PART 1

PLANNING YOUR PERSONAL FINANCES

CHAPTER 1
Personal Financial Planning: An Introduction

CHAPTER 2
Money Management Strategy: Financial Statements and Budgeting

CHAPTER 3
Planning Your Tax Strategy

CHAPTER

1 Personal Financial Planning: An Introduction

Karen's Financial Plan

Karen Edwards, 23, completed her Bachelor of Science one year ago. The major cost of her tuition and books was covered by a scholarship. Through wise planning, she was able to save $15,000 from her part-time jobs. Acting on a suggestion from her parents, Karen met with a financial planner, who advised her to invest her money in low-risk bonds and saving certificates.

Karen works in an office in Toronto, Ontario, and she earns $25,000 a year. In approximately three years, she would like to return to school and start her master's degree. Then, she would like to buy a house. Karen wants to live on her salary and invest the $15,000 for her education and future home.

QUESTIONS

1. How did Karen benefit from her parents' advice and her own financial planning?
2. What decisions does Karen need to make regarding her future?
3. How could various personal and economic factors influence Karen's financial planning?
4. What would be the value of Karen's $15,000 in three years if it earned an annual interest rate of 7 percent?
5. Conduct a Web search to obtain information that Karen may find useful.

LEARNING OBJECTIVES

1. Analyze the process for making personal financial decisions.
2. Develop personal financial goals.
3. Assess personal and economic factors that influence personal financial planning.
4. Determine personal and financial opportunity costs associated with personal financial decisions.
5. Identify strategies for achieving personal financial goals for different life situations.

The Financial Planning Process

Objective 1

Analyze the process for making personal financial decisions.

Everywhere you turn, someone is talking about money. When it comes to handling your finances, are you an *explorer*, someone who is always searching through uncharted areas? Are you a *passenger*, just along for the ride on the money decision-making trip of life? Or are you a *researcher*, seeking answers to the inevitable money questions of life?

Most people want to handle their finances so that they get full satisfaction from each available dollar. Typical financial goals include such things as a new car, a larger home, advanced career training, extended travel, and self-sufficiency during working and retirement years. To achieve these and other goals, people need to identify and set priorities. Financial and personal satisfaction are the result of an organized process that is commonly referred to as *personal money management* or *personal financial planning*.

personal financial planning The process of managing your money to achieve personal economic satisfaction.

Personal financial planning is the process of managing your money to achieve personal economic satisfaction. This planning process allows you to control your financial situation. Every person, family, or household has a unique financial position, and any financial activity, therefore, must also be carefully planned to meet specific needs and goals.

A comprehensive financial plan can enhance the quality of your life and increase your satisfaction by reducing uncertainty about your future needs and resources. The specific advantages of personal financial planning include:

- Increased effectiveness in obtaining, using, and protecting your financial resources throughout your lifetime.
- Increased control of your financial affairs by avoiding excessive debt, bankruptcy, and dependence on others for economic security.
- Improved personal relationships resulting from well-planned and effectively communicated financial decisions.
- A sense of freedom from financial worries obtained by looking to the future, anticipating expenses, and achieving your personal economic goals.

Visit the Web site
See the Weblinks under Chapter 1 on the online learning centre at www.mcgrawhill.ca/college/kapoor.

We all make hundreds of decisions each day. Most of these decisions are quite simple and have few consequences. Some are complex and have long-term effects on our personal and financial situations. While everyone makes decisions, few people consider how to make better decisions. As Exhibit 1–1 shows, the financial planning process is a logical, six-step procedure: (1) determining your current financial situation, (2) developing financial goals, (3) identifying alternative courses of action, (4) evaluating alternatives, (5) creating and implementing a financial action plan, and (6) re-evaluating and revising the plan.

STEP 1: DETERMINE YOUR CURRENT FINANCIAL SITUATION

In this first step of the financial planning process, you will determine your current financial situation with regard to income, savings, living expenses, and debts. Preparing a list of current asset and debt balances and amounts spent for various items gives you a foundation for financial planning activities. The personal financial statements discussed in Chapter 2 will provide the information you need to match your goals with your current income and potential earning power.

STEP 1 EXAMPLE: Within the next two months, Kent Mullins will complete his undergraduate studies with a major in international studies. He has worked part time in various sales jobs. He has a small savings fund ($1,700) and more than $8,500 in student loans. What additional information should Kent have available when planning his personal finances?

Exhibit 1–1

The Financial Planning Process

STEP 2: DEVELOP FINANCIAL GOALS

Visit the Web site
See Personal Financial Planning worksheets under Chapter 1 on the online learning centre at www.mcgrawhill.ca/college/kapoor.

You should periodically analyze your financial values and goals. This involves identifying how you feel about money and why you feel that way. Are your feelings about money based on factual knowledge or on the influence of others? Are your financial priorities based on social pressures, household needs, or desires for luxury items? How will economic conditions affect your goals and priorities? The purpose of this analysis is to differentiate your needs from your wants.

Specific financial goals are vital to financial planning. Others can suggest financial goals for you; however, you must decide which goals to pursue. Your financial goals can range from spending all of your current income to developing an extensive savings and investment program for your future financial security.

STEP 2 EXAMPLE: Kent Mullins has several goals, including paying off his student loans, obtaining an advanced degree in global business management, and working in Latin America for a multinational company. What other goals might be appropriate for Kent?

STEP 3: IDENTIFY ALTERNATIVE COURSES OF ACTION

Developing alternatives is crucial for making good decisions. Although many factors will influence the available alternatives, possible courses of action usually fall into these categories:

- *Continue the same course of action.* For example, you may determine that the amount you have saved each month is still appropriate.
- *Expand the current situation.* You may choose to save a larger amount each month.
- *Change the current situation.* You may decide to use a money market account instead of a regular savings account.
- *Take a new course of action.* You may decide to use your monthly savings budget to pay off credit card debts.

Not all of these categories will apply to every decision situation; however, they do represent possible courses of action. For example, if you want to stop working full time to go to school, you must generate several alternatives under the category “Take a new course of action.”

Creativity in decision making is vital to effective choices. Considering all of the possible alternatives will help you make more effective and satisfying decisions. For instance, most people believe they must own a car to get to work or school. However, they should consider other alternatives, such as public transportation, carpooling, renting a car, shared ownership of a car, or a company car.

Remember, when you decide not to take action, you elect to "do nothing," which can be a dangerous alternative.

STEP 3 EXAMPLE: Kent Mullins has several options available for the near future. He could work full time and save for graduate school; he could go to graduate school full time by taking out an additional loan; or he could go to school part time and work part time. What additional alternatives might he consider?

STEP 4: EVALUATE ALTERNATIVES

You need to evaluate possible courses of action, taking into consideration your life situation, personal values, and current economic conditions. How will the ages of dependants affect your saving goals? How do you like to spend leisure time? How will changes in interest rates affect your financial situation?

CONSEQUENCES OF CHOICES Every decision closes off alternatives. For example, a decision to invest in stocks may mean you cannot take a vacation. A decision to go to school full time may mean you cannot work full time. **Opportunity cost** is what you give up by making a choice. This cost, commonly referred to as the *trade-off* of a decision, cannot always be measured in dollars. It may refer to the money you forgo by attending school rather than working, but it may also refer to the time you spend shopping around to compare brands for a major purchase. In either case, the resources you give up (money or time) have a value that is lost.

opportunity cost What a person gives up by making a choice.

Decision making will be an ongoing part of your personal and financial situations. Thus, you will need to consider the lost opportunities that will result from your decisions. Since decisions vary on the basis of each person's situation and values, opportunity costs will differ for each person.

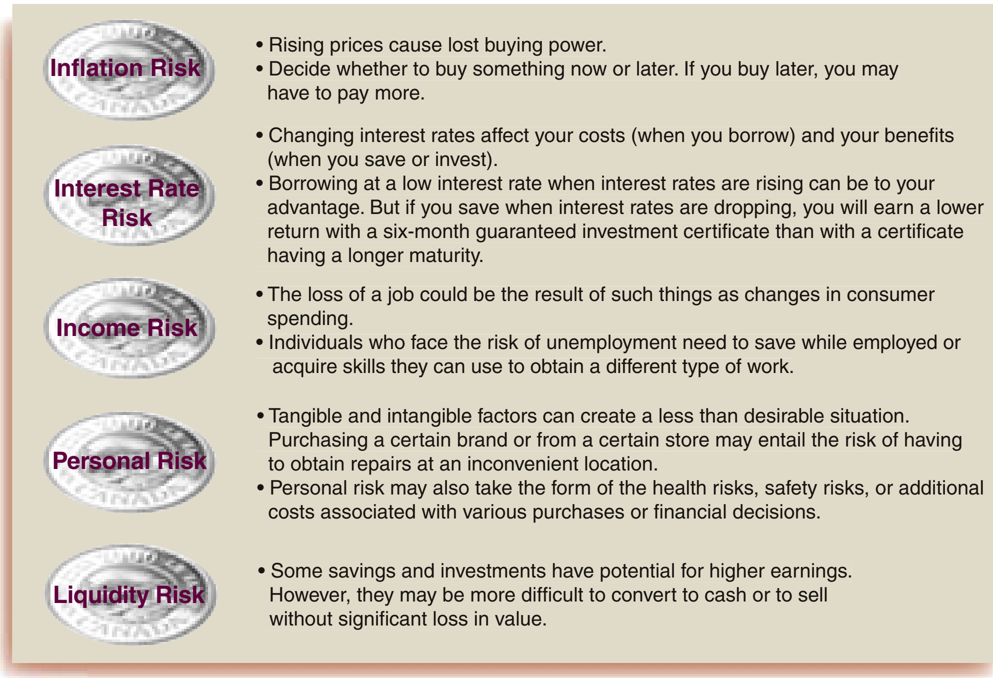
EVALUATING RISK Uncertainty is a part of every decision. Selecting a college or university major and choosing a career field involve risk. What if you don't like working in this field or cannot obtain employment in it? Other decisions involve a very low degree of risk, such as putting money in a savings account or purchasing items that cost only a few dollars. Your chances of losing something of great value are low in these situations.

In many financial decisions, identifying and evaluating risk is difficult (see Exhibit 1–2). The best way to consider risk is to gather information based on your experience and the experiences of others and to use financial planning information sources.

FINANCIAL PLANNING INFORMATION SOURCES When you travel, you often need a road map. Travelling the path of financial planning requires a different kind of map. Relevant information is required at each stage of the decision-making process. This book provides the foundation you need to make personal financial planning decisions. Changing personal, social, and economic conditions will require that you continually supplement and update your knowledge. Exhibit 1–3 offers an overview of the informational resources available when making personal financial decisions. The Financial Planning for Life's Situations box on page 7 and the appendix to this chapter provide additional information.

Exhibit 1–2

Types of Risk



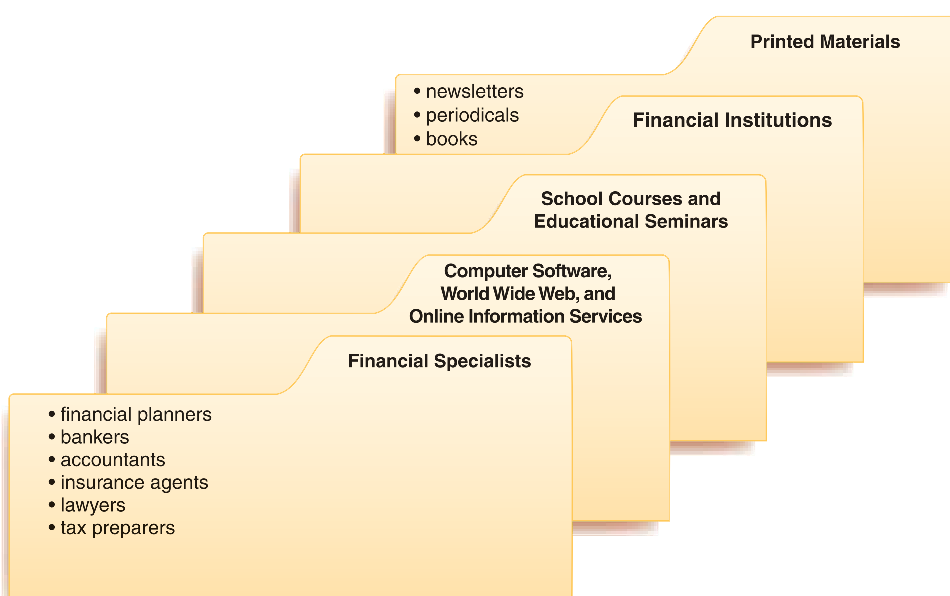
STEP 4 EXAMPLE: As Kent Mullins evaluates his alternative courses of action, he must consider his income needs for both the short term and the long term. He should also assess career opportunities with his current skills and his potential with advanced training. What risks and trade-offs should Kent consider?

STEP 5: CREATE AND IMPLEMENT A FINANCIAL ACTION PLAN

In this step of the financial planning process, you develop an action plan. This requires choosing ways to achieve your goals. For example, you can increase your savings by reducing your spending or by increasing your income through extra time on the job. If you are concerned about year-end tax payments, you may increase the amount withheld from each paycheque, file

Exhibit 1–3

Financial Planning Information Sources



Financial Planning for Life's Situations

USING THE INTERNET FOR FINANCIAL PLANNING

Web . . . e-mail . . . URL . . . cybercash!

Just a few years ago, these terms made no sense to most people. Even now, many people are still not quite sure about all this stuff. However, most know that good financial planning requires information, and the Internet is the most efficient source of information.

Throughout this book, the financial planning content presented can be expanded and updated using the Internet. The Web sites we suggest, along with others you locate yourself, will allow you to quickly obtain information for making financial decisions appropriate to your life situation. In addition, at the end of each chapter, a feature called "Creating an E-Plan: Financial Decisions Using the Web" will give you an opportunity to plan, research, and implement various components necessary for a comprehensive financial plan.

As you study the personal financial topics discussed in this book, you will find the following Internet topic areas especially useful:

- *Cyber-info for personal financial planning:* With thousands of personal finance Web sites available, where does a person begin? Some of the most useful ones include www.webfin.com, www.quicken.ca, and www.cafp.org.
- *Online banking:* No more lines. No more rude bank tellers. No more inhaling exhaust fumes while waiting in the drive-through lane. In addition to existing banks that are online, there are Web-only banks, such as www.ingdirect.ca.
- *Online tax information and advice:* Tax planning should not occur only around April 30. For assistance, go to www.ccra-adrc.gc.ca and www.kpmg.ca.
- *Applying for a mortgage online:* Instead of waiting days or even weeks, prospective home buyers can now obtain financing online at www.webfin.com and www.scotiabank.ca.
- *Buying a car online:* Information that used to be difficult to get is now available to everyone. More than 70 percent of car buyers research their planned purchases online to obtain information about vehicle features and costs at such Web sites as www.carsbynet.com and www.sympatico.ca/contents/automotive.
- *Selecting investments online:* As everyone knows, "information is power." This axiom is especially true when investing. You can obtain company information and investment assistance at www.quicken.ca and www.mutfunds.com.
- *Being your own investment broker:* You already know which investments you want to buy? Then it's time to get into the market by going to www.bmoinvestorline.com.
- *Planning for retirement:* Whether you are 40 years or 40 minutes away from retiring, you can get lots of help at www.retireweb.com.

Note: Additional Web sites appear on the end sheets of this book and in the end-of-chapter exercises. Refer to the appendix for this chapter for information on conducting Internet searches. Also, be aware that Web sites may change or no longer be in use.

quarterly tax payments, or shelter current income in a tax-deferred retirement program. As you achieve your immediate or short-term goals, the goals next in priority will come into focus.

To implement your financial action plan, you may need assistance from others. For example, you may use the services of an insurance agent to purchase property insurance or the services of an investment broker to purchase stocks, bonds, or mutual funds. Your own efforts should be geared toward achieving your financial goals.

STEP 5 EXAMPLE: Kent Mullins has decided to work full time for a few years while he (1) pays off his student loans, (2) saves money for graduate school, and (3) takes a couple of courses in the evenings and on weekends. What are the benefits and drawbacks of this choice?

STEP 6: RE-EVALUATE AND REVISE YOUR PLAN

Financial planning is a dynamic process that does not end when you take a particular action. You need to regularly assess your financial decisions. You should do a complete review of your

DID YOU KNOW?

Research indicates that people with a financial plan (developed themselves or by a professional) had significantly higher amounts in savings than those who didn't.

(Andrea Rock, "You've Gotta Have a Plan," *Money*, March 1999, pp. 117–20, 123, 125–27.)

finances at least once a year. Changing personal, social, and economic factors may require more frequent assessments.

When life events affect your financial needs, this financial planning process will provide a vehicle for adapting to those changes. Regularly reviewing this decision-making process will help you make priority adjustments that will bring your financial goals and activities in line with your current life situation.

STEP 6 EXAMPLE: Over the next six to 12 months, Kent Mullins should reassess his financial, career, and personal situations. What employment opportunities or family circumstances might affect his need or desire to take a different course of action?

CONCEPT CHECK 1–1

1. What are the main elements of every decision we make?
2. What are some risks associated with financial decisions?
3. What are some common sources of financial planning information?
4. Why should you re-evaluate your actions after making a personal financial decision?
5. What Web site feature of www.cafp.org or www.canadianfinance.com would provide assistance with your financial decisions?

Developing Personal Financial Goals

Objective 2

Develop personal financial goals

Since Canada is among the richest countries in the world, it is difficult to understand why so many Canadians have money problems. The answer seems to be the result of two main factors. The first is poor planning and weak money management habits in such areas as spending and the use of credit. The other is extensive advertising, selling efforts, and product availability. Achieving personal financial satisfaction starts with clear financial goals.

TYPES OF FINANCIAL GOALS

Two factors commonly influence your financial aspirations for the future. The first is the time frame in which you would like to achieve your goals. The second is the type of financial need that drives your goals.

TIMING OF GOALS What would you like to do tomorrow? Believe it or not, that question involves goal setting. *Short-term goals* are goals to be achieved within the next year or so, such as saving for a vacation or paying off small debts. *Intermediate goals* have a time frame of two to five years. *Long-term goals* involve financial plans that are more than five years off, such as retirement savings, money for children's college/university education, or the purchase of a vacation home.

Long-term goals should be planned in coordination with short-term and intermediate ones. Setting and achieving short-term goals is commonly the basis for moving toward success of long-term goals. For example, saving for a down payment to buy a house is a short-term goal that can be a foundation for a long-term goal: owning your own home.

Goal frequency is another ingredient in the financial planning process. Some goals, such as vacations or money for gifts, may be set annually. Other goals, such as a higher education, a car, or a house, occur less frequently.

GOALS FOR DIFFERENT FINANCIAL NEEDS A goal of obtaining increased career training is different from a goal of saving money to pay a semi-annual auto insurance premium. *Consumable-product goals* usually occur on a periodic basis and involve items that are used up relatively quickly, such as food, clothing, and entertainment. Such purchases, if made unwisely, can have a negative effect on your financial situation.

Durable-product goals usually involve infrequently purchased, expensive items, such as appliances, cars, and sporting equipment; these consist of tangible items. In contrast, many people overlook *intangible-purchase goals*. These goals may relate to personal relationships, health, education, and leisure. Goal setting for these life circumstances is also necessary for your overall well being.

GOAL SETTING GUIDELINES

An old saying goes, "If you don't know where you're going, you might end up somewhere else and not even know it." Goal setting is central to financial decision making. Your financial goals are the basis for planning, implementing, and measuring the progress of your spending, saving, and investing activities. Exhibit 1–4 offers typical goals and financial activities for various life situations.

Exhibit 1–4 Financial Goals and Activities for Various Life Situations

COMMON FINANCIAL GOALS AND ACTIVITIES		
• Obtain appropriate career training. • Create an effective financial recordkeeping system. • Develop a regular savings and investment program.	• Accumulate an appropriate emergency fund. • Purchase appropriate types and amounts of insurance coverage. • Create and implement a flexible budget.	• Evaluate and select appropriate investments. • Establish and implement a plan for retirement goals. • Make a will and develop an estate plan.

LIFE SITUATION	SPECIALIZED FINANCIAL ACTIVITIES
Young, single (18–35)	• Establish financial independence. • Obtain disability insurance to replace income during prolonged illness. • Consider home purchase.
Young couple with children under 18	• Carefully manage the increased need for the use of credit. • Obtain an appropriate amount of life insurance for the care of dependants. • Use a will to name a guardian for children.
Single parent with children under 18	• Obtain adequate amounts of health, life, and disability insurances. • Contribute to savings and investment funds for children's higher education. • Name a guardian for children and make other estate plans.
Young dual-income couple, no children	• Coordinate insurance coverage and other benefits. • Develop savings and investment programs for changes in life situation (larger house, children). • Consider tax-deferred contributions to retirement fund.
Older couple (+50), no dependent children at home	• Consolidate financial assets and review estate plans. • Obtain health insurance for post-retirement period. • Plan retirement housing, living expenses, recreational activities, and part-time work.
Mixed-generation household (elderly individuals and children under 18)	• Obtain long-term health care insurance and life/disability income for care of younger dependants. • Use dependent care service, if needed. • Provide arrangements for handling finances of elderly if they become ill. • Consider splitting of investment cost, with elderly getting income while alive and principal going to surviving relatives.
Older (+50), single	• Make arrangements for long-term health care coverage. • Review will and estate plan. • Plan retirement living facilities, living expenses, and activities.

Your financial goals should be stated to take the following factors into account:

[1] *Financial goals should be realistic.* Financial goals should be based on your income and life situation. For example, it is probably not realistic to expect to buy a new car each year if you are a full-time student.

[2] *Financial goals should be stated in specific, measurable terms*. Knowing exactly what your goals are will help you create a plan designed to achieve them. For example, the goal of "accumulating $5,000 in an investment fund within three years" is a clearer guide to planning than the goal of "putting money into an investment fund."

[3] *Financial goals should have a time frame.* In the preceding example, the goal is to be achieved in three years. A time frame helps you measure your progress toward your financial goals.

[4] *Financial goals should indicate the type of action to be taken.* Your financial goals are the basis for the various financial activities you will undertake.

The Financial Planning for Life's Situations box on page 12 gives you an opportunity to set financial goals.

CONCEPT CHECK 1–2

1. What are examples of long-term goals?
2. What are the four main characteristics of useful financial goals?

Influences on Personal Financial Planning

Objective 3

Assess personal and economic factors that influence personal financial planning.

Many factors influence daily financial decisions, ranging from age and household size to interest rates and inflation. Three main elements affect financial planning activities: life situation, personal values, and economic factors.

LIFE SITUATION AND PERSONAL VALUES

People in their 50s spend money differently from those in their 20s. Personal factors, such as age, income, household size, and personal beliefs, influence your spending and saving patterns. Your life situation or lifestyle is created by a combination of factors.

As our society changes, different types of financial needs evolve. Today, people tend to get married at a later age, and more households have two incomes. Many households are headed by single parents. More than two million women provide care for both dependent children and parents. We are also living longer: more than 80 percent of all Canadians now living are expected to live past age 65.

adult life cycle The stages in the family situation and financial needs of an adult.

As Exhibit 1–5 shows, the **adult life cycle**—the stages in the family situation and financial needs of an adult—is an important influence on your financial activities and decisions. Your life situation is also affected by marital status, household size, and employment, as well as such events as

- Graduation (at various levels of education).
- Engagement and marriage.
- The birth or adoption of a child.
- A career change or a move to a new area.
- Dependent children leaving home.
- Changes in health.
- Divorce.

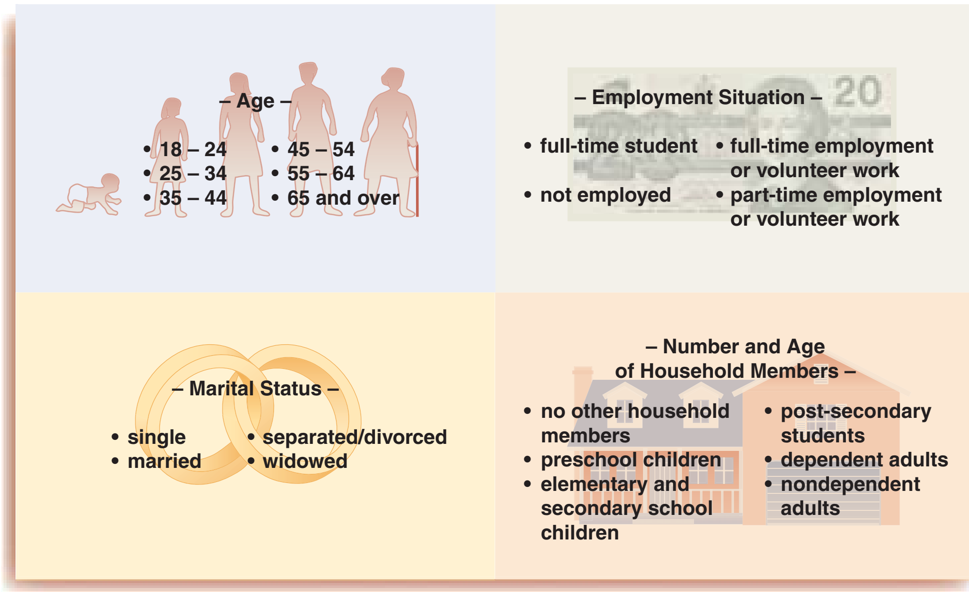


Exhibit 1–5

Life Situation Influences on Your Financial Decisions

- Retirement.
- The death of a spouse, family member, or other dependant.

In addition to being defined by your family situation, you are defined by your values—the ideas and principles that you consider correct, desirable, and important. **Values** have a direct influence on such decisions as spending now versus saving for the future or continuing school versus getting a job.

values Ideas and principles that a person considers correct, desirable, and important.

ECONOMIC FACTORS

Daily economic activities are another important influence on financial planning. In our society, the forces of supply and demand play an important role in setting prices. **Economics** is the study of how wealth is created and distributed. The economic environment includes various institutions, principally business, labour, and government, that must work together to satisfy our needs and wants.

economics The study of how wealth is created and distributed.

MARKET FORCES Prices of goods and services are generally determined by supply and demand. Just as a high demand for a consumer product forces its price up, a high demand for money pushes up interest rates. This price of money reflects the limited supply of money and the demand for it.

At times, the price of an item may seem to be unaffected by the forces of supply and demand, but in fact, at such times, other economic factors may also be influencing its price. Although such factors as production costs and competition influence prices, the market forces of supply and demand remain in operation.

FINANCIAL INSTITUTIONS Banks, trust companies, credit unions, insurance companies, and investment companies are the financial institutions with which most people do business. Financial institutions provide services that facilitate financial activities in our economy. They accept savings, handle chequing accounts, sell insurance, and make investments on behalf of others.

While various government agencies regulate financial activities, the Bank of Canada, our nation's central bank, has significant responsibility in our economy. The Bank of Canada is concerned with maintaining an adequate money supply. It achieves this by influencing borrowing, interest rates, and the buying or selling of government securities. The Bank of Canada attempts

CREATING FINANCIAL GOALS

On the basis of your current situation or expectations for the future, create two financial goals, one short-term and one long-term, using the following guidelines:

Step 1. Create realistic goals on the basis of your life situation.

A. SHORT-TERM GOAL

B. LONG-TERM GOAL

Step 2. State your goals in specific, measurable terms.

a.

b.

Step 3. Describe the time frame for accomplishing your goals.

a.

b.

Step 4. Indicate actions to be taken to achieve your goals.

a.

b.

to make adequate funds available for consumer spending and business expansion while keeping interest rates and consumer prices at an appropriate level.

GLOBAL INFLUENCES The global marketplace also influences financial activities. Our economy is affected by both the financial activities of foreign investors and competition from foreign companies. Canadian businesses compete against foreign companies for the spending dollars of Canadian consumers.

When the level of exports of Canadian-made goods is lower than the level of imported goods, more Canadian dollars leave the country than the dollar value of foreign currency coming into Canada. This reduces the funds available for domestic spending and investment. Also, if foreign companies decide not to invest their dollars in Canada, the domestic money supply is reduced. This reduced money supply may cause higher interest rates.

DID YOU KNOW?

A basket of goods and services that cost $100 in 1914 cost $1587.67 in 2001.

(www.bankofcanada.com)

ECONOMIC CONDITIONS Newspapers and business periodicals regularly publish current economic statistics. Exhibit 1–6 provides an overview of some economic indicators that influence financial decisions. Your personal financial decisions are most heavily influenced by consumer prices, consumer spending, and interest rates.

1. Consumer Prices **Inflation** is a rise in the general level of prices. In times of inflation, the buying power of the dollar decreases. For example, if prices increased 5 percent during the last year, items that cost $100 then would now cost $105. This means it now takes more money to buy the same amount of goods and services.

inflation A rise in the general level of prices.

The main cause of inflation is an increase in demand without a comparable increase in supply. For example, if people have more money to spend because of pay increases or borrowing but the same amounts of goods and services are available, the increased demand can bid up prices for those goods and services.

Exhibit 1–6 Changing Economic Conditions and Financial Decisions

Economic Factor	What It Measures	How It Influences Financial Planning
Consumer prices	The value of the dollar; changes in inflation	If consumer prices increase faster than your income, you are unable to purchase the same amount of goods and services; higher consumer prices will also cause higher interest rates.
Consumer spending	The demand for goods and services by individuals and households	Increased consumer spending is likely to create more jobs and higher wages; high levels of consumer spending and borrowing can also push up consumer prices and interest rates.
Interest rates	The cost of money; the cost of credit when you borrow; the return on your money when you save or invest	Higher interest rates make buying on credit more expensive; higher interest rates make saving and investing more attractive and discourage borrowing.
Money supply	The dollars available for spending in our economy	Interest rates tend to decline as more people save and invest; but higher saving (and lower spending) may also reduce job opportunities.
Unemployment	The number of people without employment who are willing and able to work	People who are unemployed should reduce their debt level and have an emergency savings fund for living costs while out of work; high unemployment reduces consumer spending and job opportunities.
Housing starts	The number of new homes being built	Increased home building results in more job opportunities, higher wages, more consumer spending, and overall economic expansion.
Gross domestic product (GDP)	The total value of goods and services produced within a country's borders, including items produced with foreign resources	The GDP provides an indication of a nation's economic viability resulting in employment and opportunities for personal financial wealth.
Trade balance	The difference between a country's exports and its imports	If a country exports more than it imports, interest rates may rise and foreign goods and foreign travel will cost more.
TSE 300 composite index and other stock market indexes	The relative value of stocks represented by the index	These indexes provide an indication of the general movement of stock prices.

Advice from a Pro

ON PERSONAL FINANCIAL PLANNING

"Spend less than you earn" is the foundation of long-term financial security, according to financial planner Ellen Rogin.

Although it sounds simple, most people do not follow this basic requirement for financial planning success. Ms. Rogin has been advising people about their money for more than 12 years. While the typical clients of her company range in age from 30 to 50, some are younger or older. Most of her clients are professionals and executives who have a common concern: a secure retirement. But Ms. Rogin is quick to point out that she works with people with a variety of needs, life situations, and investment philosophies. She has even advised a lottery winner, although she doesn't recommend that expectation as a steady path to long-term financial security!

The availability of information, Ms. Rogin believes, is the most significant change in the financial planning marketplace in recent years. With the Internet, television programs, and an extensive number of magazines and books, people can be better informed regarding personal finance topics and investments. However, Ms. Rogin warns that people must assess the validity of the information. She suggests "avoiding specific investment advice from magazines and other sources that may not be appropriate for your individual situation."

When planning your own financial direction, Ms. Rogin recommends three actions:

1. Set specific financial goals.
2. Reduce your debts.
3. Save for retirement.

Even if someone else is managing your finances, Ms. Rogin encourages you to "be involved." Be aware of your personal economic situation and the financial marketplace. Communicate your money views, risk acceptance, and financial priorities. Never let a financial planner, your spouse, or another family member have complete control.

Inflation is most harmful to people living on fixed incomes. Due to inflation, retired people and others whose incomes do not change are able to afford smaller amounts of goods and services.

Inflation can also adversely affect lenders of money. Unless an adequate interest rate is charged, amounts repaid by borrowers in times of inflation have less buying power than the money they borrowed. If you pay 10 percent interest on a loan and the inflation rate is 12 percent, the dollars you pay the lender have lost buying power. For this reason, interest rates rise in periods of high inflation.

The rate of inflation varies. During the late 1950s and early 1960s, the annual inflation rate was in the 1 to 3 percent range. During the late 1970s and early 1980s, the cost of living increased 10 to 12 percent annually.

More recently, the annual price increase for most goods and services as measured by the consumer price index has been in the 1 to 3 percent range. The *consumer price index* (CPI), published by Statistics Canada, is a measure of the average change in the prices urban consumers pay for a fixed "basket" of goods and services. For current CPI information, go to www.statcan.ca.

DID YOU KNOW ?

To find out how fast prices double, you can use the rule of 72. Just divide 72 by the annual inflation rate (or interest rate). An annual inflation rate of 8 percent, for example, means prices will double in nine years (72 ÷ 8 = 9).

2. Consumer Spending Total demand for goods and services in the economy influences employment opportunities and the potential for income. As consumer purchasing increases, the financial resources of current and prospective employees expand. This situation improves the financial condition of many households.

In contrast, reduced spending causes unemployment, since staff reduction commonly results from a company's reduced financial resources. The financial hardships of unemployment are a major concern of business, labour, and government. Retraining programs, income assistance, and job services can help people adjust.

3. Interest Rates In simple terms, interest rates represent the cost of money. Like everything else, money has a price. The forces of supply and demand influence interest rates. When consumer saving and investing increase the supply of money, interest rates tend to decrease. However, as consumer, business, government, and foreign borrowing increase the demand for money, interest rates tend to rise.

Interest rates affect your financial planning. The earnings you receive as a saver or an investor reflect current interest rates as well as a *risk premium* based on such factors as the length of time your funds will be used by others, expected inflation, and the extent of uncertainty about getting your money back. Risk is also a factor in the interest rate you pay as a borrower. People with poor credit ratings pay a higher interest rate than people with good credit ratings. Interest rates influence many financial decisions. Current interest rate data may be obtained at www.webfin.com.

DID YOU KNOW ?

Canadian households spent an average of $53,470 in 1999 on everything from furniture to entertainment.

(www.statcan.ca)

CONCEPT CHECK 1–3

1. How do age, marital status, household size, employment situation, and other personal factors affect financial planning?
2. How might the uncertainty of inflation make personal financial planning difficult?
3. What factors influence the level of interest rates?

Opportunity Costs and the Time Value of Money

Objective 4

Determine personal and financial opportunity costs associated with personal financial decisions.

Have you noticed that you always give up something when you make choices? In every financial decision, you sacrifice something to obtain something else that you consider more desirable. For example, you might forgo current consumption to invest funds for future purchases or long-term financial security. Or you might gain the use of an expensive item now by making credit payments from future earnings. These *opportunity costs* may be viewed in terms of both personal and financial resources (see Exhibit 1–7).

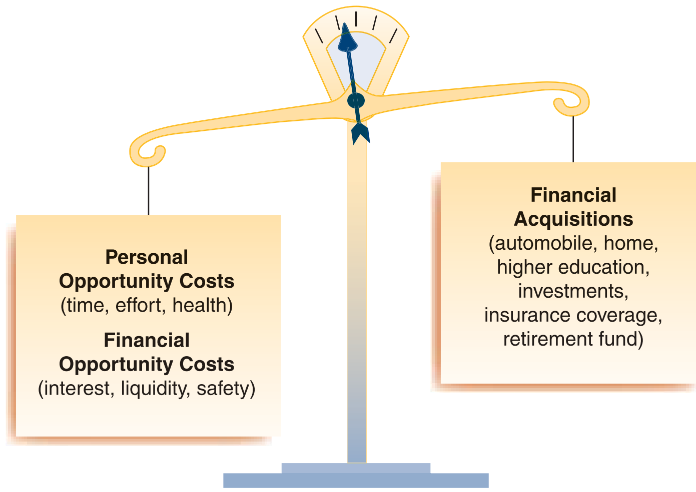
PERSONAL OPPORTUNITY COSTS

An important personal opportunity cost involves time that when used for one activity cannot be used for other activities. Time used for studying, working, or shopping will not be available for other uses. The allocation of time should be viewed like any decision: Select your use of time to meet your needs, achieve your goals, and satisfy personal values.

Other personal opportunity costs relate to health. Poor eating habits, lack of sleep, or avoiding exercise can result in illness, time away from school or work, increased health care costs, and reduced financial security. Like financial resources, your personal resources (time, energy, health, abilities, knowledge) require management.

Exhibit 1–7

Opportunity Costs and Financial Results Should Be Evaluated When Making Financial Decisions



FINANCIAL OPPORTUNITY COSTS

time value of money Increases in an amount of money as a result of interest earned.

You are constantly making choices among various financial decisions. In making those choices, you must consider the **time value of money**, the increases in an amount of money as a result of interest earned. Saving or investing a dollar instead of spending it today results in a future amount greater than a dollar. Every time you spend, save, invest, or borrow money, you should consider the time value of that money as an opportunity cost. Spending money from your savings account means lost interest earnings; however, what you buy with that money may have a higher priority than those earnings. Borrowing to make a purchase involves the opportunity cost of paying interest on the loan, but your current needs may make this trade-off worthwhile.

The opportunity cost of the time value of money is also present in these financial decisions:

- Setting aside funds in a savings plan with little or no risk has the opportunity cost of potentially higher returns from an investment with greater risk.
- Having extra money withheld from your paycheque in order to receive a tax refund has the opportunity cost of the lost interest the money could earn in a savings account.
- Making annual deposits in a Registered Retirement Savings Plan (RRSP) can help you avoid the opportunity cost of having inadequate funds later in life.
- Purchasing a new automobile or home appliance has the potential benefit of saving you money on future maintenance and energy costs.

INTEREST CALCULATIONS Three amounts are used to calculate the time value of money for savings in the form of interest earned:

- The amount of the savings (commonly called the *principal*).
- The annual interest rate.
- The length of time the money is on deposit.

simple interest Interest computed on the principal, excluding previously earned interest

There are two methods of calculating interest: **simple interest** and compound interest. Simple interest is calculated as follows: $I = P \times r \times T$

(P) Amount in savings × (r) Annual interest rate × (T) Time period = (I) Interest

For example, $500 on deposit at a 6 percent annual interest rate for two years would earn $60 ($500 × 0.06 × 2).

Compounding refers to interest that is earned on previously earned interest. Each time interest is added to the principal, the next interest amount is computed on the new balance. For example, the $500 on deposit at an 8 percent annual interest rate for two years would earn $61.80. ($500 × 0.06 = $30 the first year and [$500 + $30]× 0.06 = $31.80 the second year, $31.80 + $30 = $61.80)

compounding A process that calculates interest based on previously earned interest.

Since you are earning interest on the principal as well as accumulated interest, the total amount is greater than what you would earn under simple interest ($61.80 > $60).

You can calculate the increased value of your money from interest earned in two ways: You can calculate the total amount that will be available later (future value), or you can determine the current value of an amount desired in the future (present value).

FUTURE VALUE OF A SINGLE AMOUNT Deposited money earns interest that will increase over time. **Future value** is the amount to which current savings will increase on the basis of a certain interest rate and a certain time period. Future value computations typically involve *compounding,* since interest is earned on previously earned interest. Compounding allows the future value of a deposit to grow faster than it would if interest were paid only on the original deposit. For example, $100 deposited in a 6-percent account for two years will grow to $112.36. This amount is computed as follows:

future value The amount to which current savings will increase based on a certain interest rate and a certain time period; typically involves compounding.

$$\text{Future value (year1)} = \overbrace{\$100}^{\text{Original amount in savings}} + \overbrace{(\$100 \times 0.06 \times 1 \text{ year})}^{\text{Amount of interest earned}} = \$106$$

$$\text{Future value (year 2)} = \$106 + (\$106 \times 0.06 \times 1 \text{ year}) = \$112.36$$

The same process could be continued for a third, fourth, and fifth year, but the computations would be time consuming. Future value tables simplify the process (see Exhibit 1–8). To use a future value table, multiply the amount deposited by the factor for the desired interest rate and time period. For example, $650 at 8 percent for 10 years would have a future value of $1,403.35 ($650 × 2.159). The future value of an amount will always be greater than the original amount. As Exhibit 1–8A shows, all the future value factors are larger than 1.

The sooner you make deposits, the greater the future value will be. Depositing $1,000 in a 5-percent account at age 40 will give you $3,387 at age 65. However, making the $1,000 deposit at age 25 would result in an account balance of $7,040 at age 65.

FUTURE VALUE OF A SERIES OF DEPOSITS Quite often, savers and investors make regular deposits. An *annuity* is a series of equal deposits or payments. To determine the future value of equal yearly savings deposits, use Exhibit 1–8B. For this table to be used, the deposits must earn a constant interest rate. If you deposit $50 a year at 7 percent for six years, starting at the end of the first year, you will have $357.65 at the end of that time ($50 × 7.153). The Financial Planning Calculations box on page 20 presents examples of using future value to achieve financial goals.

PRESENT VALUE OF A SINGLE AMOUNT Another aspect of the time value of money involves determining the current value of a desired amount for the future. **Present value** is the current value for a future amount based on a certain interest rate and a certain time period. Present value computations, also called *discounting,* allow you to determine how much to deposit now to obtain a desired total in the future. Present value tables (Exhibit 1–8C) can be used to make the computations. If you want $1,000 five years from now and you earn 5 percent on your savings, you need to deposit $784 ($1,000 × 0.784).

present value The current value for a future amount based on a certain interest rate and a certain time period; also referred to as discounting.

Exhibit 1–8

The Value of Money Tables (condensed)

A. FUTURE VALUE OF $1 (SINGLE AMOUNT)

	Percent				
Year	5%	6%	7%	8%	9%
5	1.276	1.338	1.403	1.469	1.539
6	1.340	1.419	1.501	1.587	1.677
7	1.407	1.504	1.606	1.714	1.828
8	1.477	1.594	1.718	1.851	1.993
9	1.551	1.689	1.838	1.999	2.172
10	1.629	1.791	1.967	2.159	2.367

B. FUTURE VALUE OF A SERIES OF ANNUAL DEPOSITS (ANNUITY)

	Percent				
Year	5%	6%	7%	8%	9%
5	5.526	5.637	5.751	5.867	5.985
6	6.802	6.975	7.153	7.336	7.523
7	8.142	8.394	8.654	8.923	9.200
8	9.549	9.897	10.260	10.637	11.028
9	11.027	11.491	11.978	12.488	13.021
10	12.578	13.181	13.816	14.487	15.193

C. PRESENT VALUE OF $1 (SINGLE AMOUNT)

	Percent				
Year	5%	6%	7%	8%	9%
5	0.784	0.747	0.713	0.681	0.650
6	0.746	0.705	0.666	0.630	0.596
7	0.711	0.665	0.623	0.583	0.547
8	0.677	0.627	0.582	0.540	0.502
9	0.645	0.592	0.544	0.500	0.460
10	0.614	0.558	0.508	0.463	0.422

D. PRESENT VALUE OF A SERIES OF ANNUAL DEPOSITS (ANNUITY)

	Percent				
Year	5%	6%	7%	8%	9%
5	4.329	4.212	4.100	3.993	3.890
6	5.076	4.917	4.767	4.623	4.486
7	5.786	5.582	5.389	5.206	5.033
8	6.463	6.210	5.971	5.747	5.535
9	7.108	6.802	6.515	6.247	5.995
10	7.722	7.360	7.024	6.710	6.418

See Appendix A at the end of the book for more complete future value and present value tables.

The present value of the amount you want in the future will always be less than the future value, since all of the factors in Exhibit 1–8C are less than 1 and interest earned will increase the present value amount to the desired future amount.

PRESENT VALUE OF A SERIES OF DEPOSITS You can also use present value computations to determine how much you need to deposit so that you can take a certain amount out of the account for a desired number of years. For example, if you want to take $400 out of an investment account each year for nine years and your money is earning an annual rate of 8 percent, you can see from Exhibit 1–8D that you would need to make a current deposit of $2,498.80 ($400 × 6.247).

DID YOU KNOW ?

If you invest $2,000 per year (at 9 percent) from age 30 to 65, these funds will grow to $431,422. However, if you invest $2,000 per year (at 9 percent) for only eight years, from age 22 to 30, at age 65 this fund will be worth $450,270.

FINANCIAL CALCULATORS Currently, financial calculators, with time value of money functions built in, are widely used to calculate future value, present values, and annuities. For the following examples, we will use the Texas Instrument BA II Plus financial calculator, which sells for approximately $50 and is recommended by the Canadian Institute of Financial Planning.

Important keys on a financial calculator for Time Value of Money Problems (Texas Instrument BA II Plus)

- CPT – Compute key used to initiate financial calculations once all values are inputed.
- N – Number of periods
- I/Y – Interest rate per period
- PV – Present value
- PMT – Amount of payment, used only for annuities
- FV – Future value

Let's try a problem. What is the future value of $100 after three years at a 10 percent annual interest rate?

First, you must enter the data:

3	N	
10	I/Y	
100	PV	
0	PMT	(optional if registers are cleared)

To find the solution, the future value, press CPT FV, and the future value of –133.1 is displayed. The BA II Plus displays present value solutions as a (+) and future values as a (–) because it assumes one is an inflow and the other an outflow. The Financial Planning Calculations box on page 20 presents examples of using a financial calculator to solve future value problems.

The formulas for calculating future and present values, as well as tables and the use of the financial calculator covering a wider range of interest rates and time periods, are presented in Appendix A. Computer programs for calculating time value of money are also available.

CONCEPT CHECK 1–4

1. How can you use future value and present value computations to measure the opportunity cost of a financial decision?
2. Use the time value of money tables in Exhibit 1–8 or a financial calculator to calculate the following:
   a. The future value of $100 at 7 percent in 10 years.
   b. The future value of $100 a year for six years earning 6 percent.
   c. The present value of $500 received in eight years with an interest rate of 8 percent.

Financial Planning Calculations

ANNUAL CONTRIBUTIONS TO ACHIEVE A FINANCIAL GOAL

Achieving specific financial goals often requires regular deposits to a savings or investment account. By using time value of money calculations, you can determine the amount you should save or invest to achieve a specific goal for the future.

EXAMPLE 1

Jonie Emerson has two children who will start college in 10 years. She plans to set aside $1,500 a year for her children's college education during that period and estimates she will earn an annual interest rate of 5 percent on her savings. What amount can Jonie expect to have available for her children's college education when they start college?

Calculation from table:

$1,500 × Future value of a series of deposits, 5%, 10 years

$1,500 × 12.578 = $18,867

With calculator:

10 N

5 I/Y

0 PV

1,500 PMT

Then press CPT FV and the answer = $18,866.84

EXAMPLE 2

Don Calder wants to accumulate $50,000 over the next 10 years as a reserve fund for his parents' retirement living expenses and health care. If he earns an average of 8 percent on his investments, what amount must he invest each year to achieve this goal?

Calculation from table:

$50,000 ÷ Future value of a series of deposits, 8%, 10 years

$50,000 ÷ 14.487 = $3,451.37

Don needs to invest approximately $3,450 a year for 10 years at 8 percent to achieve the desired financial goal.

With calculator:

10 N

8 I/Y

0 PV

50,000 FV

Then press CPT PMT and the answer = $3,451.47

Achieving Financial Goals

Objective 5

Identify strategies for achieving personal financial goals for different life situations.

Throughout life, our needs usually can be satisfied with the intelligent use of financial resources. Financial planning involves deciding how to obtain, protect, and use those resources. By using the eight major areas of personal financial planning to organize your financial activities, you can avoid many common money mistakes.

COMPONENTS OF PERSONAL FINANCIAL PLANNING

This book is designed to provide a framework for the study and planning of personal financial decisions. Exhibit 1–9 presents an overview of the eight major personal financial planning areas. To achieve a successful financial situation, you must coordinate these components through an organized plan and wise decision making.

OBTAINING (CHAPTER 1) You obtain financial resources from employment, investments, or ownership of a business. Obtaining financial resources is the foundation of financial planning, since these resources are used for all financial activities.

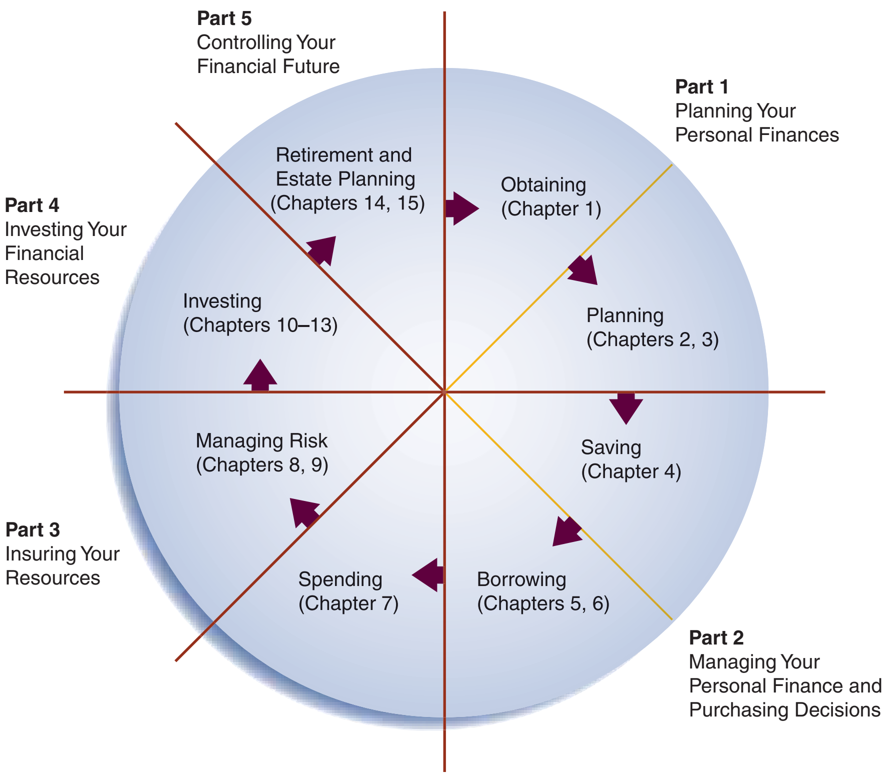


Exhibit 1–9

Components of Personal Financial Planning

Key Web Sites for Obtaining: www.quicken.ca www.monster.com

PLANNING (CHAPTERS 2, 3) Planned spending through budgeting is the key to achieving goals and future financial security. Efforts to anticipate expenses and financial decisions can also help reduce taxes. The ability to pay your fair share of taxes—no more, no less—is vital to increasing your financial resources.

Key Web Sites for Planning: www.cafp.org www.quicken.ca

SAVING (CHAPTER 4) Long-term financial security starts with a regular savings plan for emergencies, unexpected bills, replacement of major items, and the purchase of special goods and services, such as a higher education, a boat, or a vacation home. Once you have established a basic savings plan, you may use additional money for investments that offer greater financial growth.

An amount of savings must be available to meet current household needs. **Liquidity** refers to the ability to readily convert financial resources into cash without a loss in value. The need for liquidity will vary on the basis of a person's age, health, and family situation. Savings plans, such as interest-earning chequing accounts, money market accounts, and money market funds, earn money on your savings while providing liquidity.

liquidity The ability to readily convert financial resources into cash without a loss in value.

Key Web Sites for Saving: www.webfin.com

BORROWING (CHAPTERS 5, 6) Maintaining control over your credit-buying habits will contribute to your financial goals. The overuse and misuse of credit may cause a situation in which a person's debts far exceed the resources available to pay those debts. **Bankruptcy** is a set of federal laws that allow you to either restructure your debts or remove certain debts. The people who declare bankruptcy each year may have avoided this trauma with wise spending and borrowing decisions. Chapter 6 discusses bankruptcy in detail.

bankruptcy A set of federal laws that allow you to either restructure your debts or remove certain debts.

Key Web Sites for Borrowing: www.cibc.com www.scotiabank.ca

DID YOU KNOW ?

Canadian personal bankruptcies are up by 7 percent to 79, 453 for 2001. Insolvencies (consumer, business, and proposals) in Canada broke the record set in 1997 with a total of 104,111 in 2001.

SOURCE: bankruptcycanada.com

SPENDING (CHAPTER 7) Financial planning is designed not to prevent your enjoyment of life but to help you obtain the things you want. Too often, however, people make purchases without considering the financial consequences. Some people shop compulsively, creating financial difficulties. You should detail your living expenses and your other financial obligations in a spending plan. Spending less than you earn is the only way to achieve long-term financial security.

Key Web Sites for Spending: www.consumerworld.org; www.consumer.ca

MANAGING RISK (CHAPTERS 8, 9) Adequate insurance coverage is another component of personal financial planning. Certain types of insurance are commonly overlooked in financial plans. For example, the number of people who suffer disabling injuries or diseases at age 50 is greater than the number who die at that age, so people may need disability insurance more than they need life insurance. Yet surveys reveal that most people have adequate life insurance but few have disability insurance. The insurance industry is more aggressive in selling life insurance than in selling disability insurance, thus putting the burden of obtaining adequate disability insurance on you.

Many households have excessive or overlapping insurance coverage. Insuring property for more than it is worth may be a waste of money, as may both a husband and a wife having similar health insurance coverage.

Key Web Sites for Managing Risk: www.canadalife.com www.canlink.com/imperial

INVESTING (CHAPTERS 10–13) While many types of investment vehicles are available, people invest for two primary reasons. Those interested in current income select investments that pay regular dividends or interest. In contrast, investors who desire long-term growth choose stocks, mutual funds, real estate, and other investments with potential for increased value in the future.

You can achieve investment diversification by including a variety of assets in your portfolio—for example, stocks, bond mutual funds, real estate, and collectibles, such as rare coins. Obtaining general investment advice is easy; however, it is more difficult to obtain specific investment advice to meet your individual needs and goals.

Key Web Sites for Investing: www.canadafinance.com www.webfin.com

RETIREMENT AND ESTATE PLANNING (CHAPTERS 14, 15) Most people desire financial security upon completion of full-time employment. But retirement planning also involves thinking about your housing situation, your recreational activities, and possible part-time or volunteer work.

Key Web Sites for Retirement and Estate Planning: www.elderweb.org www.fiftyplus.net

Transfers of money or property to others should be timed, if possible, to minimize the tax burden and maximize the benefits for those receiving the financial resources. A knowledge of property transfer methods can help you select the best course of action for funding current and future living costs, educational expenses, and retirement needs of dependants.

DEVELOPING A FLEXIBLE FINANCIAL PLAN

A **financial plan** is a formalized report that summarizes your current financial situation, analyzes your financial needs, and recommends future financial activities. You can create this document on your own, seek assistance from a financial planner, or use a money management software package (see the chapter appendix). Exhibit 1–10 offers a framework for developing and implementing a financial plan, along with examples for several life situations. (Also see the Financial Planning for Life's Situations box on pages 24 and 25.)

financial plan A formalized report that summarizes your current financial situation, analyzes your financial needs, and recommends future financial activities.

IMPLEMENTING YOUR FINANCIAL PLAN

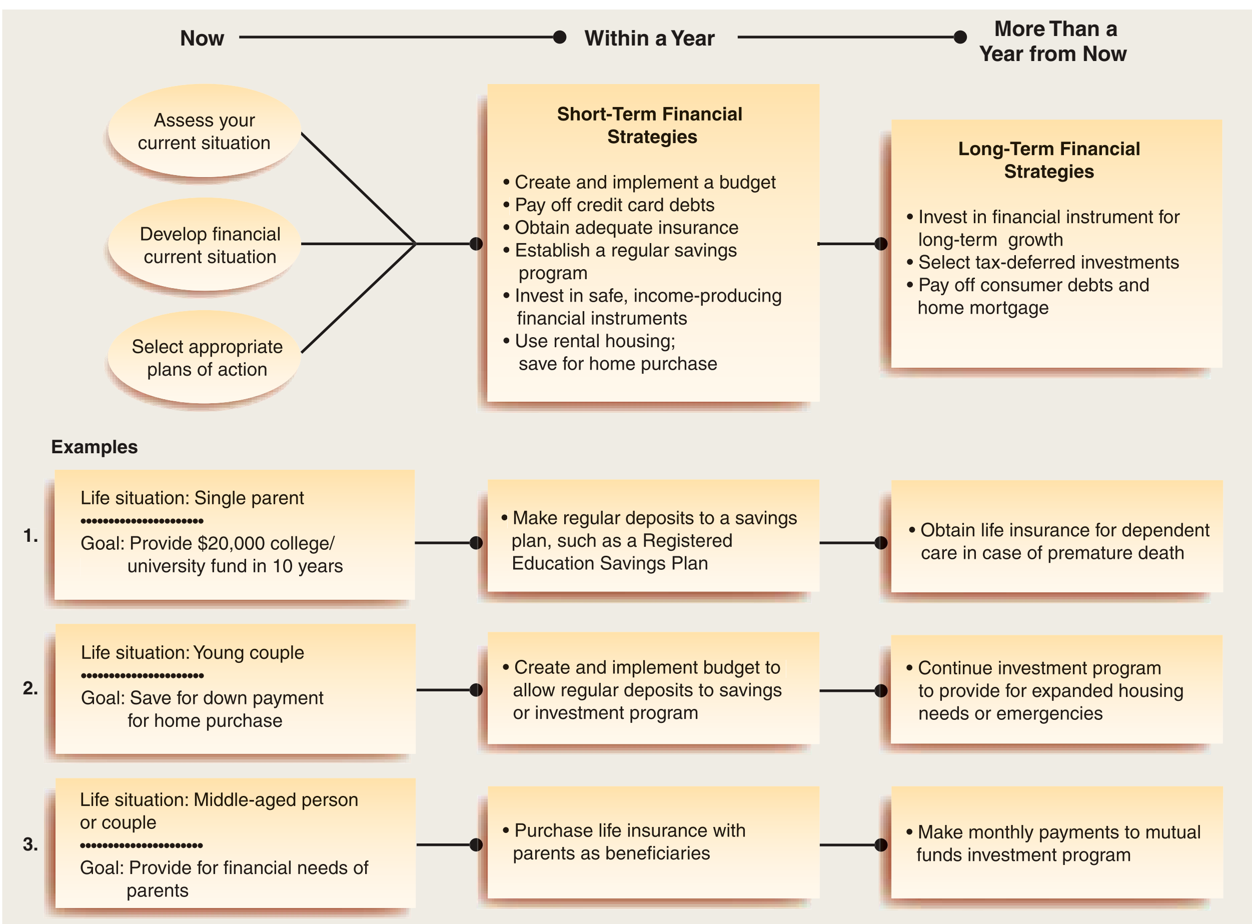
You must have a plan before you can implement it. However, once you have clearly assessed your current situation and identified your financial goals, what do you do next?

The most important strategy for success is the development of financial habits that contribute to both short-term satisfaction and long-term financial security, including the following:

[1] Using a well-conceived spending plan will help you stay within your income while you save and invest for the future. The main source of financial difficulties is overspending.

[2] Having appropriate insurance protection will help you prevent financial disasters.

Exhibit 1–10 Financial Planning in Action



Financial Planning for Life's Situations

I NEED $20,000 FOR MY EDUCATION. SHOULD I BORROW OR WORK PART TIME?

Jim Stewarts is an Accounting Major at Concordia University; he takes five courses a semester and expects to graduate in three years. Jim came to the Financial Aid Office for help in deciding whether he should borrow money or work part time. Let's look at his situation:

Residential status: Jim lives with his parents and is free of food and board charges.

Potential amount of hours allotted for part-time work: Assuming 35 weeks in a school year and that Jim will be unable to work for four weeks; Jim is left with 31 work weeks. Considering Jim's grades are of primary importance, we advise him to work for a maximum of 15 hours a week.

Potential amount of hours allotted for full-time summer employment: Jim will have 17 weeks (52 less 35 weeks) during the summer, when he can work full time for 40 hours a week. We suggest he work only 15 of these weeks so that some time is set aside for a vacation.

Type of job: Assuming an entry level job in his discipline, he will earn roughly $10 an hour.

Personal savings: It is quite common for students to have poor saving habits; therefore, we will assume that Jim currently has no savings.

IF JIM WORKS PART TIME DURING SEMESTERS AND FULL TIME DURING THE SUMMER:

During the school year, Jim can earn $4,650 ($10/hr × 15 hrs × 31 wks = $4,650).

During the summer he can earn $6,000 ($10/hr × 40 hrs × 15 wks = $6,000).

Jim's yearly gross income would be $4,650 + $6,000 = $10,650.

Yet, Jim would not have use of the entire amount. His take-home pay or net pay, which is his gross income minus taxes would be $8,839.50 ($10,650 − [.17 × $10,650]) because he is in the low tax bracket (17%) in Quebec (see Chapter 3). However, when he files his income tax, he could receive a refund. This will be discussed later.

IF JIM TAKES OUT A STUDENT LOAN FOR $20,000:

There are student loans offered by both the federal and provincial governments; these loans are of greater advantage because they offer lower interest rates than the banks and you are only required to pay them back once you graduate. If Jim were to take out a loan today for $20,000 from the Quebec Government's Aide Financiere aux Etudes program, he would pay an annual interest rate of 6.875 percent. (www.afe.gouv.qc.ca/anglais/renseigner/taux.htm) Since he would want to pay the loan back in six years after graduation, using the Present Value formula, he would make monthly payments of $339.78. (See Appendix A for PV of an Annuity equation).

$$\text{PV} = \text{Payments} \times \frac{1 - \frac{1}{(1+i)^n}}{i}$$

Where PV = $20,000, i = Interest Rate = .06875/12, n = # of Monthly Payments = 72.

Visit the Web site
See the Post-Test under Chapter 1 on the online learning centre at www.mcgrawhill.ca/college/kapoor.

[3] Becoming informed about tax and investment alternatives will help you expand your financial resources.

Achieving your financial objectives requires two things: (1) a willingness to learn, and (2) appropriate information sources. You must provide the first element; the chapters that follow will provide the second. For successful financial planning, know where you are now, know where you want to be, and be persistent in your efforts to get there.

continued

Solving for the Payments, we get $339.78. Jim would be able to make these monthly payments when he graduates, assuming he earns an accountant's starting salary of $33,000. (www.careers-in-accounting.com/ascal.htm). Overall, this loan would cost Jim roughly $24,500 ($339.78 × 72 months).

RECOMMENDATION:

We recommend that Jim work part time during the school year and full time during the summer. We have come to this conclusion on the basis of the following results:

As mentioned above, Jim's net pay will be $8,839.50. However, if he gets his parents to do his income tax for him, they will be able to show him as a dependent and receive a refund from the government. With that, they can simply reimburse Jim the $1,810.50 that was originally deducted from his paycheque. With this strategy, Jim actually has $10,650 as his net pay. Since he needs $20,000 to finance his education (or $6,666.66 in each of his three years of university), will he still have enough money left over for his additional expenses? The following table suggests that he will:

EXPENSES OF AN AVERAGE STUDENT WHO LIVES AT HOME:

Expense	Amount (monthly) $	Amount (yearly) $
Clothing	50	600
Entertainment	80	960
Videos & CD's	35	420
Miscellaneous	20	240
Total	185	2,220

$10,650 – $6,666.66 = $3,983.34 (amount of money left over after paying for school)
$3,983.34 – $2,220 = $1,763.34 (balance left over for saving)

By working part time, we recognize that Jim will forgo the additional time available for his studies. However, in our experience, students tend to squander additional time and procrastinate in completing their assigned work.

If Jim works instead of taking out a loan, he will earn enough money to finance his education, pay for additional personal expenses, and still save an amount, which he can use toward such expenditures as a car or house. Although one advantage of credit is that you can enjoy a good or service now and only pay for it later, it may be more prudent to avoid loans, if possible. The advantage of working part time is to avoid the cost of borrowed money as well as gain experience in the field. With our recommendation, Jim will be debt free upon graduation and with the money he has saved, he can start building a solid savings foundation (see Chapter 10).

SOURCE: Assignment was written by and reproduced with permission from the following students: Vikram Kotecha, Matthew Berry, Mili De Silva, and Rikesh Shah—Introductory Course in Personal Finance , JMSB, Concordia University, Winter 2002

CONCEPT CHECK 1–5

1. What are the main components of personal financial planning?
2. What is the purpose of a financial plan?
3. Identify some common actions taken to achieve financial goals.

SUMMARY OF OBJECTIVES

Objective 1

Analyze the process for making personal financial decisions.

Personal financial planning involves the following process: (1) determine your current financial situation; (2) develop financial goals; (3) identify alternative courses of action; (4) evaluate alternatives; (5) create and implement a financial action plan; and (6) re-evaluate and revise the financial plan.

Objective 2

Develop personal financial goals.

Financial goals should (1) be realistic; (2) be stated in specific, measurable terms; (3) have a time frame; and (4) indicate the type of action to be taken.

Objective 3

Assess personal and economic factors that influence personal financial planning.

Financial decisions are affected by a person's life situation (income, age, household size, health), personal values, and economic factors (prices, interest rates, and employment opportunities).

Objective 4

Determine personal and financial opportunity costs associated with personal financial decisions.

Every decision involves a trade-off with things given up. Personal opportunity costs include time, effort, and health. Financial opportunity costs are based on the time value of money. Future value and present value calculations enable you to measure the increased value (or lost interest) that results from a saving, investing, borrowing, or purchasing decision.

Objective 5

Identify strategies for achieving personal financial goals for different life situations.

Successful financial planning requires specific goals combined with spending, saving, investing, and borrowing strategies based on your personal situation and various social and economic factors.

KEY TERMS

adult life cycle 10
bankruptcy 21
compounding 17
economics 11
financial plan 23
future value 17
inflation 13
liquidity 21
opportunity cost 5
personal financial planning 3
present value 17
simple interest 16
time value of money 16
values 11

FINANCIAL PLANNING PROBLEMS

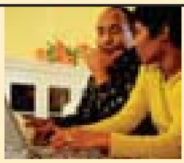
(Note: Some of these problems require the use of the time value of money tables in Appendix A or a financial calculator.)

1. *Calculating Future Value of Property*. Ben Collins plans to buy a house for $65,000. If that real estate is expected to increase in value by 5 percent each year, what will its approximate value be seven years from now? (Obj. 3)
2. *Using the Rule of 72.* Using the rule of 72, approximate the following amounts: (Obj. 3)
   a. If land in an area is increasing 6 percent a year, how long will it take for property values to double?
   b. If you earn 10 percent on your investments, how long will it take for your money to double?
   c. At an annual interest rate of 5 percent, how long will it take for your savings to double?
3. *Determining the Inflation Rate.* In the late 1980s, selected automobiles had an average cost of $12,000. The average cost of those same automobiles is now $15,000. What was the rate of increase for these automobiles between the two time periods? (Obj. 3)
4. *Computing Future Living Expenses*. A family spends $28,000 a year for living expenses. If prices increase by 4 percent a year for the next three years, what amount will the family need for their living expenses after three years? (Obj. 3)
5. *Calculating Earnings on Savings.* What would be the yearly earnings for a person with $6,000 in savings at an annual interest rate of 5.5 percent? (Obj. 4)
6. *Computing Time Value of Money* Using time value of money tables or a financial calculator, calculate the following: (Obj. 4)
   a. The future value of $450 six years from now at 7 percent.
   b. The future value of $800 saved each year for 10 years at 8 percent.
   c. The amount a person would have to deposit today (present value) at a 6-percent interest rate to have $1,000 five years from now.
   d. The amount a person would have to deposit today to be able to take out $500 a year for 10 years from an account earning 8 percent.

7. *Calculating Future Value of a Series of Amounts.* Elaine Romberg prepares her own income tax return each year. A tax preparer would charge her $60 for this service. Over a period of 10 years, how much does Elaine gain from preparing her own tax return? Assume she can earn 6 percent with a savings certificate. (Obj. 4)

FINANCIAL PLANNING ACTIVITIES

1. *Researching Personal Finance on the Internet.* Using Web sites, such as www.canadianfinance.com, www.cafp.org, or www.quicken.ca, and search engines, obtain information about commonly suggested actions related to various personal financial planning decisions. What are some of the best sources of information on the Internet to assist you with financial planning? (Obj. 1)
2. *Comparing Financial Planning Actions.* Survey friends, relatives, and others to determine the process they use when making financial decisions. How do these people measure risk when making financial decisions? (Obj. 1)
3. *Using Financial Planning Experts.* Prepare a list of financial planning specialists (investment advisers, credit counsellors, insurance agents, real estate brokers, tax preparers) in your community who can assist people with personal financial planning. Prepare a list of questions that might be asked of these financial planning professionals by (a) a young person just starting out on his or her own, (b) a young couple planning for their children's education and for their own retirement, and (c) a person nearing retirement. (Obj. 1, 3)
4. *Setting Financial Goals.* Create one short-term goal and one long-term goal for people in these life situations: (a) a young single person, (b) a single parent with a child aged eight years, (c) a married person with no children, and (d) a retired person. (Obj. 2)
5. *Analyzing Changing Life Situations.* Ask friends, relatives, and others how their spending, saving, and borrowing activities changed when they decided to continue their education, change careers, or have children. (Obj. 3)
6. *Researching Economic Conditions.* Use library resources or Web sites to determine recent trends in interest rates, inflation, and other economic indicators. Information about the consumer price index (measuring changes in the cost of living) may be obtained at www.statcan.com. Report how this economic information might affect your financial planning decisions. (Obj. 3)
7. *Comparing Alternative Financial Actions.* What actions would be necessary to compare a financial planner who advertises "One Low Fee Is Charged to Develop Your Personal Financial Plan" and one that advertises "You Are Not Charged a Fee, My Services Are Covered by the Investment Company for Which I Work"? (Obj. 4, 5)
8. *Determining Opportunity Costs.* What is the relationship between current interest rates and financial opportunity costs? Using time value of money calculations, state one or more goals in terms of an annual savings amount and the future value of this savings fund. (Obj. 2, 4)
9. *Researching Financial Planning Software.* Visit software retailers to obtain information about the features and costs of various personal financial planning activities. Information about such programs as Microsoft Money and Quicken may be obtained on the Internet. (Obj. 5)



LIFE SITUATION CASE

Triple Trouble for the "Sandwich Generation"

Until recently, Fran and Ed Blake's personal finances ran smoothly. Both have maintained well-paying jobs while raising two children. The Blakes have a daughter who is completing her first year of college and a son three years younger. Currently, they have $22,000 in various savings and investment funds set aside for the children's education. With education costs increasing faster than inflation, they are uncertain whether this amount is adequate.

In recent months, Fran's mother has required extensive medical attention and personal care assistance. Unable to live alone, she is now a resident of a long-term-care facility. The cost of this service is $2,050 a month, with annual increases of about 7 percent. While a major portion of the cost is covered by the Canada Pension Plan and Old Age Security, Fran's mother is unable to cover the entire cost. Their desire to help adds to the Blakes' financial burden.

The Blakes are like many other Canadians who have financial responsibilities for both dependent children and aging parents. Commonly referred to as the "sandwich generation," this group is squeezed on one side by the cost of raising and educating children and on the other side by the financial demands of caring for aging parents.

Finally, the Blakes, ages 47 and 43, are also concerned about saving for their own retirement. While they have consistently made annual deposits to a Registered Retirement Savings Plan (RRSP), various current financial demands may force them to tap into this money.

Questions

1. What actions have the Blakes taken that would be considered wise financial planning choices?

2. What areas of financial concern do the Blakes face? What actions might be appropriate to address these concerns?

3. Using time value of money calculations (tables in the Appendix or a financial calculator), compute the following:

a. At 12 percent, what would be the value of the $22,000 education funds in three years?

b. If the cost of long-term care is increasing at 7 percent a year, what will be the approximate monthly cost for Fran's mother eight years from now?

c. Fran and Ed plan to deposit $1,500 a year to their RRSPs for 35 years. If they earn an average annual return of 9 percent, what will be the value of their RRSPs after 35 years?

CREATING A FINANCIAL PLAN

Starting Your Financial Plan

Planning is the foundation for success in every aspect of life. Assessing your current financial situation along with setting goals is the key to successful financial planning.

Web Sites for Financial Planning

- Investing information at **www. investorlearning.ca** and **www.independentfinancial.on.ca**.
- Selected articles from Canadian MoneySaver magazine at www.canadianmoneysaver.ca, from MoneySense magazine at **www.moneysense.ca**, and IE:Money magazine at **www.iemoney.ca**.
- Information on credit cards, car loans, and mortgages at **www.scotiabank.ca** and **www.royalbank.com**.
- Current consumer price index and inflation information from Statistics Canada at **www.statcan.ca**.
- Information on Bank of Canada activities and publications at **www.bank-banque-canada.ca**.
- Retirement planning at **www.retireweb.com** and **www.elderweb.org**.

(Note: Addresses and content of Web sites change, and new sites are created daily. Use the search engines discussed in the chapter appendix to update and locate Web sites for your current financial planning needs.)

1 APPENDIX: Financial Planners and Other Financial Planning Information Sources

"ATM fees rise."
"Global currency fluctuations may affect consumer prices."
"Mortgage interest rates remain constant."
These are just a few of the possible influences on personal financial decisions that occur each day. While this book offers the foundation for successful personal financial planning, changing social trends, economic conditions, and technology influence the decision-making environment. Your ability to continually supplement and update your knowledge is a skill that will serve you for a lifetime.

Various resources are available to assist you with personal financial decisions. These resources include printed materials, financial institutions, courses and seminars, the Internet, computer software, and financial planning specialists.

Current Periodicals

As Exhibit 1–A shows, a variety of personal-finance periodicals are available to expand and update your knowledge. These periodicals, along with books on various personal-finance topics, can be found in libraries.

Financial Institutions

Some financial advisers, such as insurance agents and investment brokers, are affiliated with companies that sell financial services. Through national marketing efforts or local promotions, banks, trust companies, credit unions, insurance companies, investment brokers, and real estate offices offer suggestions on budgeting, saving, investing, and other aspects of financial planning. These organizations frequently offer booklets, financial planning worksheets, Web sites, and other materials and information.

Courses and Seminars

Colleges and universities offer courses in investments, real estate, insurance, taxation, and estate planning to enhance your knowledge of personal financial planning.

Civic clubs and community business organizations often schedule free or inexpensive programs featuring speakers and workshops on career planning, small-business management, budgeting, life insurance, tax return preparation, and investments. Financial institutions and financial service trade associations present seminars for current and prospective customers and members.

Exhibit 1–A Personal Financial Planning Periodicals

The area of personal finance is constantly changing. You can keep up with changes by reading the following periodicals. You can subscribe to them, read them at your school or community library, or access them on the Internet.

CA Magazine
277 Wellington Street West
Toronto, ON M5V 3H2
www.camagazine.com

Canadian Business
777 Bay Street, Fifth Floor
Toronto, ON M5W 1A7
www.canadianbusiness.com

Canadian MoneySaver
P.O. Box 370
Bath, ON K0H 1G0
www.canadianmoneysaver.ca

The Globe and Mail
444 Front Street West
Toronto, ON M5V 2S9
www.globeandmail.com

IE:Money
25 Sheppard Avenue West, Suite 100
Toronto, ON M2N 6S7
www.iemoney.ca

Maclean's
777 Bay Street
Toronto, ON M5W 1A7
www.macleans.ca

MoneySense Magazine
156 Front Street West
Toronto, ON M5J 2L6
www.moneysense.ca

National Post
300–1450 Don Mills Road
Don Mills, ON M3B 3R5
www.nationalpost.com

Personal Finance Software

Personal computer software is available to help you perform a variety of personal financial planning activities, from selecting a career to writing a will. These programs help you analyze your current financial situation and project your future financial position. Specialized computer programs are also available for conducting investment analyses, preparing tax returns, and determining the costs of financing and owning a home. Remember, a personal computer cannot change your saving, spending, and borrowing habits; only *you* can do that. However, your computer can provide fast and current analyses of your financial situation and progress. For information about the latest software, visit a computer store or read the articles and advertisements in magazines, such as *PC Computing*, *PC Magazine*, *Computer Life*, *Windows*, *Family PC*, and *Home PC*.

SPREADSHEETS

A spreadsheet program, such as Excel or Lotus 1-2-3, can assist with various financial planning tasks. Spreadsheet software can store, manipulate, create projections, and report data for such activities as

- Creating budget categories and recording spending patterns.
- Maintaining tax records for different types of expenses, such as mileage, travel expenses, materials and supplies, and business-related costs.
- Calculating the growth potential of savings accounts and investments.
- Monitoring changes in the market value of investments.
- Keeping records of the value of items for a home inventory.
- Projecting needed amounts of life insurance and retirement income.

MONEY MANAGEMENT AND FINANCIAL PLANNING PROGRAMS

Integrated financial planning programs can help you maintain home financial records, create a budget, observe spending patterns, write cheques, keep tax records, select and monitor investments, and project retirement needs. The most popular of these software packages are

Microsoft Money
Microsoft
1-800-668-7975
(www.microsoft.com/money)

Quicken
Intuit
1-888-829-8684
(www.quicken.ca)

TAX SOFTWARE

Each year, the software available to prepare tax returns becomes more helpful. Besides preparation and printing of the various forms and schedules, programs include tax-planning tips (with audio and video clips), audit warnings, and the ability to file your tax return electronically. The most readily available tax software includes

Quicktax
Intuit
1-888-829-8684
(www.intuit.com/canada)

Hometax
CCH Canadian Limited
1-905-624-0303
(www.hometax.com)

INVESTMENT ANALYSIS PROGRAMS

Software designed for researching, trading, and monitoring an investment portfolio is also available. Most of these programs may be connected to online services to obtain current stock quotes and to buy and sell investments.

The World Wide Web and Personal Financial Planning

The World Wide Web makes it possible to access more information from your home or office than libraries offer. You may use the Web for a variety of personal financial planning activities, including (1) researching current financial information; (2) obtaining programs to do financial planning calculations; (3) monitoring current stock and investment values; and (4) asking questions of experts and others through help lines, bulletin board services, and discussion forums. Some of the most useful Web sites providing current information on various personal finance topics include:

- *Canadian MoneySaver* magazine at www.canadianmoneysaver.ca; *IE:Money* magazine at www.iemoney.com; and *MoneySense* magazine at www.moneysense.ca.
- Current consumer price index and inflation information from Statistics Canada at www.statcan.ca.
- The Quicken Web site at www.quicken.ca.
- Information on Bank of Canada activities and publications at www.bank-banque-canada.ca.
- Investing information at www.webfin.com.

Additional Web sites are offered at the end of each chapter in the "Creating a Financial Plan."

Using Search Engines

A search engine is a Web site that allows you to locate information related to specific topics. Some of the most commonly used search engines include

www.altavista.ca
www.ca.msn.com
www.Canada.com
www.overture.com
www.searchCanada.ca
www.webcity.ca
www.webcrawler.com
www.yahoo.ca

Search engines operate in different ways and provide various features. Some search engines look for topic areas; others seek specific words. When conducting Web searches, be precise with your descriptive words. For example, use "mortgage rates" instead of "interest rates" to obtain information on the cost of borrowing to buy a home. Use "résumés" instead of "career planning" for assistance on developing a personal data sheet.

Financial Planning Specialists

Various specialists provide specific financial assistance and advice:

- *Accountants* specialize in tax matters and financial documents.
- *Bankers* assist with financial services and trusts.
- *Credit counsellors* suggest ways to reduce spending and eliminate credit problems.
- *Certified financial planners* coordinate financial decisions into a single plan.
- *Insurance agents* sell insurance coverage to protect your wealth and property.
- *Investment brokers* provide information and handle transactions for stocks, bonds, and other investments.
- *Lawyers* help in preparing wills, estate planning, tax problems, and other legal matters.
- *Real estate agents* assist with buying and selling a home or other real estate.
- *Tax preparers* specialize in the completion of income tax returns and other tax matters.

Many of these specialists offer services that include various aspects of financial planning. A financial planner's background or the company he or she represents is a good gauge of the financial planner's principal area of expertise. An accountant is likely to be most knowledgeable about tax laws, while an insurance company representative will probably emphasize how to use insurance for achieving financial goals.

WHO ARE THE FINANCIAL PLANNERS?

Many financial planners represent major insurance companies or investment businesses. Financial planners may also be individuals whose primary profession is tax accounting, real estate, or law. Financial planners are commonly categorized on the basis of three methods of compensation:

[1] **Fee-only planners** charge an hourly rate that may range from $75 to $200, or may charge a fixed fee of between less than $500 and several thousand dollars. Other fee-only planners may charge an annual fee ranging from .04 percent to 1 percent of the value of your assets.

[2] **Fee-and-commission planners** earn commissions from the investment and insurance products purchased and charge a fixed fee (ranging from $250 to $2,000) for a financial plan.

[3] **Commission-only planners** receive their revenue from the commissions on sales of insurance, mutual funds, and other investments.

Consumers must be cautious about the fees charged and how these fees are communicated. A recent study revealed that more than half of financial planners who told "mystery shoppers" that they offer "fee-only" services actually earned commissions or other financial rewards for implementing the recommendations made to their clients.

DO YOU NEED A FINANCIAL PLANNER?

The two main factors that determine whether you need financial planning assistance are (1) your income, and (2) your willingness to make independent decisions. If you earn less than $40,000 a year, you probably do not need a financial planner. Income of less than this amount does not allow for many major financial decisions once you have allocated for the spending, savings, insurance, and tax elements of your personal financial planning.

Taking an active role in your financial affairs can reduce the need for a financial planner. Your willingness to keep up to date on developments related to investments, insurance, and taxes can reduce the amount you spend on financial advisers. This will require an ongoing investment of time and effort; however, it will enable you to control your own financial direction.

When deciding whether to use a financial planner, also consider the services he or she provides. First, the financial planner should assist you in assessing your current financial position with regard to spending, saving, insurance, taxes, and potential investments. Second, the financial planner should offer a clearly written plan with different courses of action. Third, the planner should take time to discuss the components of the plan and help you monitor your financial progress. Finally, the financial planner should guide you to other experts and sources of financial services as needed.

HOW SHOULD YOU SELECT A FINANCIAL PLANNER?

You can locate financial planners by using a telephone directory, contacting financial institutions, or obtaining references from friends, business associates, or professionals with whom you currently deal, such as insurance agents or real estate brokers.

When evaluating a financial planner, ask the following:

- Is financial planning your primary activity, or are other activities primary?
- Are you licensed as an investment broker or as a seller of life insurance?
- What is your educational background and formal training?
- What are your areas of expertise?
- Do you use experts in other areas, such as taxes, law, or insurance, to assist you with financial planning recommendations?
- What professional titles and certifications do you possess?
- Am I allowed a free initial consultation?
- How is the fee determined? (Is this an amount I can afford?)
- Do you have an independent practice, or are you affiliated with a major financial services company?
- What are sample insurance, tax, and investment recommendations you make for clients?
- My major concern is ______________________________. What would you suggest?
- May I see a sample of a written financial plan?
- May I see the contract you use with clients?
- Who are some of your clients whom I might contact?

Also, make sure you are comfortable with the planner and that the planner can clearly communicate. This type of investigation takes time and effort; however, remember that you are considering placing your entire financial future in the hands of one person.

HOW ARE FINANCIAL PLANNERS CERTIFIED?

Currently, there are few regulations governing financial planners in Canada. A financial planner may be a professional lawyer, accountant, investment adviser, insurance salesperson, mutual fund specialist, or none of the above. Financial planners are bound by the same statutes and common law that apply to anyone selling services. They must perform their work with due care, and they cannot misrepresent their work or their qualifications. Financial planners should be willing and knowledgeable enough to call on an expert when advanced knowledge or licensing is required to meet the client's needs.

The Canadian Securities Administration (CSA) offers the Financial Planning Proficiency Exam (FPPE). The full-day exam includes multiple-choice questions in the morning session and essay-style questions in the afternoon portion. Anyone who uses such terms as *planner*, *consultant*, or *adviser* in combination with *wealth*, *retirement*, *money*, or *financial* has to pass the FPPE. They also need two years of industry experience and have to commit to a continuing education plan.

The following organizations and agencies can be contacted for further information about certification and regulation of financial planners:

- *The Canadian Institute of Financial Planning* offers six correspondence courses leading to the designation of Certified Financial Planner (CFP) (www.mutfunds.com/cifp)
- *The Canadian Association of Financial Planners* (www.cafp.org)
- *The Canadian Securities Institute* offers a Professional Financial Planning course (www.csi.ca)
- *The Life Underwriters Association of Canada* offers a course of studies that leads to the CFP designation
- *The Institute of Canadian Bankers* offers programs in personal finance
- *The Canadian Association of Insurance and Financial Advisors* (www.caifa.com)