Set Up A Budget And Stick To It

A foolproof guide to managing your money

BY PAULA H. HOGAN

One of the most daunting tasks facing a newly divorced person is getting control of personal finances. The good news is that taking control of your finances isn't as hard as it looks. And even more comforting, the process of organizing your finances can actually provide a positive and creative framework for your new postdivorce life.

Take stock

The first step to organizing your finances is to make a list of what you *own* and what you *owe*. This snapshot of your wealth, otherwise known as a balance sheet or net worth statement (See the sample balance sheet on page 20), is the foundation of your financial plan. It provides a wealth of information about what you have going for you and where you are vulnerable.

The asset section of the balance sheet is the list of what you own. The first part lists the funds used for day-to-day expenses, the second part lists investment accounts (i.e., the funds available for future expenses, including retirement and old age), and the last part is for property, the nonfinancial part of your wealth that you use everyday.

Financial advisors typically recommend having from three to six months' living expenses in a money market or other liquid account. (Liquid assets, listed in the first part of the asset section of the balance sheet, are assets that are readily convertible to cash without loss of principal value. Stock investments are not liquid, because their value might be depressed on the day you need cash to pay bills.)

Liquid assets form your emergency reserve, the first line of defense against financial hardship. With an adequate emergency reserve and insurance program in place, you can afford to begin building up the investment section of the balance sheet.

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Personal property, listed in the last part of the asset section, is a two-headed beast. We use this part of our wealth every day, so it can't really be counted on to pay bills. On the other hand, at financial turning points, we often convert these personal-use assets into financial wealth, for example, to finance living expenses in old age. These assets are listed separately to honor their unavailability to pay bills, but they should not be ignored as a form of wealth.

Liabilities

The liability section of the balance sheet is the list of what you owe. In the real world, it can be hard to manage debt. The goal, however, is to have debt in the right amount, at the right price, and incurred for the right reasons. Debt for consumption items, such as clothing, travel, and miscellaneous expenses, is a drag on your finances that grows heavier the longer it lasts.

Think of debt for consumption items as moving backwards, away from financial security. Credit card debt, for example, is no longer a wise strategy. Credit cards typically fund consumption items and have high, nontax-deductible interest rates. They have an absolutely erosive effect on your wealth. By contrast, lower rate and deductible debt for investment items, such as a residence or tuition for a career-related degree, can spur financial wealth if the debt is at an appropriate level and price.

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Advisors often use a rule of thumb that home mortgage principal and interest payments should not exceed 25 percent of pretax income, and payments for all debt should not exceed about 40 percent of pretax income. Some debt, for example, debt to the IRS or friends or family, can't be helped in the short-run, but is best thought of as an obstacle to progress for which you need a specific, realistic plan for repayment.

You can draw up a balance sheet for yourself in about half an hour using the sample balance sheet on page 20. Don't worry about getting the numbers perfect; use the best available estimates. Add up all of your assets and then all of your liabilities. Subtract liabilities from assets to get your Net Worth. This is the number you want to grow each year. If this number is $1 million, you are a millionaire.

Take a look at the components of your net worth:

- Do you have cash reserves equal to at least three months' living expenses?
- Do you have savings for the future?
- Do you have expensive or inappropriate debt? If you do, pay the highest interest-rate debt first. Investigate transferring balances from high interest-rate credit cards to a lower-rate card or home equity loan. Also, talk to your creditors. Generally, creditors would rather work with you to arrange regular, affordable payments than have you default on the loan and never hear from you again.
- How can you make your net worth grow? Getting rid of expensive debt is often the first step. Adding to investment accounts through a regular savings program is important, but it comes after funding a plump emergency reserve. Buying more personal property is almost always fun—but not always the right step. Making investments grow safely is critical.

Rather than getting bogged down with detailed budgeting, think about how you spend discretionary money. Are you living within your income? (Hint: If savings are going down or debt is going up, you are not living within your income.)

Reviewing your balance sheet with these issues in mind makes it possible to plan wisely and to be in control of your financial life.

Cash flow

The second financial statement that offers valuable information about your current financial condition and options is called an income statement. This report provides a "movie" of cash flowing in and out over a specific period of time, typically a year. Similar to the balance sheet, an income statement can be created easily for your own finances.

First, list each income source and annual amount. (See the sample income statement on page 21.) Be sure to use realistic estimates; aim to err on the low side. Review each income source. How secure is each item? How long will it last? How well will each item keep up with inflation?

Income that is fixed as a level payment, rather than going up each year with inflation, will shrink dramatically in value over time. For example, with an inflation rate of 4.5 percent a year, the sum of purchases you could make with a particular fixed-level of income will halve over the course of 15 years. If inflation continues at 4.5 percent for another 15 years, the standard-of-living attainable with that original fixed income would fall to one quarter of the original amount. Inflation is a serious threat to anyone living on a fixed income for more than a short period of time.

Next, make a list of annual fixed expenses. These are expenses that you will have to pay even if you go to a desert island and hide for a year. As the sample income statement shows, fixed expenses include such items as home mortgage payments, club dues, taxes, and insurance premiums. Look at each fixed expense. Can any item be reduced? Does each item make sense for you?

The difference between total income and total fixed expenses is a rough estimate of what you have to spend each year on variable expenses. It is difficult, if not impossible, to get an accurate estimate of variable expenses, especially in the midst of a major life change.

Rather than getting bogged down with detailed budgeting, think about how you spend discretionary money. Are you living within your income? (Hint: If savings are going down or debt is going up, you are not living within your income.) What do you have to do to stay

within your income? Are you paying for things you don't want or need? Where are you likely to overspend on impulse purchases? What precautions in this area make sense for you?

The sample income statement lists some common categories for variable expenses. You may find it helpful to develop estimates for these figures. Once you have all the estimates you can think of, calculate a total and multiply by 1.10 to give yourself a 10-percent cushion for errors and omissions. Subtract total fixed and total variable expenses from total income. If this number is negative, you are losing ground each year and possibly heading for disaster.

Having a specific picture of your income and expenses allows you to develop planning ideas. For example, as you review your income statement, you will almost certainly note how much easier daily life becomes if fixed expenses are as low as possible. In addition to keeping fixed expenses low, look for ways to reduce impulse spending on purchases that, in fact, are not that highly valued. Look for ways to increase earned income or to manage tax liabilities more effectively.

You will also be able to focus on potential vulnerabilities. For example, support or alimony payments may be scheduled to end after a certain number of years. If this is true for you, what will you do after the support period ends? Should you be doing something now to prepare, such as saving more or getting some retraining? Don't put yourself in a position of having to look back regretfully at opportunities lost during the support years.

Alternatively, some income, such as retirement income, doesn't start for a number of years. How will you fund everyday expenses between now and retirement? Reviewing your income statement makes planning for such decisions possible.

Look before you leap

Having composed and reviewed your balance sheet and income statement, you're now ready to look toward the future and plan your finances. The first step is to scan the horizon for things that could potentially go wrong and make sure that you are reasonably prepared to protect yourself.

Your first line of defense is to have ready access to cash for emergencies, such as a broken dishwasher, a sick family member, or for an unexpected opportunity. An emergency reserve of at least three months' living expenses is ideal. Store these funds in an account separate from your checking account. Use them when necessary and then carefully rebuild the balance. You can also use this account as a place in which to store cash for large, expected purchases, such as a new car.

As a back-up resource, get a credit card and use it. Make modest purchases each month and then pay the balance in full. Establishing your own credit makes you better prepared to face emergencies.

The second line of defense for major emergencies is to have an adequate insurance program. First, check your divorce agreement to make sure that all required coverages are in place. Then, consider other optional but important coverages, such as protection against an interruption in support payments and other income to you, the costs of property damage and liability for accidents, unreimbursed medical expenses for you and your children, and custodial care for you in old age.

In addition, when any major change occurs in your life, including divorce, it is time to update your estate plan, including wills, possibly a revocable living trust, durable powers of attorney for health care and financial matters, and beneficiary designations on retirement plan accounts and life insurance policies.

HOW MUCH TO

Save?

A rule of thumb for lifetime savings is 15 percent if starting early, 20–25 percent if starting later.

HOW MUCH TO

Spend?

Live within your income, and make a habit of saving regularly. Keep fixed expenses as low as possible. In general, postpone withdrawals from retirement accounts, unless you are age 70½.

SOCK IT

Away

Save as if your life depends on this future income, because it does. Make savings:

- **Automatic**
- **Regular**
- **Diversified**

Diversify income sources

Support payments, Social Security payments, and investment income are all great, but it's hard to beat earned income as a gratifying, reliable, and long-term source of income, self-esteem, and freedom. Talk with the not-so-newly divorced and listen to what seems to be a common thread: The happiest ones are those who get on with their lives in many different ways.

Unless you have already safely arrived at retirement with adequate wealth, you need to have a plan for regular savings. Most people find that the only effective way to save is to do it regularly and automatically. No one, regardless of income level, has any left-over money at the end of the month.

The level of savings required to provide for retirement years comes as a rude surprise to many people; it's a lot more than our consumption culture wants us to believe. If you are starting early, for example under the age of 35, consider saving 15 to 20 percent of your income every year. If you start a savings program in middle age, you will need to save at least 20 to 35 percent of income each year.

Ways to save

Savings include employer and employee contributions to retirement accounts, principal payments on mortgages, IRA contributions, additions to nontax-sheltered investment accounts, and tuition for a career-related degree or training program.

If you have children, start them off right with one of the most important financial lessons of all, and the one that is most profitably learned early: Start saving early and keep saving regularly. Teach them with words and by example.

Sometimes trying to figure out how much you can safely spend is puzzling. As explained earlier, it's dangerous to spend more than you have, but living fearfully on a shoestring is not good either. If you have an adequate savings program and have covered all of your fixed expenses, then you can safely spend or give away the funds remaining from earned income, support payments, and Social Security.

But how much portfolio income can you safely spend? Traditionally, portfolio income has meant interest and dividends. But this can be dangerously misleading. Interest and dividends are one component of the wealth generated by investment assets. Capital gains (or losses) is the other. Spending one and ignoring the other can result in your inadvertently spending capital, not income.

An alternative to spending interest and dividend payments is to think of yourself as a foundation, an organization meant to live and generate cash payments forever. If funds are invested in a mixture of stocks, bonds, and money market instruments, you can safely spend 3 to 5 percent of your whole portfolio each year and still live forever, because 3 to 5 percent is well within a reasonable estimate of long-term, annual expected return. (The higher the component of stocks in your portfolio, the higher the reasonable withdrawal rate. Over the long-term, stocks have offered a substantially higher rate of return than other investments.)

In years when the markets perform particularly well, you get a raise. In years when investments decline, you can either batten down the hatches or make a conscious decision to dip into capital. Viewing portfolio income in this manner keeps you in charge of your money instead of vice versa.

All these ideas may sound well and good, but how do you put them to work? The mechanics of personal finances can seem mysterious. Here are a few ideas.

Your accounts

The only financial accounts you really need are: a checking account for daily expenses, a savings or money market account for emergency reserves, retirement plan accounts, nontax-sheltered investment accounts, and credit card(s).

Streamlining accounts will make it easier, and thus more likely that you will review your financial condition periodically. Don't get caught in the trap of filing monthly statements instead of reviewing them. Savings are much more likely to increase if they are visible and periodically reviewed.

Having thorough financial records also is important. Good records can reduce taxes and hassles over the long-run in a major way. Keep canceled checks, credit card statements, receipts for major purchases, property tax bills, insurance payments, tax returns, and other annual expense documentation. Don't spend time setting up meticulous files; keep one box for each year of receipts. In addition, keep one file for each piece of property owned with a record of home improvements. Consider a fire-proof safe at home or a rented safe-deposit box for hard-to-replace documents.

If cash flow permits, pay small monthly bills six months in advance and pay insurance premiums annually. In addition, arrange to have income and regular fixed expenses, such as mortgage payments, processed automatically and electronically. Automated savings programs also are helpful.

A final word

Knowing your financial condition and how it can be improved puts you in charge of an important part of your life. Even those who experience a substantial drop in their postdivorce standard of living often report tremendous satisfaction with, at least, and, at last, being in control of their own destinies.

And getting organized and moving ahead on your finances is a good way to remain focused on the future, rather than the past, which is a necessary part of putting the divorce behind you and moving ahead in your new life.

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Sample Balance Sheet

A snapshot of your financial strengths and weaknesses

ASSETS (What you own)

LIQUID ASSETS (Your cushion for day-to-day expenses)

Item	Amount	
• Checking accounts (Use usual month-end balance)	________	LQ
• Savings/money market accounts	________	LQ
• Cash-surrender-value life insurance (It's often good to pay off loan balances here)	________	LQ
TOTAL LIQUID ASSETS (Your first defense against financial misfortune) **(Add LQ's)**	________	**A**

FINANCIAL INVESTMENTS (A key determinant of your future standard of living)

Item	Amount	
Nontax-sheltered (i.e., not in a tax-sheltered retirement account)		
• Certificate of deposits (list all)	________	F
• Taxable bonds or bond funds (traditional role in portfolios to decrease volatility)	________	F
• Stocks (High-potential return in exchange for year-to-year volatility)	________	F
• Mutual funds (Usually a mixture of stocks, bonds, and CD-like investments)	________	F
• Other (e.g., limited partnerships, often hard to value or of little value)	________	F
• Closely-held business (One of the few remaining tax shelters)	________	F
Tax-sheltered retirement accounts (These are powerful savings)	________	F
• IRA-regular (Funded with regular $2,000/yr. contributions)	________	F
• IRA-rollover (Funds formerly held in an employment-related account)	________	F
• Work-related accounts		
SEP-IRA's (Consider if self-employed)	________	F
401(k) Profit sharing (Retirement accounts with for-profit employers)	________	F
403(b) Accounts (Retirement accounts with nonprofit employers)	________	F
Value of vested pension benefit (Your benefits office has this number)	________	F
Annuities (Should not be held in an IRA account)	________	F
TOTAL FINANCIAL INVESTMENTS (Add F's)	________	**F**

PROPERTY (These assets affect your day-to-day standard of living and, to a limited extent, your future standard of living. They can be hard to value. Use low estimates.)

Item	Amount	
• Residence	________	P
• Vacation home	________	P
• Special collections (Use the insured value)	________	P
• Personal property (Useful estimate: Make this number 50% of residence value)	________	P
TOTAL PROPERTY (Add P's)	________	**C**

TOTAL ASSETS (What you have going for you) **(Add A+B+C)**	________	**I**

LIABILITIES (What you owe)

Item	Amount	
• Credit cards (A real drag. Get rid of this.)	________	L
• IRS debts (Often a hurdle early in divorce)	________	L
• Friends and family (A lifesaver when you need it, but in general "good fences make good neighbors")	________	L
• Home equity loan (Be careful here; use for investment not consumption)	________	L
• Car loan	________	L
• School loan	________	L
• Mortgage	________	L
• Business debt	________	L
• Other	________	L
TOTAL LIABILITIES (What you have going against you) **(Add L's)**	________	**L**
NET WORTH (It's the difference between "what you own," Assets, and "what you owe," Liabilities) **(Subtract your liabilities from your assets I-II)**	________	**II**

(IF THIS IS $1 MILLION, YOU'RE A MILLIONAIRE!) MAKE THIS NUMBER GROW EACH YEAR.

Sample Income Sheet

A look at day-to-day expenses

INCOME ($ coming in—use low estimates)		
SUPPORT PAYMENTS (What you're actually getting. How long do they last?)	________	1
INVESTMENT INCOME		
• Financial (An annual percentage of your portfolio, e.g., 3–5%)	________	1
• Rental (After all expenses, including reserves for maintenance)	________	1
SOCIAL SECURITY INCOME	________	1
PENSION INCOME (Does it go up with inflation?)	________	1
OTHER INCOME (Including, e.g., gifts, disability income payments, royalty payments)	________	1
EARNED INCOME	________	1
TOTAL INCOME (Be sure to live within this number) (Hint: If debt is rising or savings declining, you're not living within your income) **(Add 1's)**	________	1
EXPENSES ($ Going out—use high estimates)		
FIXED (Even if you go to a desert island for a year, you still have to pay these expenses)		
• Home		
– Mortgage interest	________	FE
– Mortgage principal (This counts as savings).	________	FE
– Escrow	________	FE
– Condo fees	________	FE
– Property taxes	________	FE
• Insurance		
– Health (For you and your kids. What about after COBRA?)	________	FE
– Disability (Do you have disability protection on you and your ex?)	________	FE
– Life (Do you have life protection on you and your ex?)	________	FE
– Property—car	________	FE
– Property—other	________	FE
• Support payments (If you're paying, it can be a big bite)	________	FE
• Taxes	________	FE
– Federal	________	FE
– State	________	FE
– Local	________	FE
– Medicare	________	FE
• Other		
– Tuition	________	FE
– Club fees	________	FE
– Professional fees	________	FE
• Savings (Should be 12–20% of income. Include employer matching funds, debt repayments, and tuition.)	________	FE
TOTAL FIXED (Life is a lot easier if you keep this number low) **(Add FE's)**	________	2
FUNDS AVAILABLE FOR DAILY LIVING (Subtract 1-2)	________	3
• Variable expenses		
Clothing and personal grooming	________	VE
Car maintenance and gasoline	________	VE
Home and yard maintenance	________	VE
Unreimbursed medical	________	VE
"Walking around" cash	________	VE
Utilities	________	VE
Books and subscriptions	________	VE
Charity and gifts	________	VE
Entertainment	________	VE
Food	________	VE
Travel	________	VE
• Variable expenses **(Add VE's)**	________	V
TOTAL VARIABLE EXPENSES (With 10% cushion for misc. other) **(V x 1.1)**	________	4
ESTIMATED INCOME - EXPENSES (Subtract 1-2-4) (If this number is not positive, you're not making it)	________	