CHAPTER 3

ESTABLISH A SPENDING PLAN AND SET ASIDE RESERVES

Before approving a mortgage loan, lenders will review factors like the amount of money you have available for a down payment and your ability to repay the loan. But once your loan is approved, it's up to you to make sure that you'll have enough money set aside to cover closing costs and the expense of home maintenance.

The information in this chapter will show you how to track and review your actual spending, figure out reasonable spending/savings amounts and decide on how to best set up an emergency fund.

> ***"More people should learn to tell their dollars where to go instead of asking them where they went."***
>
> ***-Roger W. Babson***

Section 1: Reviewing Your Spending Habits

A great time to get your spending and savings habits in order is before you apply for a mortgage loan.

Why is it important to review my spending habits?

Have you ever been sure you lost a $20 bill…only to stop, add up all your purchases, and find that you spent every penny of it? Knowing how and where you spend can help you take control of and successfully manage your money. It can also help you develop the habit of planning and saving for the purchases you'll need to make as a homeowner.

As a homeowner, your spending and saving needs will vary from those of a renter. The process of closing, moving and settling into your new home will generate immediate costs, so you'll need to begin planning and saving far in advance of your actual home purchase. By learning to track your spending and making adjustments to increase your savings, you'll be in a better position to buy a home and to maintain a comfortable, financially sound lifestyle.

Creating a budget and fine-tuning it will help you:

- See where you may be wasting money.
- Increase monthly contributions to savings.
- Build a solid emergency fund.

How can I track my spending?

No tricks here, just write down everything you spend. To get a real picture of your spending, everyone in your family should track their expenses at the same time. You can keep track of your spending any way you like. For example:

- Start with an expense chart and fill in an explanation and amount each time you spend money.
- Record all purchases, and then transfer everything to a chart every few days.
- Use a computer program to help track expenses.

Whether you use cash, checks or credit cards, be sure to record all of your spending. To see where your money is going, you'll probably want to monitor your spending for a full month. Don't worry if you miss a day, as long as you don't get off track for too long. Try to avoid picking a month with a big holiday, planned vacation, or another large expense because it can affect your spending records.

What are the basic spending categories?

Everyone spends money differently. By identifying your spending categories, you'll be able to see how you can cut expenses. Here's a list of common expenses:

Housing and utilities	Food (groceries and restaurants)
Cars and transportation	Insurance
Clothing	Savings
Health and medical	Personal
Gifts	Education and personal development
Charitable contributions	Recreation and entertainment
Penalties and fees	Loans and debt payment
Taxes	Cigarettes and alcohol
Professional dues	Children's expenses (i.e. day care)
Cable/satellite/Internet	Phone and/or cell phone

What can I learn from tracking my spending?

- Chances are you'll be surprised. You may find you're spending more than you think on eating out, entertainment, clothes or other things.
- You'll discover how well you're funding your priorities. For example, if your goal is to purchase a house within the next year, you may be spending in other areas instead of applying the money toward saving a down payment.
- There's a difference between tracking and reviewing your spending. Detailed, short-term *tracking* of your expenses can give you the information you need to do a broad *review* of how you're spending your money.

How often should I review my spending habits?

You should review your spending on a monthly basis. Make sure you stay within targeted amounts for each category. Don't wait until the end of the month to add money to savings. Pay yourself first. By thinking of savings as a regular, fixed "expense," you will build a healthy emergency fund.

Maintaining a written budget becomes especially important under the following circumstances:

- You decide to transition from renting to buying a home.
- You need to make a major purchase.
- Your financial priorities change.
- You're looking for new ways to save.
- You set financial goals and you want to monitor your progress toward them.

By keeping organized records of your spending, you'll be able to review and compare past expenditures.

Summary

Tracking household spending can uncover areas where you can make budget cuts that can be transformed into savings.

- Reviewing your spending habits helps you control your money.
- Some of the basic spending categories for tracking expenses are housing, transportation, personal items, and debt payments.

Section 2: Preparing Your Spending Plan

The best way to plan and manage your finances is to establish a budget. It can put you in control of your money, help you meet your goals, and help you achieve financial wellness. The first step to creating a budget is to compare your monthly spending habits with your monthly income.

> ***"To acquire wealth is difficult, to preserve it more difficult, but to spend it wisely most difficult of all."***
>
> ***-Edward Day***

Why is a budget important?

A budget can shed light on and improve your finances in the following ways:

- Reveal your current financial condition by comparing your earnings to your expenses.
- Help you prepare for the new expenses of owning a home.
- Help to avoid overspending by identifying items that are costing too much.
- Break down your expenses into helpful categories.
- Help establish financial control and direction by showing where you can save.
- Help budget for emergencies or large anticipated needs.
- Help you achieve your goals.

A good budget can help you avoid the following potentially dangerous financial situations:

- Too much debt - more than you can pay off in one year.
- Lack of cash - a habit of using credit for small daily purchases.
- Emergencies - no available cash or credit to cover emergencies.
- Making minimum payments - little or no cash to pay down principal balances.
- Cash advances - a habit of using credit cards to pay other debts.
- Skipping payments - juggling bills and paying late
- Borrowing from friends and relatives - depending on loans to pay bills.

Steps in creating a budget:

Your first step is to list your net income (your take-home pay, or the money you have after taxes). This may include:

- Full/part-time job income.
- Pension or other retirement income.
- Child support or alimony income.
- Dividends or interest.
- Bonuses, commissions, or tips.
- Tax refunds.
- Welfare or other government entitlement programs.

It's easy to calculate your disposable income. Take a look at the following example.

Table 3-1: Calculating Disposable Income

Jenny	Seth and Mary
Jenny takes home $1,000 every two weeks, and earns an annual bonus worth $500, after taxes	Seth earns $1,600 after taxes every month. Mary's take-home pay is $200 every week.
Multiplies $1,000 by 26 (the number of bi-weekly paydays in a year). This amount equals $26,000. Adds $500 from annual bonus to equal $26,500.	Multiply her take-home pay of $200 by 52 (the number of weekly pay days in a year). This amount equals $10,400.
Divides $26,500 by 12 (months in a year) and gets $2,208 as her monthly take-home or disposable income.	Divide $10,400 by 12 (months in a year) and get $866 as Mary's monthly take home or disposable income. Seth's income of $1,600 plus Mary's income of $866 equals $2,466 in combined monthly take-home income.
Begins her spending plan by listing $2,208 as her monthly take-home (disposable) income.	Begin their spending plan by listing $2,466 as their monthly take-home (disposable) income.

***Note: Disposable income is defined as the money you have available for spending, saving, and investing.**

The next step is listing your monthly expenses. There are two types of expenses: **fixed** and **variable**.

- ***Fixed expenses -*** Don't change each month. Examples of fixed expenses are your mortgage or rent payments, auto loans and insurance premiums.
- ***Variable expenses -*** Can change each month. What you spend for groceries, entertainment, transportation, credit card bills and utilities, can vary every month.

If you put some money in savings each month, be sure to include that amount as an expense in your budget. Also, be sure to include in your spending plan monthly amounts for events that may occur infrequently. For example, if you spend $600 a year on holiday gifts, divide that amount by 12 to get a monthly figure of $50.

The next step is to compute the difference between your income and expenses. Add up your income from all sources. Add up your expenses. Then subtract your expense total from your income total. You'll discover one of the following situations:

- *A **surplus*** ("In the black") - Congratulations! If your net income exceeds your expenses, your biggest worry will be how to handle your savings.
- *A **deficit*** ("In the red") - You'll get a negative dollar figure if your expenses exceed your net income. To fix this, first review both your income and expenses making certain nothing has been left out. If you've recorded everything and you still show a deficit, you'll need to balance your budget. You can do this by increasing your income, decreasing your expenses, or doing both.

Now, take a look at the following example of a spending plan.

MONTHLY EXPENSES	MONTHLY INCOME
Savings	Net take-home pay (self)
Savings	Net take-home pay (spouse)
401K/Retirement	Part-time pay (self)
Other	Part-time pay (spouse)
Subtotal:	Retirement Pay
Housing	Child support/Alimony
Rent/Mortgage	Social Security
Fees/Maintenance	AFDC
Subtotal:	Food Stamps
Transportation	Investment income
Car payment 1	Total Monthly Income:
Car payment 2	
Auto Insurance	
Gas	
Tolls/Parking	
Maintenance	
Subtotal:	
Utilities	
Telephone	
Cell Phone	
Water	
Electricity	
Gas	
Trash Service	
Subtotal:	
Monthly Debt Payments	
Credit Cards	
Student Loans	
Personal Debt	
Subtotal:	
Food & Clothing	
Grocery	
Dining Out	
Clothing	
Laundry/Dry Cleaning	
Subtotal:	
Health Care	
Insurance	
Medical/Dental	
Medication(s)	
Subtotal:	
Other Expenses	
Tobacco/Alcohol	
Recreation	
Childcare/Eldercare	
Education	
Alimony/Child Support	
Life Insurance	
Gifts	
Other	
Subtotal:	
Add Your Subtotals for Total Expenses:	

Total Income – Total Expenses = Surplus/Deficit

Look at each expense and figure out how to reduce it. For ideas on reducing your expenses, visit www.incharge.org.

Besides scrutinizing your spending for ways to cut costs, or you can consider ways to supplement your earnings.

Granted, you may not be able to reduce the costs of your fixed expenses, but you might have some leeway with what's known as your discretionary income - the money you have left after paying all your bills and fixed expenses. You may find some immediate savings results by cutting costs in discretionary-income areas such as restaurant meals, clothing, and recreation.

How do I know if my expense allocations are realistic?

As a helpful step, compare your personal expense allocations with the following Expense Allocation Chart. Look to cut back in areas where you're spending more than what's suggested on the chart.

Expense Category	Percent	Expense Category	Percent
Housing	23% - 33%	Transportation	7% - 10%
Utilities	8% - 11%	Food	5% - 10%
Clothing	1% - 3%	Health Care	3% - 5%
Personal	3% - 5%	Retirement/Savings	10% - 15%
Personal debt	0% -10%	Charities	5% - 10%

***Note: The chart offers recommended guidelines for expense allocations but may not be appropriate for your financial situation. Use it as a starting point to get a good idea for tracking your own expenses.**

How do I keep my spending plan up-to-date?

It's smart to review it every month. You should also make adjustments to your budget if you come into some additional income, make large purchases or incur emergency expenses. For example, your refrigerator conks out and you're forced to spend $800 to replace it. You'll know to make adjustments in your discretionary spending and make any other modifications you're able to on your spending plan to stay "in the black."

Each time you make a change in your spending plan, consider how that will affect the achievement of your goals.

Summary

Preparation and review of your budget will help you as you steer a course toward financial stability. Developing and sticking to your budget can help you achieve your financial goals.

- Your spending plan lets you compare your income to your expenses.
- Include all sources of income when you develop your spending plan.
- Include all expenses - fixed and discretionary - when putting together your spending plan.
- Be sure that your spending allocations are reasonable, accurate, and within your means. (Refer to the Expense Allocation Chart.)

Section 3: Setting Up Reserves

With a reserve account, you'll be able to take care of major expenses or emergencies as they occur, without delay and without having to use credit. Homeownership involves three types of costs:

- One-time costs associated with the down payment, closing cost and moving expenses.
- Scheduled monthly costs such as mortgage, insurance payments, utility bills, and taxes.
- Unscheduled or occasional costs, such as maintenance, repair or replacement of systems and appliances.

By reviewing your household's spending habits and developing a budget, you'll be in shape to cover two of these spending categories one-time costs and scheduled monthly payments. However, the third category, unscheduled costs, will require more planning and saving.

What is an emergency fund?

An emergency fund is your rainy-day fund. It is money you save to protect yourself against financial distress in the event of job loss, unexpected medical expenses, major appliance breakdowns or the need for emergency renovations. Your emergency fund should be kept in a no-fee, interest bearing savings account. You should aim to have six months of expenses saved in your emergency fund.

Why do I need to keep money in reserve?

With an emergency fund, you'll have immediate access to money for some or all unforeseen or occasional outlays. You'll be able to take care of problems as they arise, instead of waiting to get a loan approved. You'll earn money from interest payments and you'll also avoid the expense of borrowing because the funds in your reserve account will be available to you interest free.

How do I decide how much money to keep in reserve?

By simply calculating how much you'll need for normal upkeep, replacement and repair you can develop a plan for saving that amount.Another factor to consider is the length of time you plan to live in the home. For example, if you purchase a newly-built home, but plan to live in it for less than five years, you can safely forego the need to build up financial reserves to pay for storm window replacements fifteen years from now. Moreover, with careful use and proper maintenance, many items will last far beyond their projected useful lives.

Chapter 10, ***Responsibilities of a New Homeowner***, will discuss in detail the type of action you'll need to take to keep your home and all its components running safely, efficiently, and economically.

What kind of account should I use for my reserve?

The purpose of a reserve account is to save money for emergencies and large occasional expenses. Therefore, you will need an account that pays you interest while your money is on deposit, yet allows you to withdraw funds on demand - without penalties. You can begin with a regular savings account, money market account or mutual fund. As the size of your reserve fund grows, you may consider investing part of it in a time deposit account that bears higher interest, such as a certificate of deposit or bonds.

Summary

Keeping a reserve fund separate from your other savings can help to provide peace of mind and financial security for homeowners.

- A reserve fund is a savings account you establish to pay for household repairs, replacements or renovations.
- A reserve fund will protect you from the financial consequences of having to pay for major household emergencies.