

Personal Finance: Turning Money into Wealth, 6e (Keown)
Chapter 2 Measuring Your Financial Health and Making a Plan

2.1 Using a Balance Sheet to Measure Your Wealth

1) Insolvency results from taking in more than you consume financially.

Answer: FALSE

Diff: 2

Topic: Net Worth

AACSB: 7. Reflective thinking skills

2) In some cases insolvency can lead to bankruptcy.

Answer: TRUE

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

3) Net income is used in calculating one's networth.

Answer: FALSE

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

4) The house that you are leasing from the landlord is a good example of a tangible asset that you would list on your balance sheet.

Answer: FALSE

Diff: 2

Topic: Assets

AACSB: 3. Analytical skills

5) Current liabilities are those that can typically be paid off in full within twelve months.

Answer: TRUE

Diff: 1

Topic: Liabilities

AACSB: 3. Analytical skills

6) To determine your level of net worth, subtract your liabilities from your positive net equity.

Answer: FALSE

Diff: 2

Topic: Net Worth

AACSB: 3. Analytical skills

7) Before you can hope to achieve your financial goals, you will need to first measure your current financial health and develop a plan and a budget.

Answer: TRUE

Diff: 1

Topic: Nothing Happens Without a Plan

AACSB: 7. Reflective thinking skills

8) When measuring your current financial condition it is important to create

- A) positive net worth.
- B) a personal balance sheet.
- C) an income statement.
- D) positive net income.
- E) both B and C are required.

Answer: E

Diff: 2

Topic: Balance Sheet

AACSB: 3. Analytical skills

9) Assets that you purchase for the purpose of accumulating wealth to satisfy your financial goals are called

- A) monetary assets.
- B) intangible assets.
- C) investment assets.
- D) all of the above are correct.

Answer: C

Diff: 3

Topic: Balance Sheet

AACSB: 3. Analytical skills

10) Liabilities are best described as

- A) monetary items of value that you own.
- B) financial debts and obligations that you owe.
- C) your net worth.
- D) assets that depreciate over time.
- E) intangible obligations.

Answer: B

Diff: 1

Topic: Liabilities

AACSB: 3. Analytical skills

- 11) Fair market value refers to
- A) what an asset could be sold for today.
 - B) what you paid when you purchased an asset.
 - C) what an asset will be worth at some point in the future.
 - D) how the price of an asset has changed since its original purchase.

Answer: A

Diff: 2

Topic: Fair Market Value

AACSB: 3. Analytical skills

- 12) The common thread among investment assets is
- A) they are purchased for the purpose of generating wealth.
 - B) they are purchased for one's personal use, like a vehicle or residence.
 - C) they provide the necessary liquidity in case of an emergency.
 - D) they must be easily turned into cash with little or no loss in value.

Answer: A

Diff: 2

Topic: Assets

AACSB: 5. Dynamics of the global economy

- 13) You know you are insolvent when
- A) your expenses exceed your income.
 - B) your assets are less than your liabilities.
 - C) your net worth is negative.
 - D) your debt ratio is too high.
 - E) both B and C above

Answer: E

Diff: 3

Topic: Balance Sheet

AACSB: 3. Analytical skills

- 14) Which of the following are not typically found on a balance sheet?
- A) monetary assets
 - B) mortgage interest payments
 - C) current market value of home
 - D) interest earned on a CD at the bank.
 - E) both B and D are not found on a balance sheet.

Answer: E

Diff: 2

Topic: Balance Sheet

AACSB: 3. Analytical skills

15) One of the following items would not go on a balance sheet. Which one is it?

- A) current balances owed on your utility bills
- B) credit card balance owed
- C) mortgage payment paid
- D) automobile loan balance
- E) student loan balance

Answer: C

Diff: 2

Topic: Balance Sheet

AACSB: 3. Analytical skills

16) Which financial planning document should you use to measure your current financial position?

- A) budget
- B) cash budget
- C) balance sheet
- D) income statement
- E) statement of financial ratios

Answer: C

Diff: 2

Topic: Balance Sheet

AACSB: 3. Analytical skills

17) Items on the balance sheet that represent amounts owed to others are termed

- A) assets.
- B) liabilities.
- C) revenues.
- D) expenses.
- E) none of the above

Answer: B

Diff: 2

Topic: Liabilities

AACSB: 3. Analytical skills

18) When including an asset like a car on your balance sheet

- A) list its value as given in a blue book or site like www.edmunds.com.
- B) list the original purchase price of the vehicle.
- C) list the amount it would cost to purchase a new model of this vehicle.
- D) none of the above

Answer: A

Diff: 1

Topic: Blue Book

AACSB: 3. Analytical skills

19) A physical asset, such as furniture or a car, is called a(n) _____.

- A) tangible asset
- B) financial asset
- C) investment
- D) liability
- E) none of the above

Answer: A

Diff: 2

Topic: Assets

AACSB: 3. Analytical skills

20) Explain what goes on a balance sheet and its uses.

Answer: A personal balance sheet consists of three parts: assets, liabilities, and net worth. Assets include the value of monetary assets, investments, retirement plans, housing, automobiles, personal property, and "other" assets. Liabilities consist of current bills, credit card debt, housing, automobile loans, and "other" debt. Your net worth consists of the part of your assets that are clear and free of debt. It is found by subtracting liabilities from assets. The balance sheet is a useful tool to see your current financial position. It is a good barometer to gauge your financial net worth over time by comparing quarters or years. It also supplies the numbers needed for developing financial ratios to determine your financial health against common standards.

Diff: 1

Topic: Balance Sheet

AACSB: 7. Reflective thinking skills

2.2 Using an Income Statement to Trace Your Money

1) The interest charge on your credit card statement should be listed on your personal income statement as a variable expense.

Answer: TRUE

Diff: 3

Topic: Income Statement

AACSB: 3. Analytical skills

2) An income statement tracks the amount of money you have coming in and going out over some period of time, like a month or a year.

Answer: TRUE

Diff: 1

Topic: Income Statement

AACSB: 3. Analytical skills

- 3) Your net worth, or your general level of financial worth, is found by
- A) subtracting your expenses from your income.
 - B) dividing your monetary assets by your current liabilities.
 - C) subtracting your liabilities from your assets.
 - D) dividing monthly debt (less mortgage payment) by monthly income.
 - E) subtracting current liabilities from monetary assets.

Answer: C

Diff: 1

Topic: Net Worth

AACSB: 3. Analytical skills

- 4) A personal income statement is prepared
- A) on an accrual basis.
 - B) on a cash basis.
 - C) based on actual cash flows.
 - D) only B and C above
 - E) all of the above

Answer: D

Diff: 2

Topic: Income Statement

AACSB: 3. Analytical skills

- 5) Practical uses of an income statement include
- A) determining whether you are earning more than you spend.
 - B) spotting problem areas of overspending.
 - C) determining if money is available for saving or investment.
 - D) knowing where your money is going.
 - E) all of the above

Answer: E

Diff: 2

Topic: Income Statement

AACSB: 7. Reflective thinking skills

- 6) An expenditure over which you have no control and are obligated to make is a
- A) repeating expenditure.
 - B) fixed expenditure.
 - C) constant expenditure.
 - D) long-term expenditure.
 - E) contractual expenditure.

Answer: B

Diff: 1

Topic: Expenditures

AACSB: 3. Analytical skills

- 7) An expenditure that you can control over time and that you can manage is a(n)
- A) variable expenditure.
 - B) fixed expenditure.
 - C) constant expenditure.
 - D) short-term expenditure.
 - E) adjustable expenditure.

Answer: A

Diff: 1

Topic: Expenditures

AACSB: 3. Analytical skills

- 8) Which of the following might be found on an income statement?
- A) wages and salaries
 - B) interest and dividends
 - C) income taxes paid
 - D) payroll taxes paid
 - E) all of the above

Answer: E

Diff: 2

Topic: Income Statement

AACSB: 3. Analytical skills

- 9) How would an income statement benefit one in creating a financial plan?
- A) Determine whether one is earning more than one spends.
 - B) Spot problem areas of overspending.
 - C) Determine if money is available for saving or investment.
 - D) Know where one's money is going.
 - E) all of the above

Answer: E

Diff: 2

Topic: Income Statement

AACSB: 7. Reflective thinking skills

- 10) Which type of expenditure would probably be the hardest for an individual to track?
- A) credit card
 - B) cash
 - C) checks written
 - D) automatic payments
 - E) direct deposits

Answer: B

Diff: 2

Topic: Expenditures

AACSB: 7. Reflective thinking skills

11) Which of the following would be included on a personal income statement?

- A) Your 401K balance
- B) Buying a flat-screen TV on credit
- C) Making a payment to your credit card company
- D) All of the above

Answer: C

Diff: 3

Topic: Cash Flows

AACSB: 3. Analytical skills

12) If your liabilities are greater than the value of your assets you are considered

- A) unstable.
- B) bankrupt.
- C) insolvent.
- D) unbalanced.

Answer: C

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

13) A statement that records where your money has come from and where it has gone over some period of time is called a(n)

- A) income statement.
- B) balance sheet.
- C) statement of net worth.
- D) none of the above

Answer: A

Diff: 2

Topic: Income Statement

AACSB: 3. Analytical skills

14) An expenditure over which you have control, are not obligated to make, and may vary from month to month is call a _____ expenditure.

- A) fixed
- B) variable
- C) liquid
- D) vacillating
- E) none of the above

Answer: B

Diff: 1

Topic: Expenditures

AACSB: 3. Analytical skills

15) An expenditure over which you have no control, are obligated to make, and is generally at a constant level each month is called a _____ expenditure.

- A) fixed
- B) variable
- C) stationary
- D) discretionary
- E) none of the above

Answer: A

Diff: 1

Topic: Expenditures

AACSB: 3. Analytical skills

16) Suppose that Cheryl's only assets are an automobile worth \$10,000 and a checking account with a \$5,000 balance. Her only liabilities are a student loan balance of \$2,000 and a balance of \$8,000 on her car loan. What is her net worth?

- A) \$10,000
- B) \$8,000
- C) \$5,000
- D) \$2,000
- E) none of the above

Answer: C

Diff: 2

Topic: Net Worth

AACSB: 3. Analytical skills

17) What would happen to your net worth if you sold a tangible asset you owned for \$1,000 and used the money to pay off your credit card balance for \$1,000?

- A) Since your liabilities decreased, your net worth would increase by \$1,000.
- B) Since your assets decreased, your net worth would decrease by \$1,000.
- C) Your net worth would increase by \$500.
- D) Your net worth would remain the same.

Answer: D

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

18) Claudia has \$4,500 automatically deducted for insurance from her annual salary of \$60,000. Additionally \$7,500 is deducted each year in taxes. When preparing her personal income statement, what figure should Claudia enter for her income?

- A) \$55,500
- B) \$48,000
- C) \$52,500
- D) \$60,000

Answer: D

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

19) Suppose that Doug's only assets are an automobile worth \$10,000 and a checking account with a \$5,000 balance. His only liabilities are a student loan balance of \$12,000 and a balance of \$9,000 on his car loan. What is his net worth?

- A) \$21,000
- B) \$15,000
- C) \$6,000
- D) Doug is currently insolvent.
- E) None of the above statements are correct.

Answer: D

Diff: 2

Topic: Net Worth

AACSB: 3. Analytical skills

20) Describe an income statement and its functions.

Answer: An income statement consists of three parts: income, expenses, and surplus funds. Income includes income from all sources from all parties contributing to the household. Typical expense items consist of housing, food, clothing and personal care, contributions, recreation, medical expenses, insurance, and transportation. Surplus funds tell if you have any money left over at the end of the month or if you spent more than you earned. An income statement shows an itemized list of expenditures and allows you to isolate areas where you are over spending. It is a good planning tool for budgets and income tax preparation.

Diff: 1

Topic: Income Statement

AACSB: 3. Analytical skills

21) Does how you use debt effect your net worth?

Answer: Yes, it depends on what you use your credit for. If you use credit to buy tangible assets like home furnishings, cars and real estate, then you will eventually have equity in these assets as you pay down your debt. If you use debt for daily living expenses, travel and entertainment then you have nothing of value to offset your debt or liabilities.

Diff: 3

Topic: Net Worth

AACSB: 3. Analytical skills

2.3 Using Ratios: Financial Thermometers

1) Using financial ratios helps you quickly compare and analyze the raw data found in your personal income statement and balance sheet.

Answer: TRUE

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

2) A debt ratio is aimed at determining if you have adequate liquidity to meet emergencies.

Answer: FALSE

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

3) The purpose of using financial ratios is to

A) save space on your financial statements.

B) share your financial figures with your advisors.

C) help to analyze your raw data to compare how well you are doing.

D) better understand how you are managing your financial resources.

E) both C and D above

Answer: E

Diff: 3

Topic: Ratios

AACSB: 7. Reflective thinking skills

4) Which questions do financial ratios help you answer?

A) Do I have adequate liquidity to meet emergencies?

B) Do I have the ability to meet my debt obligations?

C) Am I saving as much as I think I am?

D) all of the above

E) only A and B above

Answer: D

Diff: 2

Topic: Ratios

AACSB: 7. Reflective thinking skills

5) One's _____ is found by dividing monetary assets by current liabilities and is a good measure of liquidity.

A) Debt ratio

B) Current ratio

C) Net worth

D) Net cash flows

Answer: B

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

6) One's _____ is found by dividing total debt or liabilities by total assets.

- A) Debt ratio
- B) Current ratio
- C) Net worth
- D) Asset ratio
- E) none of the above

Answer: A

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

7) Which of the following would you calculate if you were concerned about your financial resources with regards to unplanned money emergencies?

- A) liability ratio
- B) debt ratio
- C) long-term debt coverage ratio
- D) current ratio
- E) none of the above

Answer: D

Diff: 2

Topic: Ratios

AACSB: 3. Analytical skills

8) Suppose that you wanted to calculate a financial ratio to measure your liquidity. You would most likely use the _____ ratio.

- A) debt
- B) long-term debt coverage
- C) savings
- D) current
- E) none of the above

Answer: D

Diff: 2

Topic: Ratios

AACSB: 3. Analytical skills

9) Suppose that you were trying to determine how much income was available for future monetary needs as well as for investments. You would most likely use which of the following ratios?

- A) current ratio
- B) debt ratio
- C) savings ratio
- D) total asset turnover
- E) none of the above

Answer: C

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

10) The current ratio is a measure of liquidity. What information does it tell you?

- A) It tells you how many current assets you own free and clear.
- B) It tells you how much your debt payments for the current period are.
- C) It tells you how many times you can pay off your current liabilities by using your liquid assets.
- D) It tells you what portion of your total liabilities are current liabilities.

Answer: C

Diff: 3

Topic: Rating

AACSB: 3. Analytical skills

11) Kareem currently has \$6000 in monetary assets and currently has \$2000 in current liabilities. What is his current ratio now?

- A) $2000/6000$
- B) .334 times
- C) $6000/2000$
- D) 3 times
- E) Both C and D are correct

Answer: E

Diff: 2

Topic: Ratios

AACSB: 3. Analytical skills

12) Alysha currently has \$500 in monetary assets and currently has \$5000 in current liabilities. What is her current ratio now?

- A) .100 percent
- B) .10 times
- C) 100 percent
- D) 10 times

Answer: B

Diff: 2

Topic: Ratios

AACSB: 3. Analytical skills

13) Henry currently has \$1250 in monetary assets and also has \$1250 in current liabilities. What is his current ratio?

- A) 1 time
- B) 100 percent
- C) 1 percent
- D) 0

Answer: A

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

14) Below are several people and their current ratios. If they were to lose their jobs today, which one would have more time and more choices until they find their next job?

- A) Sally has a current ratio of 0.85 times.
- B) Leroy has a current ratio of 2.5 times.
- C) Bob has a current ratio of 1 time.
- D) There is not enough information to answer this question.

Answer: B

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

15) Below are several people and their current ratios. If they were to lose their jobs today, which one would probably experience financial stress and pressures the quickest?

- A) Elmo has a current ratio of 0.5 times.
- B) Andy has a current ratio of 2.1 times.
- C) Dee has a current ratio of 1 time.
- D) There is not enough information to answer this question

Answer: A

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

16) Patty currently has \$9,000 in monetary assets. Her total annual living expenses are \$36,000 per year. She has a \$12,000 balance on her car loan and she has \$45,000 in equity in her house. What is her month's living expenses covered ratio?

- A) 1.125 times
- B) 3.75 times
- C) 3.0 times
- D) There is not enough information to answer this question

Answer: C

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

17) Jorge currently has a debt ratio of 37 percent and Jose's is 102 percent. They both have the same take home pay every month. How can we describe their current financial situation?

- A) Jorge is currently solvent.
- B) Jose is currently insolvent.
- C) Jorge probably has more money available to enjoy every month.
- D) Jose probably doesn't have much money available to enjoy every month.
- E) All of the above are true based on their ratios.

Answer: E

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

18) Hector's month's living expenses covered ratio is currently 0.25 months. He just broke his leg and will not be able to work for 6 weeks. What most likely will Hector experience without a paycheck for 6 weeks?

- A) He may have to liquidate some of his tangible or investment assets to keep current on his monthly bills
- B) He doesn't have to worry because he has plenty of money in his savings accounts.
- C) He may have to borrow some money to keep current on his monthly bills
- D) There is not enough information to answer this question.
- E) Both A and C are realistic possibilities for Hector.

Answer: E

Diff: 3

Topic: Ratios

AACSB: 7. Reflective thinking skills

Hector and Maria Montez

Hector and Maria Montez are trying to figure out their current financial health. They have listed the following items from their most recent statements. They will pay off their car loan in three years. Their gross household income is \$3,800 per month. They receive \$75 month in interest income from their investments.

Savings account: \$1,200
Checking account: \$800
Credit card balance: \$1,000
Car loan balance: \$12,000
Car market value: \$8,000
Furniture; market value: \$2,000
Stocks and bonds: \$10,000

19) What is their current net worth?

- A) \$13,000
- B) \$22,000
- C) \$9,000
- D) \$35,000
- E) \$(13,000)

Answer: C

Diff: 3

Topic: Balance Sheet

AACSB: 3. Analytical skills

20) Assuming that they have no current bills other than those that are listed, what is their current ratio?

- A) 0.59 times
- B) 2000/1000
- C) 2 times
- D) Both B and C are correct
- E) Not enough information available

Answer: C

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

21) What is their debt ratio?

- A) 169 percent
- B) 1.69 times
- C) 0.59 percent
- D) 0.59 times
- E) 2 times

Answer: C

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

22) What is their month's living expenses covered ratio?

- A) 2 months
- B) 2.44 months
- C) 1.69 months
- D) 0.5 months
- E) Not enough information to answer this question

Answer: E

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

23) What questions do financial ratios help answer?

Answer: By calculating your current ratio you can answer the question, "Do I have adequate liquidity to meet emergencies?" Debt ratios answer, "Do I have the ability to meet my debt obligations?" "Am I saving as much as I think I am?" is answered by the savings ratio.

Diff: 2

Topic: Ratios

AACSB: 7. Reflective thinking skills

24) How do you calculate the current ratio, debt ratio, and savings ratio?

Answer: Current ratio is calculated by dividing the total of current assets by the total of current liabilities. A ratio of 1.0 will get you by, but a ratio of 2.0 or more is preferred. The debt ratio is determined by dividing total debt or liabilities by total assets. The savings ratio is found by dividing the income available for savings and investment by income available for living expenses.

Diff: 1

Topic: Ratios

AACSB: 3. Analytical skills

25) Explain the relationship between the debt ratio and insolvency?

Answer: The debt ratio shows the relationship between your assets or how much you own and your liabilities or how much you owe. Your assets minus your liabilities leaves your net worth. If your debt ratio is a fraction below 1.0, then your assets are larger than your debt leaving you solvent with positive net worth. If your debt ratio is larger than 1.0, then your debt is greater than your assets leaving you insolvent with negative net worth.

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

26) A financial ratio by itself is of little value. To what can you compare your financial ratios to make them very valuable financial planning tools?

Answer: Financial ratios can be compared to historical ratios, projected or budgeted ratios and expert advice or industry averages. If I knew my savings ratio for 2009 was 6 percent and my savings ratio for 2012 is 8 percent, then I know I have made an improvement in freeing up cash for savings and investment. If I budgeted my savings ratio for 2012 to be 10 percent and it is currently running at 8 percent, then I know I am not on track to meet my budgeted goals for the year. I can then analyze my income and expenditures to see why I am not on track to meet my goals or possibly my goals were not realistic based on current conditions. If my savings ratio is currently 8 percent and the experts say that the ideal or average savings ratio should be 15 percent, then I can measure how well I'm doing compared to these benchmarks and adjust accordingly.

Diff: 3

Topic: Ratios

AACSB: 3. Analytical skills

2.4 Record Keeping

1) A(n) _____ is a book or notebook or a type of document found on a computer program in which one records ones expenditures.

- A) blue book
- B) ledger
- C) cash budget
- D) income statement
- E) none of the above

Answer: B

Diff: 2

Topic: Ledger

AACSB: 4. Use of information technology

2) Which of the following will be the best type of record keeping system to use in maintaining financial records?

- A) manual method with pencil and notebook
- B) computer software
- C) the CPA's system
- D) one you will actually use
- E) Any record system out there will do.

Answer: D

Diff: 1

Topic: Record Keeping

AACSB: 7. Reflective thinking skills

3) Which type of recordkeeping system is best to use with personal finances?

- A) pencil and a notebook
- B) computerized
- C) the one your accountant suggested
- D) the one that you will use
- E) the one you did yourself

Answer: D

Diff: 2

Topic: Record Keeping

AACSB: 7. Reflective thinking skills

2.5 Putting It All Together: Budgeting

1) Having negative net income every once in a while is not such a bad thing as long as you have planned for it.

Answer: TRUE

Diff: 2

Topic: Income Returns

AACSB: 7. Reflective thinking skills

2) You have learned that a budget

A) can be pretty simple or pretty sophisticated.

B) is a process of setting spending goals for the upcoming month or year.

C) is a plan for controlling cash inflows and cash outflows.

D) includes both actual and estimated expenses.

E) All of the above are true about budgets.

Answer: E

Diff: 2

Topic: Budget

AACSB: 7. Reflective thinking skills

3) Which of the following financial documents would you use to create a financial plan?

A) balance sheet

B) income statement

C) budget

D) cash budget

E) all of the above

Answer: E

Diff: 3

Topic: Financial Planning

AACSB: 3. Analytical skills

4) Suppose that you have been operating a marketing business out of your home. It has recently expanded beyond belief. Since you have neglected your personal finances for some time, what would you do as a first step?

A) Separate your personal finances from the business finances.

B) Include your personal finances with the business finances to save time.

C) Rent a separate office for your business activities.

D) Purchase a software program to handle both your business and personal finance at the same time.

Answer: A

Diff: 3

Topic: Financial Planning

AACSB: 3. Analytical skills

5) A plan for controlling and forecasting your cash inflows and cash outflows is called a(n) _____.

- A) income statement
- B) balance sheet
- C) cash budget
- D) statement of changes in financial position
- E) none of the above

Answer: C

Diff: 1

Topic: Budget

AACSB: 3. Analytical skills

6) Leroy went shopping today and used his Visa card to buy a new sweater. He wrote a personal check to pay for a new video game. He bought some snack food using cash. Which of these purchases are difficult to track and monitor on his budget?

- A) The sweater because it costs more than what he budgeted for clothing this month
- B) The video games because he did not add a budget category for electronics.
- C) The snacks because cash transactions don't leave a paper trail.
- D) all of the above

Answer: C

Diff: 2

Topic: Budget

AACSB: 3. Analytical skills

George and Betty

George and Betty, a middle-aged couple, have watched their savings account dwindle over the years. They both make good incomes and can't understand why they aren't saving more each month. Below is their financial information to complete an income statement.

Gross monthly income: \$8,000
Income taxes withheld monthly: \$2,300
Monthly interest income from investments: \$100
Monthly insurance payments: \$700
Monthly housing expenses: \$4,500
Monthly food expenses: \$800
Miscellaneous expenses: \$400

- 7) What is George and Betty's net income?
- A) \$1,700
 - B) \$(600)
 - C) \$(500)
 - D) \$1600
 - E) Not enough information available to answer question.

Answer: B

Diff: 2

Topic: Expenditures

AACSB: 3. Analytical skills

- 8) What is their current savings ratio?
- A) 10.3 percent
 - B) negative 10.3 percent
 - C) zero
 - D) none of the above.

Answer: B

Diff: 2

Topic: Ratios

AACSB: 3. Analytical skills

- 9) George and Betty ask you for financial advice. What would you tell them to do?
- A) They should hire a Certified Financial Planner to assist them.
 - B) Nothing. With their income they are in good shape financially.
 - C) They need to live within their means.
 - D) Both A and C would be good advice for them.

Answer: D

Diff: 1

Topic: Record Keeping

AACSB: 3. Analytical skills

10) Explain the steps in developing a cash budget.

Answer: First, determine your anticipated income by referring to last year's adjusted income. Next, estimate your level of taxes to determine after-tax income available for living expenses. Add fixed and variable expense estimates together to determine your level of spending. Last, subtract living expenditures from expected take-home pay to calculate income available for savings and investment.

Diff: 2

Topic: Budget

AACSB: 3. Analytical skills

11) Tell how to implement the "envelope" budgeting system.

Answer: For those new to budgeting or those with small amounts of self-discipline, the envelope system is useful. Use a separate envelope for each major monthly expense, including one for miscellaneous, and label each with the expense name. Allocate the proper amount of money for each envelope expenditure from the appropriate paycheck/source of income. Use the money in each envelope only for its intended use and you should have enough to go around. As soon as possible, incorporate an envelope for savings and emergencies.

Diff: 3

Topic: Financial Planning

AACSB: 3. Analytical skills

2.6 Hiring a Professional

1) As long as a financial planner is certified you need not worry about his ability to provide you with the correct financial plan for your situation.

Answer: FALSE

Diff: 1

Topic: Professional Financial Planners

AACSB: 7. Reflective thinking skills

2) Which of the following is a relevant question to ask a financial planner?

A) What are your credentials and professional designations?

B) Would you provide us with references?

C) Would you show us a similar financial plan you have done for someone else?

D) Will you provide us with a written estimate of your services and their cost?

E) All of the above

Answer: E

Diff: 3

Topic: Professional Financial Planners

AACSB: 7. Reflective thinking skills

- 3) Under what conditions should people hire a professional financial planner?
- A) when they need someone to improve or validate the plan they prepared themselves
 - B) when they start receiving late payment penalties from their creditors
 - C) when it is apparent their financial planning skills are limited
 - D) when they run into complex tax or legal issues
 - E) all of the above

Answer: E

Diff: 3

Topic: Professional Financial Planners

AACSB: 7. Reflective thinking skills

- 4) What are the four choices in managing your financial affairs?

Answer: The most simple approach is to manage your finances yourself. A second choice is to jointly plan your finances with a professional planner. A third choice is to let a professional planner put your entire plan together for you. If you still want to develop your own plan you might want a professional planner to validate what you have done rather than do the planning.

Diff: 2

Topic: Financial Planning

AACSB: 7. Reflective thinking skills

- 5) Prepare a list of questions to ask a prospective financial planner you are considering.

Answer:

1. How long have you been a financial planner?
2. What are your credentials and professional designations?
3. Do you actively participate in continuing education to keep up with the times?
4. How do you keep up with the latest financial changes?
5. Will you provide us with references?
6. Will you let me see a copy of a financial plan you did for someone else in similar circumstances, of course with the name removed to preserve confidentiality?
7. Who will work with you and will the work be done by a junior staffer or a computer program?
8. How many companies do you represent?
9. How do you get paid — fee, commission, or a combination? What will it be, how often are you paid, and how will your fee be calculated?
10. Will you provide a written estimate of the services I expect and the cost of those services?

Diff: 2

Topic: Professional Financial Planners

AACSB: 7. Reflective thinking skills

6) List the benefits a professional financial planner can offer.

Answer: A financial planner has the knowledge and skills to teach you the financial axioms. The pro will be able to help you prepare balance sheets, income statements, budgets, financial ratios, as well as savings, investments, and retirement plans that are realistic from an objective point of view. A financial planner can save you much time and costly mistakes. He or she may suggest a computer software program to meet your individual needs as well as give tax advice. You want to develop a win-win situation with this person.

Diff: 2

Topic: Professional Financial Planners

AACSB: 7. Reflective thinking skills

7) The experts say that, stereotypically, a fee only financial planner is a better option than one who earns commissions on what they sell you. Why is this sometimes true?

Answer: Because of the Agency relationship and self-interested behavior, a commission earning Financial Planner may be more interested in the commissions they will earn verses what is best for your personal needs. There is the potential for them to recommend financial products that pay higher commissions to them and these products may not be best suited for your individual needs or there may be less expensive options available. A fee only planner has no incentive since their fees are not contingent on your financial decisions. They know they must do a good job for you or you will not continue with them or refer new business to them.

Diff: 3

Topic: Financial Planning

AACSB: 7. Reflective thinking skills