FOUNDATIONS FOR FINANCIAL WELLBEING

2 Introduction to Budgeting

pocketsmith

Introduction to Budgeting

‘Budget’ is derived from the Old French word bougette, originally meaning ‘little leather bag’.

So how’s your bag looking?
Neat and tidy, a clumsy mess or woefully empty?

No matter the state of your finances, this guide will take you through the need-to-knows of budgeting. What a budget is, how to set one up, and how to find strategies that work for you in order to stay on track.

What is budgeting?

Put simply, a budget is a plan for where your money is going to go — what you'll spend, what you'll save, and how you'll pay your expenses. Sounds simple, right? Well, sort of! Once your budget is set up in a way that works for you, it should feel comfortable and easy, but getting to that point can take a bit of careful attention, which is why we created this guide.

Why is it important to have a budget?

Having a budget is more important than many of us realize. The reason sticking to a budget is important is because it gives us a clear view of where our money is going. Some budgets are rigid and hands-on, others are more relaxed and laid back, but all budgets have one thing in common – they keep you accountable for your spending.

Having a budget essentially ensures that you're keeping on top of your bills and not spending more than you earn.

Living below, within or beyond your means

One of the most critical aspects of having a budget is making sure you're living within or below your means. When you're spending less than you earn, you're living below your means. When you're spending more than you earn, you're living beyond your means, and this behavior is where debt can start to accumulate over time.

A budget is the key to saving money

A well thought-out budget ensures you know what's coming in, what's going out, and what's left over for saving or investing. Without keeping tabs on where your money is going, it's hard to set money aside for saving or investing, which is why so many people struggle to build up long-term financial confidence.

The big mistake

The big mistake so many of us make is we leave savings at the bottom of our priority list.

We pay bills, we spend, and then we say we'll save what's left. But what often happens is that without planning out how much will be saved and when, there's little leftover, and this stops us making progress with our savings goals.

Savings should be our next most important priority after expenses. The trick is to pay yourself (your savings) like you pay a bill, and then spend what's leftover after that — not the other way around.

How to set up a budget

Nodding your head but wondering how to put it all into practice?
Don't stress — we've got our step-by-step guide to setting up a budget right here.

1 Work out what's coming in

Your first step is to work out your income. This will always be your starting point. Work out how much you've got coming in and how often.

If your income fluctuates you have two options:

1. Work out an average income based on your usual earning patterns, by adding up your last few months' worth of income and dividing it to get a monthly average.
2. Work out a baseline that you can reasonably rely on as your worst-case scenario, and work with that to begin with, before creating rules for anything that comes in on top of that.

2 Work out your regular expenses

Once you've got your money coming in, it's time to look at what's going out. Start with your regular expenses and costs of living.

These will be split into two categories:

1. Fixed costs — costs that stay the same every month, like rent and mortgage payments.
2. Variable costs — costs that vary month to month depending on usage, like utilities, fuel and food.

Work out how much you need to cover all your fixed expenses in each pay cycle. To do this, you'll need to work out how much from each pay needs to go towards covering all your expenses.

Example:
If you're paid weekly, but your rent is paid monthly, you'll need to set aside a portion of your weekly pay each week so that when your monthly due date arrives, your rent is ready to go.

Here are the calculations you'll need to make to get your expenses allocated to the same frequency as your pay cycle:

To pay monthly bills weekly:
Take your monthly expense, multiply by 12, and divide that by 52.

To pay weekly bills monthly:
Take your weekly expense, multiply by 52, and divide that by 12.

To pay fortnightly bills weekly:
Simply divide your fortnightly expense by 2.

To pay weekly bills fortnightly:
Simply multiply your weekly expense by 2.

To pay fortnightly bills monthly:
Take your fortnightly expense, multiply by 26, and divide that by 12.

To pay monthly bills fortnightly:
Take your monthly expense, multiply by 12, and divide that by 26.

Doing this ensures that you're paying towards all of your bills equally from each payday, so you're never left trying to pay all your expenses out of one paycheck!

We'll crunch the numbers on your variable expenses in the next step.

3 Identify your surplus

Now you've worked out how much is coming in, and how much needs to go out, we need to identify the difference between the two. This is your surplus.

1. To start with, take your income per payday that you established in Step 1.
2. Then, deduct the fixed expenses allocation you worked out in Step 2.
3. Then, we need to take off your variable expenses. The easiest way to do this is take an estimate based on your previous spending.
4. Once you've got your estimate, take that off of your total.
5. Whatever's left is your surplus, which can be allocated between spending and saving. We'll decide what to do from here in Step 5.

4 Set up your bank accounts for success

The easiest way to keep on top of your income and expenses is to compartmentalize your bank accounts. If you have your income paid into one account, and that's the same account you pay bills from, buy groceries from, save in, and make discretionary purchases from, there's a good chance you'll get confused.

At a basic level, these three accounts can help you get started:

1. Spending account – where your day-to-day discretionary spending happens.
2. Bills account – where all your expenses we worked out in Step 2 are paid from.
3. Savings account – where you stash cash separate from your spending account.

Setting up these accounts means when your pay hits, you can move your fixed expenses allocation into your bills account, put some away for savings, and leave the rest for discretionary sending knowing everything else is taken care of.

5 Decide how much you'll save and spend

At the end of Step 3, we established our surplus. This is the amount you have leftover once your bills are paid and your variable expenses are accounted for. The rest is for discretionary spending and saving — woohoo!

To decide how to split this money up between spending and saving, we need to look at how much you really need to leave for discretionary spending. This will depend on your lifestyle, and how aggressively you want to save right now.

Let's say you have $300 left after you've deducted all your expenses.

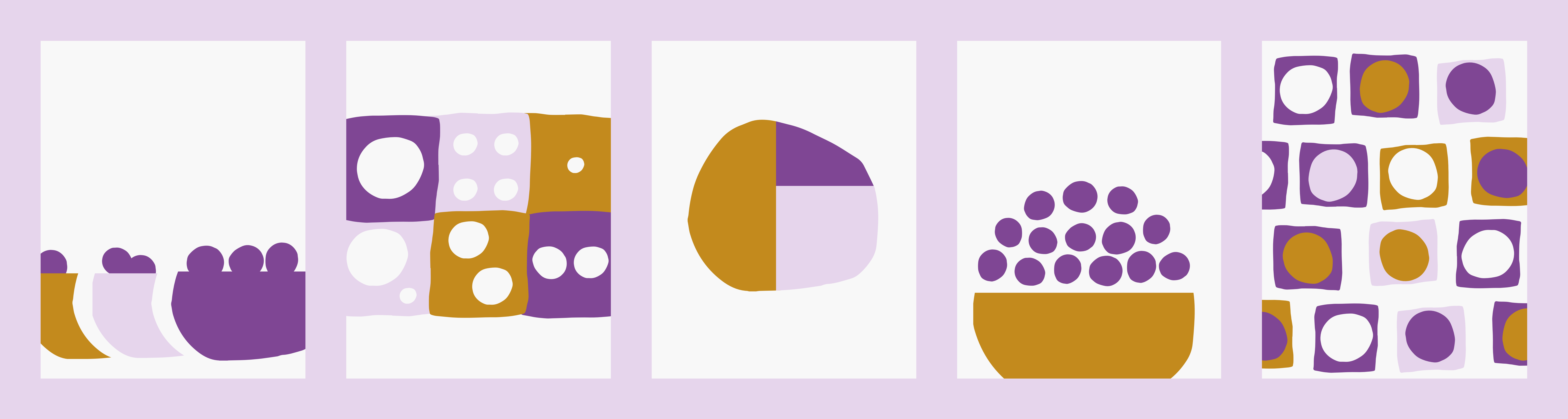
If you wanted to take saving slow and steady:
You might stash $50-$100 and leave yourself $200 for discretionary spending.

If you wanted to aggressively save:
You might save $200 and leave yourself $100 for discretionary spending.

What's important here is to be realistic when deciding how much to leave for spending. All too often we start out a savings journey with the best of intentions, and want to get things moving really quickly. To do that, we go aggressive on saving and leave ourselves very little to spend. This might work for a couple of weeks, but a bit like a crash diet, it can get tiresome — and fast.

Think carefully to establish a savings-to-spending ratio that works for you, and don't be afraid to switch it up for a bit of variety!

It can help to set a savings goal to work towards, to help keep you committed to stashing your cash each payday.



Different budgeting strategies to try

What we've just taken you through is the very foundations of what a budget does.

Essentially, it takes your income, deducts your expenses, and splits the rest between spending and saving. But there are many different ways to make a budget work for you, and finding the right one to suit your financial personality is the key to long-term financial success.

Here are a few popular methods to try:

The Barefoot Investor 'Buckets'

Scott Pape, personal finance expert and author of The Barefoot Investor, uses a bucket system, which hundreds of thousands of people have used to transform their own finances.

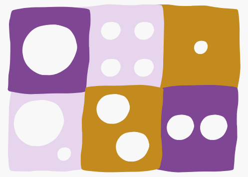
The Barefoot Buckets are three types of account where you'll put your money when it comes in:

1. Blow — This is the money you're going to spend in the short term. This is used for daily expenses, the occasional splurge, holidays, and some extra cash to fight financial fires.
2. Grow — This is your money maker. The grow bucket is where you do your investing and look for longer-term wealth building.
3. Mojo — The mojo bucket is used for your rainy day emergency savings. It's safety money for any financial emergencies that crop up.

Based on our budgeting step-by-step guide above, you can use the Barefoot Bucket system with your surplus money we established was left over after your expenses have been paid. Your blow bucket may also contain your variable expenses, and you can also set up extra buckets for specific savings goals if you prefer.

For a comprehensive rundown of the Barefoot buckets and accounts, check out this guide.

The Envelope System



The cash envelope system does, well, exactly what it says on the tin. Perfect for those who struggle not to dip into their savings via online banking, the cash envelope system sees you withdraw cash at the beginning of the week, and manually allocate different amounts into different cash envelopes.

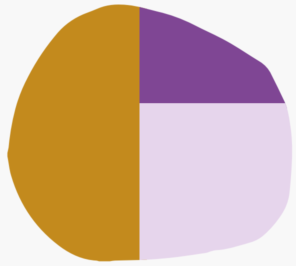
If you need help splitting your takeaway spending from your public transport fare, this system could be the one for you.

The 50/30/20 Budget

The 50/30/30 budget is a budgeting style that uses percentages to allocate your money between your wants, your needs and your savings.

The general rule of thumb is:

- 50% of your income goes to your needs
- 30% of your income goes to your wants
- 20% of your income goes to your savings



Ultimately, these percentages are yours to change as you wish. Your expenses may already be far more than 50% of your income, and that's okay. The concept of applying a percentage rule to your money is still valuable.

This tool can also be useful for those on fluctuating incomes. By applying a percentage rule to each paycheck, you ensure that you're topping up your savings and expenses categories accordingly, based on how much is coming in. What this does is stop you overspending on a higher earning period, and ensures that if more money comes in, more saving is done and more money is allocated to your bills and expenses.

Sinking Funds

Not so much a budgeting strategy as an optional add-on, but sinking funds can be incredibly helpful in spreading the cost of life's big expenses.
A sinking fund is essentially a gradual savings bucket assigned to certain things, like car repairs, a new fridge, medical expenses, or other annual costs like insurance.

You can top up your sinking funds in two ways:

1. For fixed amounts like annual expenses, you can reverse engineer your buckets and put aside a weekly/monthly amount throughout the year to eventually reach the total.
2. For more uncertain amounts like car repairs, you might decide to simply put $10 per week into that backup sinking fund, so that if those costs do arise, you've got some money there to put towards it.

Budget Cycling

Budget cycling is the perfect strategy for those who struggle with an all-or-nothing mindset. What budget cycling does is it works with the same end goal as regular static savings plans, but has you concentrate most of your savings sacrifices in one week of the month.

Example – Let's say you earn $800 per week, and have $300 left after bills and expenses.

You could either save $100 per week – so approximately $400 per month – leaving you with $200 to spend per week. That's all very well, but what if one week you've got two birthdays and want to celebrate a big win at work?

With budget cycling, you can have it all. Instead of setting that $100 per week savings amount, you save more on some weeks, and less on others.

With your $300 to play with each week, your four main weeks of the month could look like this:

Week 1: Big save week — save $250, and have a lean week at home with $50 to spend.

Week 2: Big spend week — skip saving this week and enjoy your full $300 for those birthdays and work wins.

Week 3: Somewhere in between — go 50/50 this week and save $150, and spend $150.

Week 4: Relax a little — you've already hit your $400 savings goal for the month, so you have options. You can either go ham on saving and stash some extra, or you can sit back and spend a little more. The choice is yours.

Budget cycling helps you achieve the same savings outcomes, but with more freedom to spend as you like.

Regularly reviewing your budget

One of the critical drivers of success with budgeting is consistency. It's all very well to save a certain amount each week for a few weeks, only to fall off the wagon and dip into those savings you've worked so hard for.

To stay consistent, diarize a regular review of your finances. You can do this weekly, monthly or quarterly, depending on what works best for you.

Here are some things to look out for in your reviews:

- Are you making consistent progress with your savings goals?
- Is your spending-to-saving ratio still sustainable and realistic?
- Could you make any tweaks to boost your savings?
- What have you been spending on, and are you happy with where your money is going?
- Have you started to form any habits that could keep you from achieving your financial goals?
- Have you got any extra expenses to factor into your regular allocations?
- How are your buckets or sinking funds tracking? Do you have enough for your upcoming costs?

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