business, hopefully your personal Net Worth is increasing every year! Another reason to have a personal balances sheet is that it will come in very handy if you ever apply for a personal loan (auto loan, student loan, home loan). Lenders want to evaluate your liquidity and solvency, the same as they do for businesses. The better your liquidity and solvency, the more likely you are to obtain the loan.

Instead of a business Income Statement, you should track your household income and expenses. You can use a format similar to the Income Statement or Enterprise Budgets. Simply list all of your sources of income each month (wages, salary, gifts) and all of your living expenses (rent, food, utilities, loan payments, etc.). The "bottom line" of your monthly budget should show you how much money you have available after you pay all of your expenses – exactly like we did for the business. Again, lenders are interested in seeing your monthly budget so that they can determine whether you will be able to repay a loan.

Personal Liquidity

Businesses need to have cash on hand or in their checking accounts to meet their expenses. The same applies to your personal life. You should try to keep at least 1-2 months of living expenses in your personal checking account. This will allow you to meet your living expenses without having to dip into your emergency savings. Believe me, just doing this takes a lot of financial pressure off of your shoulders. You can sleep a lot better at night when you know that you have enough money in your checking account to pay your bills on time!

Emergency Savings

Sometimes, life happens. Unexpected events seem to pop up at the worst time. Your refrigerator dies right before a big holiday meal. The battery in your car dies on a cold morning. Your appendix decides that it doesn't like you anymore and you have to go to the hospital. All of these require cash – you have to pay for them. For this reason you should try to build your savings account up to at least two months of living expenses. When you have two months of living expenses in your savings account, you can handle a lot of the unexpected events that life throws at you. If you don't have much money in your savings account you will have to rely on credit cards, emergency loans, or the sale of some of your assets (car, house, etc.) to pay these bills. Once you settle down and start a family, you might want to increase the amount you keep in your

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savings account to 3-6 months on living expenses. This will be your financial “safety net” in case something bad or unexpected occurs. Trust me, having enough money in your savings account is a great stress reducer!!

Here’s a simple example. Assume that Greta’s personal monthly living expenses (not her business expenses) are $3,000/month. How much money should Greta keep in her checking personal account and personal savings account? She would be wise to keep at least $3,000 in her checking account to meet her monthly bills. That is, if she can start each month with approximately $3,000 in her checking account she will be able to pay her bills without any trouble. Greta should set a goal of having at least $6,000 in her savings account – this is equal to 2 months of living expenses. If she were to get sick and have to close down her business temporarily she would be able to meet her living expenses for roughly 2 months – she has about 2 months to get better and get back to work.

Checking Accounts

Most adults over the age of 18 should have a checking account. It is easier to pay your monthly bills with a check instead of using cash or money orders. Also, most employers today are requiring their employees to have a checking account so that they can “direct-deposit” their paychecks. This makes it easier and less expensive for the employer. Here are some other reasons that you should use checking accounts to pay your bills or hold your cash:

- You tend to spend less money when you write checks versus using a credit card or a debit card. The reason – it’s too easy to use a credit card or debit card, and you don’t actually see the money changing hands. When you write a check you realize instantly that you spent money when you record it in your checkbook register.
- Carrying cash around to pay your bills is dangerous. If you lose the money or get robbed, that money is gone. If you lose your checkbook, simply call your bank and tell them – they will not process any checks after that date, and they will help you get a new checkbook and register. Also, the money in your checking account is insured by the bank. If the bank were to go bankrupt you would still get your money bank.
- You should NEVER put money in the mail to pay your bills. Only put checks in the mail to pay your bills.
- Most checking accounts are linked to Automated Teller Machines (ATMs). This makes it convenient for you to get cash from your account whenever you need it.

Most banks offer basic checking accounts with no monthly or annual fees. You pay for your checks (maybe $35 every few years) and that’s about all. Most checking accounts do not pay any interest to the accountholder – if they do the interest rate they pay is very small. Don’t worry about this – the main reason to have a checking account is to easily pay your living expenses and get your hands on your money when you need it.

At this stage of your life you might open a student checking account with your bank. Student accounts are very basic. Here’s how they work - You deposit money into the account when you open the account. You will probably have to order some checks – it takes a week or so to receive your checks. The account may have a “debit card” associated with it. A debit card is basically an electronic check – you swipe your card to pay for something, and the money comes out of your checking account immediately. Your student account may have a “minimum balance” requirement. A minimum balance of $200 is common. This means that you must keep

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at least $200 in your checking account at all times; if your balance goes below $200 you might have to pay a fee. So – keep your balance about the minimum balance!!

Banks offer personal checking accounts for non-students, too. These accounts may have a few more “bells and whistles” associated with them than a student account. They may pay interest to the account holder. They may have slightly different minimum balances and fees than a student account.

Using Your Checking Account

Once you have opened a checking account and deposited money into the account, it’s time to start using it. You will get a supply of checks and a checkbook register. The checkbook register is used to record every deposit you make into your account, every check that you write, and to keep a running balance of how much money is in your account. You should write down EVERY transaction related to your checking account – this is very important!

At the end of each month you will receive a statement from your bank. This statement shows all of the activity in your account that the bank has processed. It will show all of the deposits that have been processed by the bank and all of the checks that the bank has paid out of your account. It will also give you the Ending Balance for your account. The Ending Balance shows how much money is actually in your account at the end of the month.

The Ending Balance of your account may be different from the running balance you have in your checkbook register. This is because some of the checks you wrote have not been cashed or processed yet, or some of the deposits you made have not been processed by the bank yet. For example, if you deposited $100 into your account at the end of the month it may not have been processed before the bank sent out your monthly statement – that $100 is not included in the bank’s Ending Balance for your account, even though the funds may actually be in your account.

Well, how do I know if the bank’s Ending Balance is correct or if my checkbook register has an accurate balance in it? Good question! To do this we need to “balance your account.” You should balance your account every month to be sure that neither you nor the bank has made a mistake. Here’s how:

1. When you get your monthly statement from the bank, get out your checkbook register and grab a calculator.
2. In your checkbook register, place an “X” next to every check and deposit that the bank has listed on your monthly statement. We say that these transactions have “cleared the bank”. That just means that the bank has processed those transactions.
3. Use the checkbook balancing worksheet that is usally on the last page of the monthly statement.
    a. Write the ending balance **from the statement** on the first line of the worksheet (Line A).
    b. Total all deposits to your account that have NOT cleared (are not listed on your statement). These will be all of the deposits in your checkbook register that do NOT have an “X” next to them. Write this total on next line of the worksheet (Line B).
    c. Add Lines A and B to calculate the subtotal and enter the result on Line C.

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d. Total all checks from your account that are not listed on your monthly statement. These are the checks or withdrawals that do NOT have an "X" next to them in your checkbook register. Enter the total on Line D.

e. Subtract Line D from Line C. This amount should be exactly equal to the **ending balance in your checkbook register**. If not, you have made a mistake – go back and do it again!

Savings Accounts

You should think about using a savings account to hold your emergency money. Remember we said that you should have at least 2 months of living expenses in your savings accounts? A savings account is slightly different from a checking account in a couple of ways:

- Most savings accounts pay an interest rate (a rate of return) to the accountholder. This interest rate is usually relatively low, but it's better than earning nothing on your account. Most checking accounts do not pay interest to the accountholder.
- Savings accounts usually do not provide very many checks. Most people transfer money from their savings account to their checking account to pay their bills. But you should still balance your savings account each month in the same way that you balance your checking account.

It is a good idea to link your savings account to your checking account. This will allow you to easily transfer money from one account to the other. It may also offer a service called "over-draft protection". You may have heard the phrase "bouncing a check." This means that you wrote a check for an amount greater than you had in your checking account. For example, your checking account has a balance of $100 and you wrote a check for $150. There isn't enough money in the account to pay the check – you end up "bouncing" the check. Over-draft protection automatically moves enough money from your savings account to your checking account to prevent bouncing a check.

Certificates of Deposit (CDs)

Another place that you can store your emergency money is something called a Certificate of Deposit, or a CD. A CD is basically a loan that you are making to the bank. You write a check to the bank and you sign the CD's certificate (the paperwork). The certificate clearly lays out the terms of this loan. It will clearly specify:

- the amount your loaned the bank (the principal)
- the interest rate the bank will pay you and how often they will pay interest
- the "term" of the loan (length of time)
    - at the end of the term the bank will pay you all of your initial principal and all of the interest it owes you
- any penalty for getting your money before the end of the term
    - the penalties are usually 1-3 months of interest earnings

CDs are usually 100% insured by the bank. This means that you will receive your money (principal and interest) in the slim chance that the bank has financial problems.

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The “terms” of CDs typically range from one month to 10 years. CDs with longer terms usually earn a slightly higher rate of interest than the shorter term CDs.

CDs are good places to keep your emergency money. They usually pay a higher interest rate than savings accounts. They are insured – you will be able to get your money back if your bank has to go out of business. And, because they have penalties for taking your money out before the end of the term, they make you think before you pull your money out of the CD – this reduces the probability that you take money out of your emergency savings for something that’s not really an emergency!

Summary

To wrap up this lesson, remember that most of the principles you learned for businesses apply to your personal finances. You should keep good records, especially a personal balance sheet and a personal budget. Liquidity is important for your household as well – try to keep at least 1 month of living expenses in your checking account. And preparing for the unexpected is a smart thing to do – try to keep at least 2 months of living expenses in your emergency savings (3-6 months is better than 2months!).

Take time to learn about your personal finances. The earlier you learn, the better your life will be!

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