Personal Finance 7th edition Madura Solutions Manual

SKU: 9780135173091-SOLUTIONS

Chapter 1
Overview of a Financial Plan

■ Chapter Overview

Every individual and family needs to develop a financial plan to make the best use of resources to achieve financial goals. Financial planning will help them clarify their goals and ensure that spending, financing, and investing decisions are aligned with those goals.

Chapter 1 discusses the benefits of financial planning. Sound financial planning enables you to create greater wealth over time and it also helps you make career decisions that have a lasting impact on your finances. Several types of financial decisions are listed with two individuals making different decisions about choice of major and college. Students will understand how to make their own financial planning decisions, judge the advice of financial advisers, and evaluate the career of financial adviser.

This chapter also focuses on how the choice of career and skills you develop on the job impact your income level. Organizations pay workers based on their qualifications and how those qualifications fit the organization's needs. Personal finance skills transfer well to the job market. Discipline, initiative, and self-management skills developed through sound financial planning are all skills that employers demand.

In addition, this chapter briefly discusses the six component plans that makeup the overall financial plan. These components are budgeting and tax planning, managing liquidity, planning and financing large purchases, protecting wealth and income through various types of insurance plans, investing money, and retirement and estate planning. Different life events quite often necessitate a change in the financial plan and goals.

Each component of a financial plan impacts cash inflows and outflows, and all the components are interrelated. Understanding these relationships is the key to creating and following a personal financial plan. Your budget identifies cash inflows and outflows and helps determine liquidity needs. Your financing decisions determine monthly payments and protecting your wealth requires cash outflows, both of which feed back into your budget. Investments and retirement planning require living today on less than you earn in order to have funds for future consumption (i.e., to invest today).

Creating a financial plan requires six steps. First, an individual must establish financial goals. Once these are established, the individual must consider his or her current financial position. Next, alternative plans that could help achieve the goals should be identified and evaluated. At this point, one plan should be chosen and implemented. In the final two steps, the individual evaluates his or her financial plan and revises it as needed.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

■ Chapter Objectives

The objectives of this chapter are to:

- Explain how personal finance enhances your wealth.
- Explain how personal finance enhances your job marketability.
- Identify the key components of a financial plan.
- Explain how financial planning affects your cash flows.
- Outline the steps involved in developing your financial plan.

■ Teaching Tips

1. Discuss this quote with students: "Most people don't plan to fail; they fail to plan." Ask students for examples of situations (financial or otherwise) where they have seen this happen. Guide the discussion toward financial matters.
2. Compare financial planning to planning a trip.

Steps in Financial Planning	Steps in Planning a Trip
Set goals	Decide where you are going
Determine your current financial position	Locate your home on the map
Identify and evaluate alternative plans	Identify and evaluate alternate routes
Choose and implement a plan	Pick a route and start the journey
Evaluate plan	Is the trip going smoothly?
Revise plan as needed	Road construction causes major delays, so you pick an alternate route

A financial plan is just a financial road map.

3. Many younger students have difficulty in recognizing the benefits of devising a financial plan now and saving for the future at a young age. The compounding of money can be easily demonstrated using the "Rule of 72." The Rule of 72 can be used as an indicator of how long it will take a single sum of money to double in value at a given interest rate or rate of return percentage. The length of time is calculated by dividing 72 by the interest rate. For instance, at 8% a sum of money would double every nine years. Provide this example for students:

   What if your parents had been able to invest $1,000 at 8% the day you were born?

Age	Value of Investment	Age	Value of Investment
0	$ 1,000	45	$ 32,000
9	2,000	54	64,000
18	4,000	63	128,000
27	8,000	72	256,000
36	16,000	81	312,000

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

This concept can also be used further to determine the rate of return necessary to achieve a financial goal by simply dividing 72 by the number of periods available to reach the financial goal. This answer will provide the percentage return needed to reach that goal. For instance, you want to have $10,000 for a down payment on a house in nine years. Currently, you have saved $5,000. You would need a return of 8%. Other considerations, such as amount of risk to be taken, would then also need to be assessed, but this is a quick tool to make preliminary estimates.

4. Have students develop a written set of goals. Suggest a minimum of two goals for each time frame—short-, intermediate-, and long-term goals. One of the short-term goals should be achievable by the completion of the course. Remind students that goals need not only to be written but also should include a definitive dollar amount, should be monitored, and should be assessed periodically to determine the progress toward overall life goals. Evaluate the students' goals to ensure that they are realistic given their anticipated income from their future profession.

5. Teams—At the beginning of the semester/class, divide students into teams of three to five students. In many chapters, these teams can be used to discuss concepts and issues and to review quantitative materials and quizzes.

6. Discuss with students that goals are not stagnant. They change as an individual's life changes. If you marry or have a child or change your career or job, for example, you should review and perhaps modify your financial goals. Changes in the economic environment can affect the achievement of financial goals positively or negatively. The last decade, unfortunately, had negative effects on most consumers' financial goals, including delaying the purchase of a house, retiring, or changing careers, etc. Encourage students to share their family experiences relative to loss of jobs, foreclosures, postponing or eliminating education plans, etc.

7. A good team exercise to introduce the members to each other and to generate discussion is to distribute a "financial goals/interests" questionnaire. Each member of the group gives an answer, which is recorded on the questionnaire. This discussion readily shows how different people are in their approach to their finances, and how important it is to know each other's financial goals in a relationship.

   Sample questions:

   How much will you need annually to live comfortably in retirement?

   How much do you need for an annual clothes budget?

   What percentage of your income do you intend to save?

   What type of vacation do you envision on an annual basis?

   Will you support your children through college?

   How much do you need to spend to have a nice dinner at a restaurant?

   Do you believe in using credit cards for long-term purchases, or do you believe you should pay the balance in full each month?

   Do you need a new car, or are you content with used cars?

8. Survey the class by a show of hands: Which job would you accept?

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

Job #1—35 hours per week with a beginning salary of $75,000. It is everything you do NOT like to do. You get four weeks of vacation.

Job #2—60–70 hours per week with a beginning salary of $25,000. It is everything you ever dreamed of doing in a career, but you receive only one week of vacation.

After a show of hands, ask several students why they chose the job they did. This usually generates animated discussion of different value systems.

9. Have each student look up three different jobs they are interested in pursuing. Go to the Occupational Outlook Handbook and research job demand and salaries for each job. Does this information impact their job choice?

10. Search the Web for "CNN Money Essentials." There are seven major categories with 29 personal finance lessons to help your students learn various personal finance topics. Encourage the students to use this resource. Spend a few minutes going over the "Goals" lesson listed under "Getting Started."

11. What does the phrase "Keeping up with the Jones" mean? Discuss how peer pressure can affect your personal finances.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

■ Answers to End-of-Chapter Review Questions

1. Personal financial planning is the process of planning your spending, financing, and investing in order to optimize your financial situation. A personal financial plan involves decisions about financial goals and describes the spending, financing, and investing plans necessary to achieve those goals.

2. Applying personal finance skills can help you increase your wealth in numerous ways. For example, identifying financial goals and writing down steps needed to achieve those goals increase the likelihood that you will accomplish your goals. Understanding the time value of money and employing budgeting techniques to increase savings early on helps you amass wealth over time.

3. Different careers generate different levels of income initially, and over time. Careers also require varying types of credentials that can often take years to acquire. Post-high school education decisions need to combine your strengths and interests with an understanding of the costs and benefits.

4. Decisions that managers make are very similar to personal finance decisions where you analyze the costs and benefits of each decision. You are practicing self-management skills when you apply personal finance techniques. You can utilize these skills whether working for others or starting your own business. You might also decide to pursue a career in finance.

5. (1) Budgeting and tax planning
   (2) Managing your liquidity
   (3) Financing your large purchases
   (4) Protecting your assets and income (insurance)
   (5) Investing your money
   (6) Planning your retirement and estate

6. Budget planning is the process of forecasting future expenses and savings. It involves evaluating your current financial position by assessing your income, your expenses, your assets, and your liabilities. Until you know what money you spend on it will be impossible to forecast all of your expenses. Many of you will be surprised when you find out how much you spend on eating out or snacks.

7. Your net worth is your assets (what your own) minus your liabilities (what you owe). You can measure your wealth by your net worth, and budgeting strategies can help you increase your net worth and thereby your wealth. For example, you can build your net worth by setting aside part of your income to invest in additional assets or reduce your liabilities.

8. Income is influenced by education and career decisions. If expenses are not accurately estimated, it may be difficult to reach savings goals. Many financial decisions are affected by tax laws, such as certain types of income being taxed at a higher rate than others. Knowledge of tax laws allows you to make more favorable choices.

9. Liquidity means having sufficient funds to cover short-term cash deficiencies. In managing your liquidity, you consider money management and credit management. Money management means deciding how much money to retain in liquid form and how much to invest. Credit management deals with the decisions you make on the amount of credit to use to support your spending.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

10. Most people do not have the saving available to purchase big ticket items such as a house or a car. Therefore, in order to acquire these items they must borrow money, or finance these items, and repay it over time.

11. The primary objective of investing is to use funds not needed for liquidity purposes to earn a high return. Most investments also carry an amount of risk. Potential investments include stocks, bonds, mutual funds, and real estate.

12. A plan to protect your assets requires insurance planning, retirement planning, and estate planning. Insurance planning involves determining the types of insurance you need such as health, automobile, and life. Insurance reimburses you for damages to your assets, limits your exposure to potential liabilities, or protects your income. Retirement planning involves determining how much money you should set aside each year for retirement. Retirement planning must begin well before you retire so that you can accumulate sufficient money to invest and use after you retire. Estate planning is the act of planning how your estate will be distributed after you die. Effective estate planning can protect your wealth against unnecessary taxes and ensure that your wealth is distributed to your family in the manner that you desire.

13. Budgeting focuses on the relationship between your income (cash inflows) and spending (cash outflows). Liquidity management focuses on depositing excess cash or obtaining credit if you are short on cash. Financing focuses on obtaining cash to support large purchases. Protecting your assets focuses on using some of your cash to purchase varying types of insurance. Investing focuses on using some of your cash to build wealth. Planning your retirement and estate dictates the wealth that you will accumulate by the time you retire and its distribution before or after your death.

14. (1) Establish your financial goals.
    (2) Consider your current financial condition.
    (3) Identify and evaluate alternative plans that could achieve your goals.
    (4) Select and implement the best plan for achieving your goals.
    (5) Evaluate your financial plan.
    (6) Revise your financial plan.

15. Your goals will influence the amount of money and the timing you need to achieve the goals. If goals are not realistic, they will be very difficult to accomplish, and you will become discouraged and lose interest in planning. Short-term goals are those to be accomplished in less than a year such as saving $500 for Christmas gifts. An intermediate goal takes from one to five years to accomplish, such as paying off a three-year note. A long-term goal takes more than five years to accomplish; an example is saving for retirement in a set number of years.

16. Some factors that might affect your current financial position are: your level of debt, your marital status and family responsibility, your age and level of wealth accumulated, your career choice, and your level of education.

17. Your goals are where you want to be, and your current financial position is where you are. Your alternative financial plans will "map" how to get from one position to the other. However, for goals to be effective they must be realistic. In most cases saving 50% of your income is not a realistic goal.

18. Once you have developed and implemented a plan, you must monitor it. Monitoring the plan will ensure that you are following the plan and that the plan is working as intended.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

19. You may find you need to revise the plan to make it more realistic. In addition, your life circumstances and financial condition may change. As your financial conditions change, your goals may change, especially as the result of specific events such as graduating college, getting married, or the birth of a child.
20. Online resources may be from credible sources or they may present false or misleading information. Also, you need to understand that free personal finance advice found online does not necessarily apply to everyone's personal situation.
21. You should change your plan because your goals may be unrealistic due to the weaker economic conditions.
22. Consumer spending is reduced during a weak economy, so the demand for the products or services produced in a new business might be limited. Thus, the business might not achieve a sufficient level of sales to survive.
23. Peer pressure can cause you to make impulse purchases and spend beyond your means. This in turn impacts your ability to save and invest for future needs.
24. College tuition rates vary significantly depending on a number of factors such as whether it is a public or private university. Some tuition totals for a four-year degree can reach $200,000. In addition to the cost, you need to focus on schools that have good programs for the major you have selected.
25. Different careers vary widely with respect to lifetime earnings. Since one of the primary determinants of your financial plan is income, it is extremely important to select a major (i.e., career) that should generate enough income to achieve your goals.
26. Ricardo will need a career that generates enough income to achieve his goal of traveling. If you review Exhibit 1.7 you will see that there are several careers that will combine his interests with his personal goal and provide the income needed to travel. Ricardo might also decide to revise his personal goal of seeing the world to one that is less expensive.
27. You can opt to live at home and attend a nearby university or college, attend a public school instead of a private school, or attend a two-year community college and then transfer to another institution to finish your degree after earning an associate's degree.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

■ Answers to Financial Planning Exercises

1.

Julia's income		$1,800
Julia's expenses		
Rent	$650	
Utilities	100	
Car payment	210	
Dental	150	
Groceries (($60 × 52)/12)	260	
Miscellaneous	150	
Total expenses		1,520
Available for savings: ($1,800 – $1,520)		$ 280

2.

Increase in car payment	= $ 115
Increase in insurance	= 60
Opportunity cost	= $175 per month that could not be used for savings, other purchases, etc.

3. Net worth is the difference between assets and liabilities:

$$\$3,000 - \$500 - \$135 = \$2,365$$

4. Lakynn added $960 to her assets and lowered her cash assets by $600 for a plane ticket, so her new net worth is:

$$\$4,500 + (\$80 \times 12) - \$600 = \$4,860$$

5. Purchasing a tablet computer for $500 will not change her net worth since she reduces cash by $500 but added an asset worth $500. If she invests the money at 4% she will have $520 at the end of the year. $500 × 1.04 = $520.

6. Mason's cost = $47,000 × 4 = $188,000 and Kage's costs = $7,700 × 4 = $30,800. Mason will owe $157,200 more than Kage upon graduation. ($188,000 − $30,800 = $157,200.)

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual

Ethical Dilemma

7. a. No. Larry's goal should be to assist Sandy and Phil in reaching their goal. The numerous transactions that he recommended are resulting in a decrease in their portfolio, which will hardly help them to reach their goal.

   b. Yes. Students need to be aware that stockbrokers are sales people and work on commission. Therefore, the more transactions, the more commissions and the higher the broker's income is.

   Note to Instructor: The instructor may wish to have the students research the name of this practice, which is churning. They may also wish to have the students research the legal aspects of churning.

■ Financial Planning Online Exercise

a. Mint pulls all your financial information together into one site and automatically updates your information as it changes.

b. You can set up Mint to access your bank accounts, investment accounts, credit card accounts, and even loans you have taken out.

c. Mint lists low cost sources for credit cards, loans, insurance, and other financial products. Mint will also show the highest interest bearing accounts for you to stash your savings and also show you ways to improve your credit score.

■ Answers to Questions in The Sampsons—A Continuing Case

1. The Sampsons should give first priority to a new car for Sharon, because her existing car is possibly not safe and will likely require more repairs in the future. The children will not be going to college until at least 11 years from now, so saving for college education can wait until after the Sampsons purchase a new car.

2. The Sampsons could monitor the amount of money saved each month and determine whether it met their goal of saving $1,000 per month. If their savings is less than $1,000, they could assess their cash outflows in that month to determine how their money was spent. This may help them determine what cash outflows could be reduced in the future to meet their savings goal.

Copyright © 2020 Pearson Education, Inc.

Personal Finance 7th edition Madura Solutions Manual