Personal Finance

FIFTH CANADIAN EDITION

Jeff Madura • Hardeep Singh Gill

Brief Contents

Contents

Preface

When will you be able to buy a home? Can you afford a new car or a vacation? How can you pay off your credit card balance? What should you invest in?

The answers to these questions are tied directly to how you, as a **student,** manage your finances. Managing your finances wisely will bring a sense of security and freedom that you can enjoy for years to come. Very few courses you will take throughout your post-secondary career will have the potential to profoundly shape your future like a personal finance course. Taking this course is your first step on the path toward a stable financial future.

With *Personal Finance*, Fifth Canadian Edition, as your guide, you will master key concepts that will aid you in managing and increasing your personal wealth. The aim of this textbook is to equip you with knowledge and decision-making tools to help you make sound financial decisions.

New to the Fifth Canadian Edition

New Chapter 15 – Retirement Income Planning

The increased importance of, and unique challenges related to, retirement income planning are highlighted in the fifth Canadian edition with the addition of a new chapter. The introduction of a chapter on retirement income planning will provide students with an opportunity to focus on the steps involved with planning retirement income, retirement income budgeting, income conversion options, risk factors, and retirement income strategies.

Highlights of Financial Planning for Indigenous Peoples

Throughout the fifth Canadian edition, financial planning topics related to the unique aspects of the relationship between Indigenous Peoples and financial legislation are brought into focus. Discussion related to Indigenous Peoples appears in Chapters 4 through 9 and 16.

Key Chapter Updates

Chapter 2: In Chapter 2, time value of money examples have been re-written to provide better content flow and improve student understanding of this important component of personal financial planning.

Chapter 4: In Chapter 4, the steps to completing a tax return, tax exhibits, and tax examples have been updated to reflect the changes made to the Income Tax and Benefit Return, formerly known as the T1 General Income Tax and Benefit Return. In particular, the calculation of Federal Tax has been incorporated into the Income Tax and Benefit Return, thereby eliminating Schedule 1. The section on who has to file a return and the advantages of filing a return for students has been updated. Throughout the chapter, numerous aspects of tax planning—for example, the five basic sources of total income—have been expanded or reorganized, and additional examples have been provided, such as the calculation of the medical expense amount and TFSA contribution amounts. In addition, a detailed discussion of the income tax implications for on-reserve and off-reserve income of Indigenous Peoples is provided throughout the chapter.

Chapter 6: In Chapter 6, the topic of excessive spending is introduced for the first time in this edition as consumers move away from using cash toward almost exclusively using credit. In addition, the sections on credit cards and identity theft have been reorganized making them more reader friendly.

Chapter 7: In Chapter 7, the section on housing options has been reduced to focus the discussion on homes and condominiums. Formulas for the gross debt service (GDS) and total debt service (TDS) ratios have been inserted into the text, making it easier for a reader to identify the inputs for each formula. New definitions for key terms, such as condominium, mortgage stress test, and prime lending rate have been added to bring attention and emphasis to expanded topics. In addition, a detailed discussion, with an example, of the Home Buyers Program (HBP) is included. Readers are also provided with a discussion on a common home buying mistake—buying more home than you can afford. Unique features of CMHC loan insurance as it relates to on-reserve land are discussed.

Chapter 9: This entire chapter on health and life insurance has been reorganized. In addition to a discussion focused on Indigenous health benefits, the section on life insurance includes new definitions and less technical content. A new section on the psychology behind the life insurance decision has also been added.

Chapter 10: In Chapter 10, the section on investment return and risk has been reorganized. Specifically, the presentation of the formula for measuring return, the holding period return (HPR), has been simplified by replacing the mathematical notation with descriptive words. The discussion concerning the components of return has been expanded to include the real rate of return, the expected inflation premium, and the risk premium. Common methods for rebalancing an asset allocation are discussed in detail for the first time in the fifth Canadian edition.

Chapter 11: In Chapter 11, the topic of short selling stock is discussed in greater detail. The margin requirements for buying and selling stock are provided for the first time in the fifth Canadian edition. The exhibit on financial ratios used in financial analysis has been updated with new ratios and a cleaner presentation. The discussion of dividend discount model (DDM) now includes definitions for the three main types of DDM models—zero-growth, constant-growth, and variable-growth.

Chapter 12: The chapter on bonds now includes clarification on the distinction between three different calculations for the bond yield—the current yield, the yield to call, and the yield to maturity. Additional financial planning problems provide students an opportunity to solidify their understanding of these topics.

Chapter 13: In Chapter 13, an exhibit outlining the advantages and disadvantages of mutual funds is provided to emphasize the key features of mutual funds. For the first time, mutual fund series labels (A, D, F, I) are discussed in order to help students distinguish among mutual funds. The section on different types of mutual funds has been expanded to included asset allocation funds, target date funds, and portfolio funds. The section on exchange-traded funds (ETFs) has been expanded to include a detailed discussion on the types of ETFs and the advantages and disadvantages of ETFs.

Chapter 14: This chapter has been renamed Retirement Savings Planning. The chapter includes a new opening Exhibit 14.1 that highlights the three main components of Canada's retirement income system and the retirement plans associated with each. The main portion of the chapter has been reorganized around Exhibit 14.1. A number of new examples and concepts are introduced throughout the chapter. For example, a detailed discussion of the two major reforms to the Canada Pension Plan (CPP) are included. This discussion leads to a discussion of the significant changes that the CPP is undergoing, including changes to the contribution rate, the retirement benefit amount, and the pensionable earnings calculation. The discussion on pension adjustments has also been significantly expanded, and examples have been included.

Chapter 15: In Chapter 15, topics related to retirement income planning are introduced. The introduction of this new chapter for the fifth Canadian edition allows for a broader discussion of the steps involved with retirement income planning, the process of estimating a retirement budget, the types of retirement income conversion options, and the risk factors and strategies for spending your investment portfolio.

Features

Learning Objectives

Corresponding to the main headings in each chapter, and indicated by marginal callouts throughout the chapter, the list of learning objectives guides students through the material.

Key Terms

Throughout the text, key terms and their definitions appear where they are first discussed. These terms are also available as Glossary Flashcards in the Pearson eText and MyLab Finance.

Explanation by Example

Practical examples applying concepts in realistic scenarios throughout the chapters help cement student understanding of key concepts.

Free Apps for Personal Finance

Throughout each chapter, students are advised of a variety of useful applications that they can download to their smartphones, for free, that apply to many of the key concepts covered in the chapter.

Myth or Fact

Throughout the text, "Myth or Fact" features highlight popular misconceptions about financial planning; providing students with an opportunity to reinforce key ideas from the chapter and/or to use their intuition to determine whether a statement is a myth or a fact.

Summary

In bullet form, the summaries correlate the key points from each chapter with the learning objectives provided at the beginning of the chapter.

Review Questions

The Review Questions test students' understanding by asking them to compare and contrast concepts, interpret financial quotations, and decide how financial data can be used to make personal finance decisions.

Financial Planning Problems

At the end of each chapter, Financial Planning Problems require students to demonstrate knowledge of mathematically based concepts to perform computations in order to make well-informed personal finance decisions.

Challenge Questions

Multi-step financial planning problems called Challenge Questions require deeper analysis, inviting students to apply knowledge and demonstrate chapter material comprehension.

Ethical Dilemmas

End-of-chapter ethical scenarios focus on topics of student interest to engage the reader. Designed to help students apply ethical principles to financial situations and problems, these real-life ethical situations are presented along with critical thinking questions.

Psychology of Personal Finance

Personal finance behaviour is influenced by psychology. For example, some spending decisions are made on impulse due to the desire for immediate satisfaction. Throughout the text, we discuss how financial planning decisions are affected by psychology. At the end of every chapter, there is also an accompanying section that tests students' understanding of how psychological forces influence personal finance decisions.

Mini-Cases

At the end of each chapter, mini-cases provide students with an opportunity to synthesize and apply a number of concepts from each chapter in a practical manner. There are one to two mini-cases per chapter.

An Interactive Approach

Personal Finance's interactive approach incorporates online resources along with many examples, problems, and ongoing case studies, all of which focus on providing students with hands-on practice applying financial concepts.

MyLab Finance

This integrated online homework tool gives students the hands-on practice and tutorial assistance they need to learn skills efficiently. Ample opportunities for online practice and assessment in MyLab Finance are seamlessly integrated into the content of each chapter and organized by section within the chapter summaries. The Gradebook offers an easy way for the instructors and students to see their performance in the course.

MyLab Finance provides students with personalized Study Plans and the opportunity for additional practice. Select Financial Planning Problems and Review Questions are available in the Study Plan. A Chapter Quiz with 15 multiple-choice and 15 true/false questions for extra review is available for each chapter in the MyLab Finance. Financial Literacy Test questions are also available for instructors to assign. MyLab Finance also includes helpful financial planning tools such as financial calculators, tutorials, and glossary flashcards. We have developed new videos on personal finance tied to the key concepts of the fifth Canadian edition of *Personal Finance*. These videos are available in the Multimedia Library of MyLab Finance. Please visit MyLab Finance for more information and to register.

Financial Planning Online Exercises

Financial Planning Online Exercises available on MyLab Finance show students how to obtain, critically evaluate, and use internet-based resources in making personal finance decisions.

Build Your Own Financial Plan

Personal Finance's structure mirrors a comprehensive financial plan. In each chapter, students learn the skills they need to build their own financial plan. The Build Your Own Financial Plan continuing case is an integrated series of problems and worksheets that present a portion of a financial plan based on the concepts presented in each chapter. The case material and associated worksheets are available on MyLab Finance. At the end of the course, students will have completed a financial plan that they can continue to implement beyond the school term.

Build a Financial Plan for the Sampson Family

Sharon and Dave Sampson are the parents of two children, but they have made few plans regarding their financial future. They are eager to start saving toward a new car, their children's post-secondary education, and their retirement. Students apply chapter concepts to counsel the Sampsons. The Sampsons—A Continuing Case and accompanying worksheets are provided on MyLab Finance.

Build a Financial Plan for Brad Zelinski

Brad has expensive tastes—as evidenced by his soaring credit card balance—and he needs assistance in gaining control over his finances. The case materials and worksheets for Brad Zelinski—A Continuing Case are also available on MyLab Finance.

Pearson eText

MyLab Finance also includes the Pearson eText. The Pearson eText gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners within the class.

Hallmarks of *Personal Finance*, Fifth Canadian Edition

We recognize that students who decide to take a course in personal finance have a variety of academic backgrounds, interests, and personal goals. For some, such a course might be a prerequisite to a future in finance or business. Others may decide to take the course because they want to learn more about how to create a budget or to plan for a large purchase such as a car on their current income. Our aim with this text is to provide students with all the tools they need to fully understand and plan their personal finances in a way that is useful, engaging, and rewarding.

Key Topics in the Fifth Canadian Edition of *Personal Finance*

We have included several important topics for Canadian students in this edition. You will find some examples of these key discussions in the following chapters:

Chapter 2: In Chapter 2, we discuss the importance of the time value of money (TVM) concept and provide a step-by-step introduction to the calculator steps, using the TI BA II Plus calculator, used to perform TVM calculations.

Chapter 4: In Chapter 4, we provide background on taxes and tax planning strategies, and then provide an appendix that guides students step by step through the process of completing a tax return.

Chapter 6: In Chapter 6, we discuss identity theft, different identity theft tactics, and ways to protect against this kind of theft.

Chapter 9: In Chapter 9, we discuss the various levels of health and life insurance coverage available to Canadians, including disability, critical illness, and long-term care.

Chapter 10: In Chapter 10, we examine different types of investments and the trade-offs that need to be considered when examining investment return and risk.

Chapter 11: In Chapter 11, we show students how to complete an analysis of a firm, an economic analysis of stocks, and an industry analysis of stocks in order to determine an investment strategy.

Chapter 15: In a new Chapter 15, we present items to consider when planning your retirement income, including steps to retirement income planning, retirement budgeting, retirement income options, risk factors, and retirement income strategies.

Decision-Making Emphasis

All of the information presented in this text is geared toward equipping students with the expertise they need to make informed financial decisions. Each chapter establishes a foundation for the decisions that form the basis of a financial plan. When students complete each chapter, they are, therefore, prepared to complete the related financial plan subsection provided on MyLab Finance. Key to understanding personal finance is knowing how to apply concepts to real-life planning scenarios. The many examples, financial planning problems, exercises, and cases place students in the role of the decision-maker and planner.

Focus on Opportunity Costs

Personal Finance calls attention to the trade-offs involved in financial decisions. The decision to buy a new car affects the amount of funds available for recreation, rent, insurance, and investments. The text uses numerous examples and exercises to illustrate and teach students about the interdependence of personal finance decisions.

The quantitative side of financial planning intimidates many students. *Personal Finance* simplifies the mathematics of personal finance by explaining its underlying logic. Formulas and calculations are explained in the text and then illustrated in examples. Examples that can be solved using a financial calculator are depicted with a keypad illustration. Students are referred to websites with online calculators whenever pertinent. The Financial Planning Problems and Financial Planning Online Exercises available in MyLab Finance provide students with ample opportunity to practise applying math-based concepts.

Developing Employability Skills

This textbook enhances the employability skills of students in the following ways:

- It provides a background on all the major personal finance functions, which is essential for employment in financial services fields such as banking or insurance, where personal customer service is crucial.
- It enables students to develop their own personal financial plan, which is a necessary skill in order to pursue employment as a financial advisor.

- The financial planning exercises and cases give students experience in critical thinking and solving dilemmas, which is necessary for many occupations.
- The personal budgeting and financial planning skills that students attain can be applied to many occupations in the business world, because businesses must manage liquidity and financing in order to accommodate their spending plans.

Acknowledgments

I wish to acknowledge the help and support of the many people associated with Pearson Canada who made this textbook possible, including Keara Emmett, Executive Portfolio Manager; Söğüt Y. Güleç, Content Manager; Rachel Stuckey, Content Developer; and Sarah Gallagher, Project Manager.

A special thanks go to those who offered feedback on the previous edition:

Michele Behnke, Cambrian College

Benjamin Carnovale, Confederation College

Geoff Hoffman, Conestoga College

Sergiy Rhkhmayil, Ryerson University

I also wish to thank Cecile Wendlandt, who provided the initial spark that gave me the energy to work on this project.

—Hardeep Gill

About the Authors

Jeff Madura

Dr. Jeff Madura is currently Emeritus Professor of Finance at Florida Atlantic University. He has written several successful finance texts, including *International Financial Management* (in its 13th edition), and *Financial Markets and Institutions* (in its 12th edition). He has more than 200 articles on financial topics published in academic journals, including *Journal of Financial and Quantitative Analysis*; *Journal of Banking and Finance; Journal of Money, Credit and Banking; Financial Management; Journal of Financial Research; Journal of Financial Services Research; and Financial Review*. Dr. Madura has received multiple awards for excellence in teaching and research. He has also served as a consultant for financial services firms. He has served as a director for the Southern Finance Association and Eastern Finance Association, and he is also former president of the Southern Finance Association.

Hardeep Singh Gill

Hardeep Singh Gill is currently an instructor in the JR Shaw School of Business at NAIT. Since 1995, he has been professionally involved in various aspects of the financial services industry and instructing. He has developed numerous courses on topics related to finance and financial services. In addition to numerous other professional designation programs, Hardeep has completed the Certified Financial Planner (CFP) designation program, and he is a Chartered Financial Analyst (CFA) charterholder. He has been nominated for Instructional Excellence Awards and is continually trying to improve personal finance pedagogy, most recently with the application of software.

Chapter 1

Overview of a Financial Plan

Learning Objectives

1. Explain how you could benefit from personal financial planning
2. Identify the key components of a financial plan
3. Outline the steps involved in developing a financial plan

After a long semester that ended with their graduation from college, Mo (age 23) and Farah (age 23) could not help but feel an overwhelming sense of satisfaction as they enjoyed the sand and surf on their post-graduation beach vacation. Now that they were moving on with their respective careers, the soon-to-be-married couple faced a new set of financial challenges.

As they imagined their financial futures, the young couple had to think about a number of financial choices, some of which could be accomplished only at the expense of not reaching other goals immediately. Should they buy a new car now? If they did buy a new car, how would this decision impact their plans for their wedding and honeymoon? The couple also had to consider whether they should move out of their apartment and buy a house. How would home ownership impact their cash flow? Although it was a long way off, Mo and Farah were also wondering when they should start thinking about retirement. All of these decisions require detailed planning, but the idea of establishing personal and financial goals for their futures seemed like a difficult task. There was so much they wanted to do and they were not sure if they would ever have the financial resources to do it all.

In a world where there are few guarantees, thorough financial planning, prudent financial management, and careful spending can help you achieve your financial goals.

The personal financial planning process enables you to understand a financial plan and to develop a personal financial plan. The simple objective of financial planning is to make the best use of your resources to achieve your financial goals. The sooner you develop your goals and a financial plan to achieve those goals, the easier it will be to achieve them.

Questions

1. What are some of the important financial decisions that Mo and Farah should consider at this stage of their lives?
2. What steps should Mo and Farah take in order to establish their goals?
3. If they wanted professional advice, how should they go about finding a financial planner?

How You Benefit from an Understanding of Personal Finance

LO 1 Explain how you could benefit from personal financial planning

personal finance (personal financial planning)
The process of planning your spending, financing, and investing activities, while taking into account uncontrollable events, such as death or disability, in order to optimize your financial situation over time.

personal financial plan
A plan that specifies your financial goals and describes the spending, financing, and investing activities that are intended to achieve those goals and the risk management strategies that are required to protect against uncontrollable events, such as death or disability.

per capita debt
The amount of debt each individual in Canada would have if total debt (consumer debt plus mortgages) were spread equally across the population.

Personal finance, also referred to as **personal financial planning**, is the process of planning your spending, financing, and investing activities, while taking into account uncontrollable events such as death or disability, in order to optimize your financial situation over time. A **personal financial plan** specifies your financial goals and describes the spending, financing, and investing activities that are intended to achieve those goals and the risk management strategies that are required to protect against uncontrollable events such as death or disability. Although Canada is one of the world's wealthier countries, many Canadians do not manage their financial situations well. Consequently, they tend to rely too much on credit and have excessive debt. Excessive debt levels affect your ability to achieve important financial goals. Consider the following statistics:

- In the third quarter of 2019, the outstanding balance on credit cards in Canada exceeded $100 billion for the first time.
- The household savings rate has been below 3.2 percent for every quarter since late 2015. That is well below the historical average of 7.59 percent from 1961 until 2019.
- In the first quarter of 2019, the delinquency rate on 90-day non-mortgage debt rose 3.5 percent to 1.12 percent.
- From 2000 to 2018, the level of household debt relative to disposable income has increased from 106.9 percent to 174.9 percent.
- As of January 2020, the per capita debt of Canadians has increased to $18 829. **Per capita debt** represents the amount of debt each individual in Canada would have if total debt (consumer debt plus mortgages) were spread equally across the population.

You have numerous options regarding the choice of bank deposits, credit cards, loans, insurance policies, investments, and retirement plans. All of these options involve decisions you will have to make for yourself. Relying on government benefits alone may not provide you with the financial future you imagine for yourself. With an understanding of personal finance, you will be able to make decisions that can enhance your financial situation. How much do you know about personal finance? Various government agencies of various countries have attempted to assess financial literacy in recent years. Surveys have documented that people tend to have very limited personal finance skills. In addition, surveys have found that many people who believe they have strong personal finance skills do not really understand some basic personal finance concepts. Do you consider yourself financially literate? Try the financial literacy self-assessment quiz from the Financial Consumer Agency of Canada available on the Government of Canada website at www.canada.ca. Even if your knowledge of personal finance is limited, you can substantially increase your knowledge and improve your financial planning skills by reading this text. An understanding of personal finance is beneficial to you in many ways.

Make Your Own Financial Decisions

An understanding of personal finance enables you to make informed decisions about your financial situation. Each of your spending decision has an **opportunity cost**, which represents what you give up as a result of that decision. By spending money for a specific purpose, you forgo alternative ways that you could have spent the money and also forgo saving the money for a future purpose. For example, if your decision to use your cellphone costs $100 per month, you have forgone the possibility of using that money to buy new clothes or to save for a new car. Informed financial decisions increase the amount of money that you accumulate over time and give you more flexibility to purchase the products and services you want in the future.

opportunity cost
What you give up as a result of a decision.

myth or **fact** Financial planners are registered with a provincial financial planning regulatory agency.

Opportunity cost will also affect your savings decisions. In Chapter 3, we will discuss how you can use budgeting tools to increase your savings. Savings can then be used toward short-, medium-, or long-term goals. Generally, the savings in an emergency fund—a short-term goal—will earn less interest than your investments in a retirement plan—a long-term goal. Although an emergency fund is very important to your personal financial plan, saving too much for short-term needs does limit your opportunity for long-term growth. You should strive to balance your savings goals among short-, medium-, and long-term goals.

Judge the Advice of Financial Planners

The personal financial planning process will enable you to make informed decisions about your spending, saving, financing, and investing. Nevertheless, you may prefer to rely on advice from various types of financial planners. An understanding of personal finance allows you to judge the guidance of financial planners and to determine whether their advice is in your best interest rather than in their best interest.

Example

You want to invest $10 000 of your savings. A financial planner guarantees that your investment will increase in value by 20 percent ($2000) this year, but he will charge you 4 percent of the investment ($400) for his advice. If you had a background in personal finance, you would know that no investment can be guaranteed to increase in value. Therefore, you would realize that you should not trust this financial planner. You could either hire a more reputable financial planner or review investment recommendations made by financial planners on the internet (often at no cost).

FP Canada
A national professional body working in the public interest that is dedicated to championing financial health for all Canadians by certifying professional financial planners and leading the advancement of professional financial planning in Canada.

FP Canada™ is a national professional body working in the public interest that is dedicated to championing financial health for all Canadians by certifying professional financial planners and leading the advancement of professional financial planning in Canada. It provides a series of questions that you can ask a financial planner. The answers that you receive to these questions will help you evaluate whether or not you are comfortable with the perspective and business approach of a potential financial planner. FP Canada lists these questions on the How to Interview a Financial Planner page of their website (www.financialplanningforcanadians.ca). Each question comes with some hints and tips so that you can get the most benefit from the responses you receive.

Become a Financial Planner

Although taking a single course such as this is not sufficient to become a financial planner, an interest in and aptitude for the number of products and ideas discussed in this text may lead you to consider a career in the financial services sector. Financial planners are in demand because many people lack an understanding of personal finance, are not interested in making their own financial decisions, or simply do not have the time necessary to research and educate themselves on financial issues in order to make informed decisions. (It should be clearly stated, though, that most planners cannot make decisions for their clients. An individual must give permission to the financial planner before any action can be taken.)

The FP Canada website provides a description of the steps that must be completed in order to earn the Certified Financial Planner (CFP)® designation. Obtaining this credential is a significant step toward building a successful career as a financial planner because it indicates that you have met the education, examination, experience, and ethical requirements set by FP Canada. Step 1 involves the successful completion of an approved core curriculum program and the introduction to professional ethics (IPE) course. Step 2 involves successful completion of an approved advanced curriculum program. Step 3 involves successful completion of the CFP® professional education program, which covers essential and advanced topics in integrated financial planning, ethical considerations in financial planning, and communication, behaviour, and professional skills. At Step 4, a candidate will complete their CFP® final exam on the path to CFP® certification. After completing this exam and obtaining three years of qualifying work experience in a financial planning-related position, the candidate is eligible to complete their final step by applying for CFP® certification. In order to maintain their certification, a CFP® professional must adhere to FP Canada Standards of Professional Responsibility, complete 25 hours of continuing education requirements, and renew their CFP® certification on an annual basis. Additional information describing the path to CFP® certification may be found on the FP Canada website (www.fpcanada.ca). The CFP® examinations cover fundamental financial planning practices, financial management, investment planning, insurance and risk management, tax planning, retirement planning, and estate planning and legal aspects. Obtaining and maintaining CFP® certification allows you to be identified by potential clients as a financial planner who is dedicated to a high level of professionalism in providing financial planning advice.

Components of a Financial Plan

LO 2 Identify the key components of a financial plan

A complete financial plan contains your personal finance decisions related to five key components:

1. Budgeting and tax planning
2. Managing your financial resources

3. Protecting your assets and income (insurance)
4. Investing your money
5. Planning your retirement and estate

These five components are very different; decisions concerning each component are captured in separate plans that, taken together, form your overall financial plan. To begin your introduction to the financial planning process, let's briefly explore each component.

A Plan for Your Budgeting and Tax Planning

Budget planning (also referred to as **budgeting**) is the process of forecasting future income, expenses, and savings goals. That is, it requires you to decide whether to spend or save money. If you receive $750 in income during one month, the amount you save is the amount of money (say, $100) that you do not spend. The relationship between income after taxes, spending, and saving is illustrated in **Exhibit 1.1**. Some individuals are "big spenders": they focus their budget decisions on how to spend most or all of their income and therefore have little or no money left for saving. Others are "big savers": they set a savings goal and consider spending their income after taxes only after allocating a portion of it toward saving. Budgeting can help you estimate how much of your income will be required to cover monthly expenses so that you can set a reasonable and practical goal for saving each month.

budget planning (budgeting)
The process of forecasting future income, expenses, and savings goals.

A first step in budgeting should be to evaluate your current financial position by assessing your income, your expenses, your **assets** (what you own), and your **liabilities** (debt, or what you owe). Your **net worth** (or wealth) is the value of what you own minus the value of what you owe. You can measure your wealth by your net worth. As you save money, you increase your assets and therefore increase your net worth. Budgeting enables you to build your net worth by setting aside part of your income to either invest in additional assets or reduce your liabilities.

assets
What you own.

liabilities
What you owe; your debt.

net worth
The value of what you own minus the value of what you owe.

myth or **fact** Budgeting is more important for individuals who have trouble covering their monthly expenses.

FREE APPS for Personal Finance

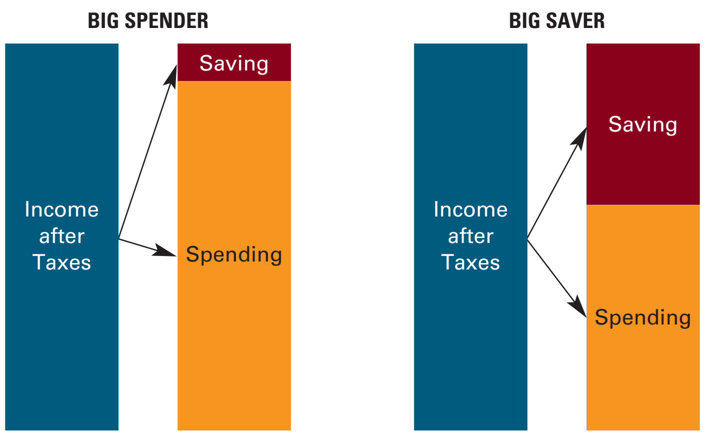
Your Spending Decisions

Application

Use iSpending by Hana Mobile LLC to keep track of your income and expenses. You can add transactions under different categories, such as income, food, and entertainment. Summaries for today/week/month/year are also available.

LIFE STAGES. Your budget is influenced by your income, which in turn is influenced by your life stage. **Exhibit 1.2** provides an overview of the six major life stages and the key financial considerations you will make at each of those stages. Individuals who are pursuing post-secondary education during their education stage of life tend to have smaller incomes, usually from part-time jobs, and thus smaller budgets. At this stage, it is important to establish good saving and spending habits—such as saving money inside a TFSA—and begin establishing a credit history. After completing their education, individuals advance to the early career stage of life and are able to obtain

Exhibit 1.1 How a Budget Plan Affects Savings



jobs that pay higher salaries, which result in larger budgets. Adopting the pay-yourself-first principle, managing your debt, buying furnishings for your own place or a car for your first job, and building your investment portfolio by starting with a mutual fund are important considerations for someone at this life stage.

As you progress through the next three life stages, you may experience various milestones. Milestones, such as getting married, having children, or starting a new job, will often result in a need or desire to update your personal financial plan. However, waiting for milestones before creating a personal financial plan can be very

Exhibit 1.2 Typical Financial Planning Life Stages

	Life Stages					
	Education	**Early Career**	**Family and Mid-Career**	**Prime Earning**	**Early Retirement**	**Late Retirement**
Age Group	**0 to 22**	**23 to 30**	**31 to 49**	**50 to 64**	**65 to 74**	**75+**
Consider Your Current Financial Position	• establish good saving and spending habits • consider saving money inside a TFSA • pay for post-secondary education • establish a good credit history	• follow the pay-yourself-first principle • pay off student loans and other short-term debt • buy furnishings for a home • buy a car • consider a mutual fund, inside or outside an RRSP	• buy a home and review insurance needs (health, life, disability, critical illness) • start a family • open an RESP account • continue saving through an RRSP/TFSA or an employer-sponsored savings plan • reduce/ minimize taxes • have a will and power of attorney • start a business	• pay off mortgage and other debt • minimize taxes payable • review adequacy of retirement savings • support children's education through RESP • consider downsizing home • assess job security • support elderly relatives – financially and emotionally	• apply for OAS/CPP benefits • review RRSP/LIRA/ workplace pension maturity options • inventory potential sources of income and other assets • determine an appropriate retirement income distribution pattern • determine impact on lifestyle if a spouse become sick or dies • make changes to your will and power of attorney	• consider a life annuity • assess the need for a reverse mortgage • consider hiring a wealth manager • finalize plans for the distribution of your estate
Milestones	• Graduation	• First Job • New Job/Raise	• Marriage • First House • 1st Baby • Divorce	• Empty Nest • Parental Care • Close to Retirement	• Retirement • Empty Nest • Travel • Parental Care	

dangerous because you may not have any time to prepare. For example, when you reach the milestone of marriage, you may find that the expense of planning a wedding requires you to change your spending habits. At that point, you will have to ask yourself how much you can afford to spend on a wedding. If you have not been planning ahead, you may have to scale back on your wedding plans. As a student, not planning ahead for a milestone would be the same as not studying for your final exam until the day before you are supposed to write it—not a good idea! Budget planning is the first step in building a successful plan so that you do not have to sacrifice what you really want when the time comes.

Although the majority of your personal financial plan will be in place by the time you reach the late retirement life stage, it is still important to be aware of any issues that are outstanding. In particular, you may need to review your wealth management options and your estate plan. Managing your money will become more difficult as you move through this life stage. Therefore, it is important to understand what wealth management options are available and to plan accordingly. In addition, your estate plan should be reviewed to ensure that it reflects your wishes at death. As you can see, personal finance is a subject that you will encounter throughout your life. Refer back to Exhibit 1.2 as you read this textbook. The alternatives you will consider at each life stage and/or milestone will be discussed at various points in the textbook.

Another key part of budgeting is estimating the typical expenses that you will incur each month. If you underestimate expenses, you will not achieve your savings goals. Achieving future wealth requires you to sacrifice by moderating your spending today.

Many financial decisions are affected by tax laws, as some forms of income are taxed at a higher rate than others. By understanding how your varying financial choices would be affected by taxes, you can make financial decisions that have the most favourable effect on your after-tax cash flows. Budgeting and tax planning are discussed in Part 1 because they underpin decisions about all other parts of your financial plan.

A Plan to Manage Your Financial Resources

Short-term cash needs and unexpected expenses, such as emergencies, are a fact of life, and you must plan how you will cover them. Your ability to cover these expenses depends on your liquidity. **Liquidity** refers to your access to ready cash, including savings and credit, to cover short-term or unexpected expenses. The budget planning process described above will help you reach your savings goals. Your liquidity can be allocated to short-term needs, such as a cup of coffee or an unexpected car repair, or to long-term needs, such as retirement. You can enhance your liquidity through money management and credit management.

Money management involves decisions regarding how much money to retain in liquid form and how to allocate the funds among short-term investment instruments. If you do not have access to money to cover short-term needs, you may have insufficient liquidity. As a result, it is important to set up an emergency fund to cover short-term needs. An **emergency fund** contains the portion of savings that you have allocated to short-term needs such as unexpected expenses in order to maintain adequate liquidity. Finding an effective liquidity level involves deciding how to invest your money so that you can earn a return but also have easy access to cash if needed. Money management is discussed in Chapter 5.

As an alternative to establishing an emergency fund by investing some of their savings for short-term needs, many individuals rely on credit to supplement their liquidity. As a result, credit and credit management are important aspects of liquidity. **Credit management** involves decisions regarding how much credit to obtain to support your spending and which sources of credit to use. Credit is commonly used to

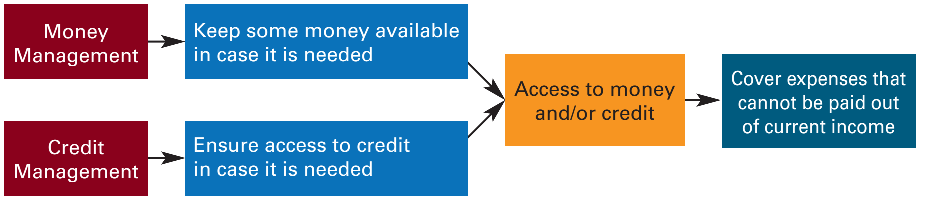
liquidity
Access to ready cash, including savings and credit, to cover short-term or unexpected expenses; also, the ease with which an investor can convert an investment into cash without a loss of capital.

money management
Decisions regarding how much money to retain in liquid form and how to allocate the funds among short-term investment instruments.

emergency fund
A portion of savings that you have allocated to short-term needs such as unexpected expenses in order to maintain adequate liquidity.

credit management
Decisions regarding how much credit to obtain to support your spending and which sources of credit to use.

Exhibit 1.3 Managing Your Liquidity



cover both large and small expenses when you are short on cash, so it enhances your liquidity. Credit should be used only when necessary since you must repay borrowed funds with interest (and the interest expenses may be very high). Unfortunately, the use of consumer credit has steadily increased since 1980. Combined with the steady decline in the household savings rate mentioned earlier in this chapter, it is clear that credit management has become a very important part of liquidity for many Canadians. Credit management is discussed in Chapter 6. The use of money management and credit management to manage your liquidity is illustrated in **Exhibit 1.3**.

Loans are typically needed to finance large expenditures, such as university or college tuition, a car, or a home. The amount of financing needed is the difference between the amount of the purchase and the amount of money you have available, as illustrated in **Exhibit 1.4**. Managing loans includes determining how much you can afford to borrow, deciding on the maturity (length of time) of the loan, and selecting a loan that charges an appropriate interest rate.

A Plan for Protecting Your Assets and Income

risk
Exposure to events (or perils) that can cause a financial loss.

risk management
Decisions about whether and how to protect against risk.

insurance planning
Determining the types and amount of insurance needed to protect your assets.

In the context of insurance, the term **risk** can be defined as exposure to events (or perils) that can cause a financial loss. **Risk management** represents decisions about whether and how to protect against risk. Individuals may avoid, reduce, accept, or share (insure) their exposure to risk. Insuring against risk involves insurance planning.

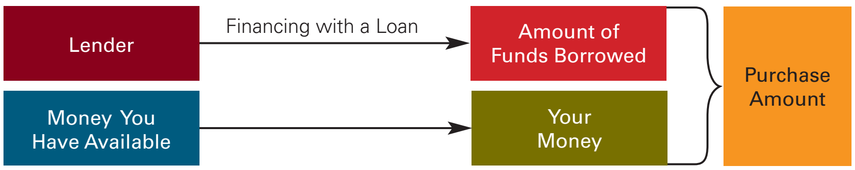
To protect your assets, you can conduct **insurance planning**, which determines the types and amount of insurance that you need. In particular, automobile insurance and homeowner's insurance protect your assets, while health insurance and life insurance protect your income. In general, it is important to insure risks that would result in either a significant loss of income for a long period of time or an unplanned use of your financial resources.

A Plan for Investing Your Money

investment risk
Uncertainty surrounding not only the potential return on an investment but also its future potential value.

Any savings that you have beyond what you need to maintain liquidity should be invested. Because these funds normally are not used to satisfy your liquidity needs, they can be invested with the primary objective of earning a return. Potential investments include stocks, bonds, mutual funds, and real estate. You must determine how much you wish to allocate toward investments and what types of investments you wish to consider. Since investments are subject to **investment risk** (uncertainty

Exhibit 1.4 Financing Process



surrounding their potential return and future potential value), you need to understand your personal tolerance to risk in order to manage it. There are many different kinds of risk; however, at this point in our discussion, risk can most easily be defined as a potential loss of return and/or loss of capital. Your ability to accept such potential losses is your **risk tolerance**.

risk tolerance
A person's ability to accept risk, usually defined as a potential loss of return and/or loss of capital.

A Plan for Your Retirement and Estate

Retirement planning involves determining how much money you should set aside each year for retirement and how you should invest those funds. Retirement planning must begin well before you retire so that you can accumulate sufficient money to invest and support yourself after you retire. Money contributed to various kinds of retirement plans, with the exception of tax-free savings accounts (TFSAs), is sheltered from taxes until it is withdrawn from the retirement account. Money contributed to a TFSA is not only tax sheltered but also tax free when it is withdrawn.

retirement planning
Determining how much money you should set aside each year for retirement and how you should invest those funds.

Estate planning is the act of determining how your wealth will be distributed before and/or after your death. Effective estate planning protects your wealth against unnecessary taxes and ensures that your wealth is distributed in a timely and orderly manner.

estate planning
Determining how your wealth will be distributed before and/or after your death.

The Components of a Financial Plan

The components of a financial plan are illustrated in **Exhibit 1.5**. Each part is shown as a step in the exhibit, with the lower step serving as a foundation for the higher steps. Budgeting focuses on how cash received (from income or other sources) is allocated to savings, spending, and taxes. Budget planning serves as the foundation of the financial plan, as it is your base for making personal financial decisions.

The next component is managing your financial resources because you must have adequate liquidity and a plan for financing your major purchases such as a new car or a home. Insurance is used to protect your wealth. Next, you can consider investment alternatives such as stocks, bonds, and mutual funds. Finally, planning for retirement and estate planning focuses on the wealth that you will accumulate by the time you retire.

An effective financial plan builds your wealth and therefore enhances your net worth. In this text you will have the opportunity to develop the components of your financial plan. **Exhibit 1.6** lists examples of the decisions you will make in each component.

HOW THE COMPONENTS RELATE TO YOUR CASH FLOWS. **Exhibit 1.7** provides a summary of the components of a financial plan and how each component affects your cash flows. Specifically, this exhibit also shows how each component of the financial plan reflects decisions on how to obtain or use cash. You receive income in the form of a salary from your job and use some of that cash to spend on products and services. Budgeting focuses on the relationship between your income and your expenses. Your budgeting decisions determine how much of your income you spend

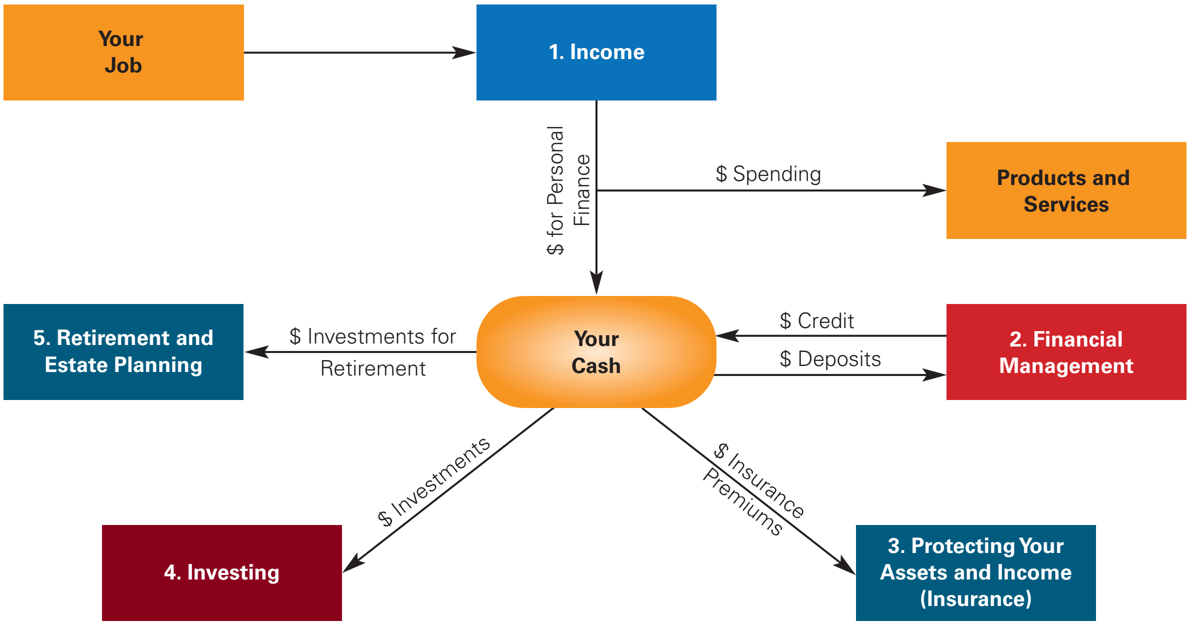
Exhibit 1.5 Components of a Financial Plan

Exhibit 1.6 Example of Decisions Made in Each Component of a Financial Plan

A Plan for	Types of Decisions
1. Managing your income	What expenses should you anticipate?
	How much money should you attempt to save each month?
	How much money must you save each month toward a specific purchase?
	What debt payments must you make each month?
2. Managing your financial resources	How much money should you maintain in your bank account?
	Should you use credit cards as a means of borrowing money?
	How much money can you borrow to purchase a car?
	Should you borrow money to purchase a car or should you lease a car?
	How much money can you borrow to purchase a home?
	What type of mortgage loan should you obtain to finance the purchase of a house?
3. Protecting your assets and income	What type of insurance do you need?
	How much insurance do you need?
4. Investing	How much money should you allocate toward investments?
	What types of investments should you consider?
	How much risk can you tolerate when investing your money?
5. Planning your retirement and estate	How much money will you need for retirement?
	How much money must you save each year so that you can retire in a specific year?
	How will you allocate your estate among your heirs?

on products and services. The residual income can be allocated for your personal finance needs. Financial management focuses on depositing a portion of your excess cash in an emergency fund or obtaining credit to support your purchases. Protecting your assets and income focuses on determining your insurance needs and spending money on insurance premiums. Investing focuses on using some of your excess cash

Exhibit 1.7 How Financial Planning Affects Your Cash Flows



to build your wealth. Planning for your retirement and estate focuses on periodically investing cash in your retirement account and determining how you will distribute assets before and/or after your death.

If you need more cash inflows, you may decide to work additional hours to make more income. You also may decide to rely on savings that you have already accumulated or obtain loans from creditors. In some instances, you could also withdraw some of the cash value of your insurance policy, or sell some of your investments, or withdraw funds from your retirement account. On the other hand, if your income exceeds the amount that you are spending, you could increase your spending on additional products and services, or you could increase your savings deposits or repay some, or all, of the principal on existing loans. Excess funds could also be used to make new investments or contribute towards your retirement account. Your optimal choice when using cash is dependent on various conditions that are explained throughout the text.

How Psychology Affects Your Financial Plan

Psychology has a major impact on human behaviour and decision making. Therefore, it has a major impact on your spending behaviour and your ability to implement an effective financial plan. For this reason, the impact of psychology on financial planning is given attention in various sections, like this one, throughout the text. Consider the two completely different types of spending behaviour described here, so that you can determine which type reflects your own behaviour.

FOCUS ON IMMEDIATE SATISFACTION AND PEER PRESSURE. Some people allow their desire for immediate satisfaction and their focus on peer pressure to influence most of their financial planning decisions. This causes them to spend excessively, meaning that they make purchases that are not necessary. They tend to spend every dollar they earn, without serious consideration to use any money for other purposes. They also tend to make many impulse purchases, which are purchases made on the spur of the moment, not because they needed the products or were even shopping specifically for those products. They get a strong dose of pleasure from the purchase, perhaps more so than the ultimate use of some of the products that they buy. This type of behaviour may be referred to as “shopping therapy” or “retail therapy” because the act of shopping (and buying) boosts the morale of some people. However, the boost provided by the therapy may quickly vanish, so that additional therapy (shopping) is needed. The spending can become addictive.

People who spend based on peer pressure may purchase a new car that they cannot afford, even when they already own a reliable car, just because their friends or neighbours have a new car. While they receive immediate satisfaction from having a new car, they may now also have the obligation of a $500 monthly car payment for the next four years. This decision will use up much of their monthly income, and could prevent them from allocating any funds toward all the other financial planning functions such as managing liquidity, insurance, investments, and retirement planning. Notice that all these other financial planning functions are intended to offer future benefits. Thus, the behaviour of people who spend based on immediate satisfaction and peer pressure causes them to spend excessively now, which leaves nothing for the future. They may say that all of their spending was on necessities and they did not have any extra funds to use for financial planning purposes. Their perception of necessities, however, is whatever allows them to achieve immediate satisfaction.

People with this type of mindset may make promises to themselves that they will reduce their spending in the future in order to focus on financial planning functions. But with this mindset, they may always find reasons to justify spending their entire paycheque—or more.

Another psychological force is a hopeless feeling that is used to justify spending. Some people think that if they can allocate only a small amount, such as $500 for saving or other forms of financial planning, they will never be able to achieve any long-term goals. Thus, they use this reasoning to justify spending all of their income. Their logic is that they might as well enjoy use of the money now.

FOCUS ON THE FUTURE. Other people have more discipline when deciding whether to spend all of their income, and their decision making is influenced by other psychological forces. They may have a strong desire to avoid debt at this point in their lives because they would feel stress from the obligation of making large debt payments. For this reason, they may avoid purchasing a new car or any types of purchases that would cause large credit card payments, and this allows them to use their income for other purposes. They recognize that by spending conservatively today, they will have additional money available that they can use for financial planning functions in order to improve their financial future.

ASSESS YOUR OWN SPENDING BEHAVIOUR. How would you describe your spending behaviour? Do you focus only on achieving immediate satisfaction, or are you disciplined so that you can improve your financial future? If you spend conservatively now so that you can improve your financial future, you'll benefit from this text, because it explains how you can conduct your financial planning. Conversely, if you spend excessively now to achieve immediate satisfaction, you have no money left to direct toward financial planning functions discussed in this text, such as managing liquidity, insurance, investing, or retirement planning. Take this brief quiz to determine which behaviour category you are in:

Do you pay rent for a single apartment rather than share an apartment?

Do you have large monthly car payments?

Do you have credit card bills for which you can make only the minimum payment each month?

Do you spend all of your income within the first day or two of receiving your paycheque on clothes, electronic games, or other items, even if that money is needed for rent or car loan payments?

Do you always find a reason each month to spend all of your income?

If you answered "yes" to any of these questions, you might be able to reduce your spending behaviour so that you could allocate more money toward financial planning functions. This will allow you to accumulate more wealth in the future, and with that wealth, you will be able to afford more spending in the future. This text will help guide you to achieve these goals.

Developing the Financial Plan

LO 3 Outline the steps involved in developing a financial plan

Six steps are involved in developing each component of your financial plan.

Step 1: Establish Your Financial Goals

You must determine your financial goals. In the financial planning process, it is important to establish SMART goals. That is, goals should be specific (S), measurable (M), action-oriented (A), realistic (R), and time bound (T).

SPECIFY YOUR GOALS. Goals can be specified in a number of ways. One goal could be to save a specific amount of money so that you can make a down payment on a house. Another could simply be to pay down your debt and improve your creditworthiness. Goals may also be specified in the form of an amount of cash flow that you hope to have someday, such as $25 000 per year in income from your RRSP during your retirement.

MEASURE YOUR GOALS. Whether you are saving a fixed dollar amount, paying down debt, or building a nest egg for retirement, you must determine how much cash you will need to accomplish each of these goals. Financial calculators available on the internet can help you plan your goals.

ACT ON YOUR GOALS. A goal must include specific action steps that you will take to reach your goal. For example, do you need to contact your bank to open a savings account so that you can start putting money aside from each paycheque?

SET REALISTIC GOALS. You need to be realistic about your goals so that you can have a strong likelihood of achieving them. A financial plan that requires you to save almost all of your income is useless if you are unable or unwilling to follow that plan. When this overly ambitious plan fails, you may become discouraged and lose interest in planning.

TIMING OF GOALS. Financial goals can be characterized as short term (within the next year), medium term (typically between one and five years), or long term (beyond five years). For instance, a short-term financial goal may be to accumulate enough money to purchase a car within six months. A medium-term goal would be to pay off a school loan in the next three years. A long-term goal would be to save enough money so that you can maintain your lifestyle and retire in 25 to 30 years.

myth or **fact** When setting goals, it is important to share them with family members so you are motivated to achieve them.

Example

Maeva loves to travel—so much so that she is planning a trip to Europe after high school graduation. After going online and researching the cost of her trip, she determines that she will need to save $3000 over the next two years. Next, she calculates how much she can earn if she works full time over the next two summers and part time during the school year. After speaking to her manager at work about adding shifts and discussing her travel budget with her parents to get their feedback, Maeva is confident that she can achieve her goal. She concludes that in two years' time, she will be in a position to book airfare and have enough money saved for hotels, trains, food, and shopping for her European vacation.

Maeva's goal is a SMART goal since it meets each of the criteria set out above. It is specific in that she is saving for a trip to Europe after high school graduation. It is measurable since she has specified that she needs to save $3000. It is action-oriented since she has researched the cost, calculated the additional income she needs, spoken with her manager about adding shifts, and discussed her plan with her parents. Maeva's research has led her to the conclusion that her plan is realistic. Finally, her plan is time bound since she wants to take the trip in the next two years.

FREE APPS for Personal Finance

Goal Planning

Application

Use GoalsOnTrack, a goal tracking and planning app by Vancouver IT Services Inc., to help you set SMART goals, break down long-term goals into milestones or sub goals, and organize them within your own categories. GoalsOnTrack's vision board tool allows you to upload your own pictures and music to create an animated slide show to help you motivate yourself through visualization practice.