

Managing your finances

Getting started - some basic ideas

There are certain elements common to all kinds of financial planning whether it involves running a business, running our own lives or running the country. The difference is only in the detail of the application not in the basic ideas. Here we'll go through these basic building blocks and, in other primers, we'll see how they apply.

Firstly, we must recognise just how important being in control of our finances is. Nobody in their prime wants to be doing their accounts or thinking about money for the pure fun of it. The reason we do it is not because we want to make ourselves feel miserable but, in fact, the reverse.

Knowing what we're doing with our money, where it's going, whether or not we're spending it wisely, actually liberates us rather than constrains us. It means that we're in control. It means we're aware of problems before they hit us and it means we can take action before it's too late.

More and more we're being asked to take responsibility and control of our own lives, in an ever more complicated, demanding and fast changing world. We're expected to think about education costs, housing costs, health costs, pension costs and a host of other things over a time span that covers pretty well the whole of our adult lives. And we're likely to have to do this in an environment where the career we start out on is unlikely to be the one we finish up with. So how do we go about it?

Money is a scarce resource

Except for, possibly, a very small number of people on this planet just about every person or organisation can lay claim to having more ideas for what they can spend money on than they actually have money to spend. So what are we supposed to do about that? Where does this lead us? Well, it leads us into various possibilities.

Many years ago, one of my very first work colleagues when confronting his wife with the fact that they needed to economise was told, in no uncertain terms, "The economies will come from

you earning more!" So that is one solution, increase the income side of the equation and more will be available for spending. That is not always possible in the short term but can be done. For example, we may take a second job while saving for a deposit on a property. We may look at our investments and make them more productive.

Other possibilities will be to review our level of expenditure and possibly to cut back, or to decide on priorities or to review the timing of our spending and phase the items in as we can afford them. So how do we do this?

Objectives

The value of planning and of developing objectives in a rational and logical way cannot be over-emphasised. There'll be short term objectives, like living a comfortable and enjoyable life and saving for holidays, there'll be medium term objectives like buying a house and supporting our children and their education, and there'll be very long term objectives like building up a pension pot for our retirement including thinking about how long we want to work for and what kind of lifestyle we want to enjoy. All of these should be thought about and given priorities and placed in the context of the careers or businesses that we're trying to build up.

At this stage of our planning we may not be able to put precise numbers on many of the items but we can at least be thinking about them and thinking when they are going to figure in our calculations, and their significance. We're at the beginning of a long journey and we're merely trying to decide where we'd like to get to.

Options and Choices

Once we've got our objectives clear in our minds we can start to think about the options we have. There may be various ways of reaching our ultimate goals. Or we may not be able to do everything, certainly not all at once, and so we have some choices to make. But at least now we're trying to stay in control of the situation rather than running haphazardly in all directions.

For some things we may think that we have very little in the way of options but it's surprising how few this really is. What we do need is a way of evaluating one alternative course of action from another and being able to choose, that is make a decision, sometimes rational sometimes less so.

Choices and decisions

In financial decision making many kinds of techniques have been developed to help us make decisions but they all boil down to the one question.

"Do the benefits of doing a particular thing outweigh the costs of doing it?" In other words, "Is it worth it?"

If the benefits are going to outweigh the costs then we go ahead with the decision. If not, then we reject the option or we try to find ways to achieve the benefits but at a lower cost. The problem lies in identifying the benefits and the costs and most of the time we will not be able to quantify either of these very precisely. That, in itself, doesn't matter; our conclusion could be very subjective, as long as we're trying to think through the situation.

In analytical terms a decision is a choice between two alternatives. So whenever you have to make a decision, that is ask yourself "Shall I do this?" you must ask yourself the next part of the question, "Rather than what?" Then you will find that the issues fall neatly into place.

Example 1

"Would you like a new dishwasher?"

"Yes please"

Try again

"Rather than what?"

"A romantic weekend away?"

Example 2

"Would you like to spend £74 going on a 3 hour speed awareness course?"

"No thanks."

Wrong answer! Try again.

"Rather than what?"

"Rather than a conviction, a £60 fine and 3 points on your licence."

"Yes please."

Planning

We're now in a position to put together some financial plans. There'll be different kinds of plans. There'll be long term plans that at this stage can only be directional and will not be very detailed in financial terms. There'll also be detailed budgets dealing with only short term horizons, maybe the year ahead, and these we'll spend a lot of time thinking about and preparing.

It may be that when we have put together our plan or our budget it simply doesn't work. Perhaps we're planning to spend more money than we've got, in which case we'll have to review matters and see what can be done. The Chancellor has to do this, big business has to do this and individual households have to this. And the remedies are similar in all cases. We could look to increase our income, we could look to reduce or re-phase our expenditure, we could borrow or we could sell some assets. We must review and adjust our plans until they make financial sense.

Operation, Control and Evaluation

Once we have a plan we can now start working to it knowing that we have thought about it carefully and, if we follow it, we should end up achieving our goals and being in a sound financial state. We need to check against it regularly, possibly monthly in the case of a budget, when we receive our bank statements and credit card bills, and see if we're meeting our financial targets. If all is going to plan then we can continue on our way. If not, and we're overspent, then we'll have to find ways of getting back on track.

Risk

Any form of forecasting and planning involves trying to see into the future and so is inherently risky. Furthermore, there'll be risks associated with the kinds of ventures which we undertake or the kinds of investments which we put our money into. Prudent financial planning, therefore, involves considering some of these risks and trying to minimise the impact they may have or, at least being aware of the consequences if they take place. There may be risks associated with the certainty or otherwise of our jobs. There may be risks associated with unexpected inflation, or price rises or interest changes. There may be risks associated with the possibility of ill health or bad weather.

Whatever they are, if we're to plan for a smooth ride then we should take them into account. Some things we may choose to formally insure against. In other cases it may be best not to live life right up to the limit but to have a contingency or a bit of slack built into our financial plans so that we can absorb at least some of the smaller shocks without being thrown off course.