Budgeting Basics

Budgeting lies at the foundation of every financial plan. It doesn't matter if you're living paycheck to paycheck or earning six-figures a year, you need to know where your money is going if you want to have a handle on your finances. Unlike what you might believe, budgeting isn't all about restricting what you spend money on and cutting out all the fun in your life. It's really about understanding how much money you have, where it goes, and then planning how to best allocate those funds. Here's everything you need to help you create and maintain a budget.

Budgeting

Do you know why a budget is so important? On the surface it seems like creating a budget is just a tedious financial exercise, especially if you feel your finances are already in good order. But you might be surprised at just how valuable a budget can be. A good budget can help keep your spending on track and even uncover some hidden cash flow problems that might free up even more money to put toward your other financial goals.

For most people, the word "budget" conjures up thoughts of penny-pinching and the unpleasant task of crunching numbers. This couldn't be further from the truth. A budget is at the cornerstone of a solid financial foundation, regardless of your situation, and it isn't that hard to do.

What is a Budget?

A budget is nothing more than a breakdown and plan of how much money you have coming in and where it goes. Could you imagine a business becoming successful if it didn't keep track of its income and expenses? The same holds true when it comes to your personal finances. If you don't know how much money you have coming in and where it goes, your road to financial success will be a difficult one.

The biggest fear that most people have when creating a budget is that they will need to suddenly cut back on all of the fun spending -- things like the occasional coffee or dinner out, movie night, or even the trip to grandma's for the holidays. While you may find that you do need to cut some spending after putting together a budget, without actually sitting down and creating one, it is impossible to know what expenses need to be cut, if any.

Creating a budget may not sound like the most exciting thing in the world to do, but it is vital in keeping your financial house in order. Before you begin to create your budget it is important to realize that in order to be successful you have to provide as much detailed information as possible. Ultimately, the end result will be able to show where your money is coming from, how much is there and where it is all going.

Creating a Budget

Here's How:

Gather every financial statement you can. This includes bank statements, investment accounts, recent utility bills and any information regarding a source of income or expense. The key for this process is to create a monthly average so the more information you can dig up the better.

Record all of your sources of income. If you are self-employed or have any outside sources of income be sure to record these as well. If your income is in the form of a regular paycheck where taxes are automatically deducted then using the net income, or take home pay, amount is fine. Record this total income as a monthly amount. Of course, if you're married, be sure to include your spouse's income as well. In addition to your regular pay, you'll want to also include any other sources of income you may have, such as dividends, interest, a side business, and so on.

Create a list of monthly expenses. Write down a list of all the expected expenses you plan on incurring over the course of a month. This includes a mortgage payment, car payments, auto insurance, groceries, utilities, entertainment, dry cleaning, auto insurance, retirement or college savings and essentially everything you spend money on. After you've listed your fixed monthly expenses, it is time to dig deeper to find out where the rest of your money goes. Take out your checkbook or pull your latest bank statement to help you with this step. Jot down how much you spend on things like utilities, groceries, entertainment, subscriptions, and so on.

Break expenses into two categories: fixed and variable. Fixed expenses are those that stay relatively the same each month and are required parts of your way of living. They included expenses such as your mortgage or rent, car payments, cable and/or internet service, trash pickup, credit card payments and so on. These expenses for the most part are essential yet not likely to change in the budget.

Variable expenses are the type that will change from month to month and include items such as groceries, gasoline, entertainment, eating out and gifts to name a few. This category will be important when making adjustments.

Total your monthly income and monthly expenses. If your end result shows more income than expenses you are off to a good start. This means you can prioritize this excess to areas of your budget such as retirement savings or paying more on credit cards to eliminate that debt faster. If you are showing a higher expense column than income it means some changes will have to be made.

Make adjustments to expenses. If you have accurately identified and listed all of your expenses the ultimate goal would be to have your income and expense columns to be equal. This means all of your income is accounted for and budgeted for a specific expense.

If you are in a situation where expenses are higher than income you should look at your variable expenses to find areas to cut. Since these expenses are typically essential it should be easy to shave a few dollars in a few areas to bring you closer to your income.

Review your budget monthly. It is important to review your budget on a regular basis to make sure you are staying on track. After the first month take a minute to sit down and compare the actual expenses versus what you had created in the budget. This will show you where you did well and where you may need to improve.

Traits for Budgeting Success

Once you're taken the time to create a budget, now it's time to make sure you follow it. Budgeting can be like going on a diet—you start with good intentions, but after a few weeks or months you drift away from your plan. Don't let that happen to you.

Creating a budget isn't incredibly difficult, but where most people fail is trying to maintain the budget. It usually starts with good intentions, but just like dieting, it doesn't take much to derail your entire plan.

Here are a few basic traits that will ensure budgeting success.

A Positive Attitude

Without a doubt, you need to go into the budgeting process with a positive attitude. If you think of budgeting as a chore, or that you are sacrificing something, you'll find it is extremely difficult to keep at it.

Don't think of the negative aspects of a budget, but think about the rewards. If you stick to your budget, what will you achieve? You may get out of debt sooner, you might be able to save money for a family vacation, or even be able to stash more money away for retirement or your child's education. Whatever your financial goals are, you need to focus on the budget as a tool to reach these goals.

Stay Motivated

Building on the positive attitude, you need to maintain motivation. What can happen over time is that you get into the habit of following your budget, and it all becomes routine. If you lose that motivation, you become complacent.

To become motivated again, consider rewarding yourself, or even increasing your goals. You need to find something that will push you to go the extra mile. If your goal was to have that credit card paid off in eight months and you've been plugging along just fine, challenge yourself to pay it off in seven months. If you do, reward yourself with something you'd enjoy.

The feeling of accomplishing your financial goals is intoxicating, so if you can continue to push yourself to reach these goals, you'll be able to maintain the excitement and motivation needed to keep at it.

Keep Realistic Expectations

One of the biggest budget killers is unrealistic expectations. If you set your sights too high, you only become discouraged when you fail to reach them. While it is admirable to try and accomplish great things, you need to set goals that are challenging, yet realistic.

One way to do this is to start fairly small with short timeframes. If you create smaller bite-sized goals over the coming months, you can see how likely you are to accomplish them, then, build upon those goals to set your sights a little higher. This is not only a great way to stay motivated, but it also helps keep your goals manageable.

Try Using Cash to Keep Your Spending Under Control

If you are struggling to stay within your budget or seem to spend more money than you should, it might be a good idea to go back to using cash for daily purchases. It is no surprise that most of us are beginning to move away from cash for everyday spending; the convenience of debit and credit cards is very tempting. Some cards actually offer rewards or cash back that makes the use of cash even less appealing. The problem with this convenience is that you can begin to forget the true value of the money you are spending and end up having trouble staying within your limits.

How Cash is Different

This is where using cash can help. When your everyday transactions are done by swiping a card you don't physically see the money change hands. I'm sure everyone knows what spending $2.00 on a cup of coffee feels like but the fact you only see this number in the form of a receipt or on the cash register display doesn't have the same effect has reaching into your wallet or purse and physically handing the money to someone else.

The problem lies within the way we think about money in each scenario. When you use an electronic form of payment you are only restricted by the amount of money in the bank or the available credit on the card. So throughout the week when you are spending money on groceries, gas, the morning coffee or lunch out with co-workers you don't realize how much each small purchase is adding up unless you are balancing your checkbook immediately after each purchase.

On the other hand if you were to use cash for these same purchases you would have a clear idea of the consequences of this spending without even thinking about it. If you started the week with $40 in your wallet and began to use that for all of your purchases you would see this $40 turn into $35, $25, $10 and so on. You are reminded of how much you have spent and how much money you have left every time you look in your wallet. This alone can make you think twice before making a purchase.

Try it for Yourself

Take a week or two and give this a try to see what effect it has on your everyday spending. Before your regular routine on Monday create a budget for how much money you will need throughout the week. If you regularly buy lunch out, count that, or if you stop for coffee on the way to work be sure to include that as well.

Once you have a pretty good idea of how much money you will spend throughout the week you should have that much cash on you at the start of the week. Whether this is $20 or $100, only have the amount of cash that you have budgeted with you and use this cash for all of those everyday expenses.

After one week how did you do? Did you find that you had money left over or did you have to pack a sack lunch on Friday because you spent your last dollar on Thursday? Regardless of the outcome you have a very real sense of where your money is going throughout the week and because of this you can now put together a realistic and meaningful budget. Convenience can be costly but cash can help you regain control of spending.

Deterrents to Budgeting Success

How Overspending Can Break Your Budget

The main reason to create a budget is to help you keep your finances under control by keeping track of how much money you're spending and where it goes. When you begin to stray from your budget it's usually because of spending too much money somewhere. But if you have a budget that tells you exactly how much you're supposed to spend, why is it so easy to overspend? There are a number of reasons we overspend, so when you understand what causes overspending, you can help put a stop to it and keep your budget on track.

To build wealth and reach financial independence, you simply need to spend less than you earn. It is an easy concept to understand, but why is it so difficult? To answer this question, you need to examine the roots of overspending. When you know what factors drive your spending, you can fight back and save money so that you can spend less than you earn.

Easy Access to Credit

For most people, this is the biggest reason for overspending. Just take a look in your mailbox and you'll quickly see why. People are flooded with credit card, mortgage, auto loan, and refinancing offers on a daily basis. Oftentimes, simply filling out the short form or jumping on their website will be all it takes to obtain a new line of credit.

It can almost feel like free money. They send you a card with a $2,000 limit, so it is easy to think that you now have access to more money. While you do have access to this additional credit, the real problems start when you're charging things that you don't have the cash to pay for. It is all too easy to think about the small monthly payments instead of the total purchase price.

Easy Access to Cash

Remember the days when you had to get a paper check from your employer, make a trip to the bank to deposit it, and then keep cash on hand or write checks? Those days are long gone, and most people have access to their bank account 24 hours a day. This can be dangerous.

When you had to rely on keeping enough cash on hand or carefully balance your checkbook each day, the act of spending money meant you had to do a little planning and some simple math. Now, all you have to do is swipe your debit card like you would a credit card and the funds are electronically whisked out of your account. When you aren't physically handing someone money or a check for a purchase, it can almost feel as if you aren't spending money at all.

Misusing Credit Cards

Credit cards can be a great tool when used properly. In the early days, these cards typically required that you paid the balance in full each month. This came in handy as you could make purchases without using your own cash and then repay it all at the end of the month. Effectively, this is an interest free short-term loan. When used as intended, this can be a powerful financial tool.

The problem is when you begin to let the balance carry over from month to month. If you make a $200 purchase on your credit card and find out that at the end of the month you can't afford to repay the full amount, you've started down a slippery slope. It may start with good intentions while you promise yourself that you'll have enough next month, but more often than not, that doesn't happen.

This is when the high interest rates on the cards really begin to hurt you. The card company makes the minimum payment due a very small amount, which means that you can afford to make the payment, but if you continue to pay the minimum, you'll end up spending the next 20 years paying off that original purchase and spend more on interest than the cost of the original item. That is no way to build wealth.

Giving in to Temptation

Have you ever had a friend or co-worker come up to you and suggest a fun activity? Everyone loves going out and having a good time, but you have to make sure that it is in your best financial interest. We all need to enjoy life, but it is important to know when to decline. It can be easy to simply go out to eat or to the movies and just pay for the evening with your credit card, which if you don't pay off in full each month means you'll be paying for that evening for a long time.

Don't squander your financial future for a few guilty pleasures today if it isn't in your budget. If you know that you can't afford an activity, don't cave in. Instead, invite your friends over for a dinner party, game night, or some other activity where you can still enjoy time together, but without breaking your budget.

Spending to Feel Good

Let's face it—buying yourself something feels good. Whether it is a new pair of shoes, the hottest new video game, or even a good book—we all enjoy getting something new. There is absolutely nothing wrong with this, as long as you don't go overboard.

This is where it can pay to set aside a little "fun money" in your budget. Take a few dollars out of each paycheck and tuck it away for times like these. You'll feel good about your purchase whether you make it with cash or by credit card, but you'll feel even better when you don't have to spend the next two years trying to pay it off with 20% interest.

The Bottom Line

You should now have all of the information needed to help you create your budget. So, go ahead and total up your monthly income and all of your monthly expenses. Subtract your expense total from your income total and you'll have either a positive or negative number. If you have a positive number, congratulations, you are spending less than you earn. Don't worry if you have a negative number. The whole reason for creating a budget is to identify deficiencies and find out how to address them.

Now that you can visually see how much you fall short, you can adjust your spending or saving in certain areas to improve the situation. Oftentimes you'll realize that by just making a few small adjustments to your spending habits, you can significantly improve your situation. Maybe this means cutting back on one of your magazine subscriptions, eating out one time less a month, or even just hitting the matinee instead of the prime time movie. Typically, just saving a few dollars here and there can be enough to not only make sure you spend less than you earn, but also apply a few extra dollars to things like high-interest credit card debt or your retirement savings.