

# Personal Financial Literacy

## Learning Objectives

1. To understand important concepts of personal finance.
2. To be able to apply business accounting concepts to personal finance.
3. To learn about the different ways to use assets to produce income and create personal equity and net worth.
4. To understand risk and return in evaluating investment opportunities.
5. To be able to develop a personal financial plan.

## Chapter Outline

### Personal Financial Literacy

- Definition
- Personal Income Statement
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- Personal Balance Sheet

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- The Rat Race
- Evaluating Your Personal Financial Position
- Taking Control
- Overcoming Obstacles
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### Evaluating Assets and Sources of Income

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- Ownership
- Retirement

### Summary

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Many of the business accounting concepts and methods of financial analysis that we have discussed in this book can be used in managing an individual's personal finances. This chapter discusses how these concepts can help individuals to manage their personal finances. It is often the case that parents cannot or do not teach their children about managing money effectively. Also, schools do not teach students about the fundamentals of earning and managing money. The result is that often young adults start their careers with little or no knowledge of effectively earning and managing their money.

Financial literacy is the ability to understand money—how you get it and how you use it. Unfortunately, most people don't take the time or have the opportunity to learn about managing their own money. Managing money takes financial knowledge, discipline, and a plan. Anyone can improve his or her financial position by obtaining the necessary knowledge and tools. It is important to start when young to develop and apply fundamental money management principles to enable individuals to create equity and net worth.

This chapter includes information from prominent authors and corporate programs on money management and investing. This information focuses on understanding the fundamental concepts of managing and investing money and how to develop your own personal financial plan. Two important goals are, first, to generate enough monthly income or cash flow to live as you would like and, second, to develop the knowledge and establish goals to increase your own equity or net worth. An excellent source for this information is the book *Rich Dad, Poor Dad: What the Rich Teach Their Kids about Money That the Poor and Middle Class Do Not* by Robert Kiyosaki (1997, Warner Business Books).

## Personal Financial Literacy

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### Definition

Personal **financial literacy** is the ability to know and understand the management of money to achieve personal financial and investment goals. Financial literacy is not just for the rich or people who are able to make large investments, but also for the average person who may only be able to invest in small amounts. The knowledge and principles are the same in each situation and can lead to very beneficial results.

Kiyosaki offers one rule regarding financial literacy: "You must know the difference between an asset and a liability, and buy assets. If you want to be rich, this is all you need to know. It is rule #1. It is the only rule" (p. 58). This may sound absurdly simple, but most

people have no idea how profound this rule is. Most people struggle financially because they do not know the difference between an asset and a liability.

Most adults work to receive a paycheck. This paycheck generally comes every two weeks on Friday. Retired people and some other workers get their paycheck once a month on the first day of the month. What they do with that paycheck is directly related to their understanding of fundamental money management principles.

## Personal Income Statement

We have already discussed company P&Ls for separate departments in a hotel, Consolidated P&L Statements for the total hotel, and Consolidated P&Ls for an entire company. The P&L measures the ability of a company to maximize revenues and minimize expenses. The result is maximum profits.

These same accounting concepts apply to personal finance and money management for an individual. Maximizing revenues in companies is the same as maximizing income for individuals. Unfortunately, most individuals relate their income only to the company paycheck that they receive every other Friday. These individuals completely miss the point by relying on this paycheck as their only source of income. Financially literate individuals find ways to have *additional* sources of income and do not rely only on their company paycheck. They maximize their income by developing additional sources of income other than their paycheck.

Controlling expenses is as important to individuals as it is to companies in order to maximize profitability. For individuals, it is building **equity** or **net worth** instead of maximizing profits. This means having money left over after paying expenses. In today's society, it is too easy for individuals to spend money that they do not have. Kiyosaki points out that often individuals spend all of their paychecks on expenses or liabilities. Then it gets worse. They charge more expenses on credit cards. This is very bad management of their money. First, they are spending all of their income and not saving or investing any of it. Second, they are spending more than they are earning with the paycheck they receive every other Friday by charging additional expenses on credit cards. Remember our profit formula for a business: **Revenue minus expenses equal profits**. For individuals, the profit formula is income from monthly paychecks minus monthly expenses results in equity or net worth. If people spend more than they earn, they will have no equity and a negative net worth, which is similar to a company having an operating loss instead of a profit.

Today individuals not only are spending more than they are making, *but they put the excess expenditures on credit cards!* This provides them a way to live with a loss by just putting it on plastic. The result is debt that grows rather than declines. Often the monthly credit card payments only pay the interest and do not reduce the outstanding balance. Finally, the third bad thing that many individuals are doing is paying high interest rates on their credit cards. Things are out of control! Individuals spend more than they make

and put excessive expenditures on several credit cards with high interest rates. This often leads to two people working or one person working multiple jobs just to get enough income to meet monthly expenses and make the minimum monthly credit card payments. *Notice, we didn't say that people are paying off their credit cards. We said most individuals just make the monthly payments, which goes to interest. They are never able to pay off their credit cards.* This leads to what Kiyosaki calls *the rat race*.

## Personal Cash Flow

Cash flow is the ability to maintain enough cash in your bank account or to increase the cash in your bank account so that you can cover all incurred living expenses. This primarily refers to an individual's checking account but will also include a savings account if there is one.

A *positive cash flow* means that an individual maintains enough money in her or his checking account to pay all monthly expenses without taking money out of savings or investment accounts. These individuals are earning more income than they are spending on expenses.

A *negative cash flow* means that an individual does not maintain enough money in his or her checking account to pay all monthly expenses. These individuals have to take money out of their savings or investment account or they put the excess expenses on a credit card just to take care of their monthly expenses. This means they are spending more money on expenses than they are earning with income. Again, notice that we did not say the excess pays off credit card balances. Generally, the monthly minimum only pays the interest expense or a partial payment of the total balance.

There are three main reasons that individuals cannot maintain a positive monthly cash flow. The first is that they only have one source of income—their paycheck every other Friday. The second is that they do not understand the difference between spending money on expenses and liabilities rather than investing in income-producing assets. Third, they do not have the discipline or financial knowledge to keep their monthly expenses lower than their monthly income.

## Personal Balance Sheet

Individuals have assets, liabilities, and owner equity just like businesses do. This includes both current and long-term assets and current and long-term liabilities. Too often individuals don't look at their money and finances as a business but only look at how much money they make each paycheck and how they are going to spend it or try to make ends meet.

Kiyosaki has very basic descriptions of assets and liabilities. Remember them!

*Liabilities take money out of your pocket.*

*Assets put money into your pocket.*

We all make choices of what we are going to do with the money we earn. Unfortunately many individuals get caught up in the rat race and end up trying to spread their income around to pay the monthly rent, utilities, groceries, and gas and then make the minimum monthly credit card payments. They really don't have a financial choice because they owe everyone. They have to pay on their expenses and have no money left to save or invest.

Kiyosaki's Rule #1 is to invest in assets. This means that an individual must allocate some of her or his monthly income to savings and investments (assets). Assets earn income. For example, savings accounts pay interest daily, quarterly, or annually.

Certificates of Deposit (CDs) also pay interest quarterly or annually. Investments in the stock market generally pay dividends quarterly or annually and have the potential that the stock price will go up (appreciation). However, there is also the risk that the stock price can go down. The point is that individuals that have financial literacy discipline themselves to investing some portion, even if it is only 5% or 10% of their monthly income, into assets. This gives them the opportunity to start building equity or net worth. This means they will own more than they owe.

Let's look at two examples of a college student's balance sheet during senior year. We will use March 31 as our balance sheet date.



**EXAMPLE 1**

**NO FINANCIAL LITERACY**

<u>Assets</u>		<u>Liabilities</u>	
Cash—Checking Account	\$ 100	Car Loan @ 9%	\$ 6,000
Cash—Savings Account	-0-	Student Loan @ 4%	10,000
Investments	-0-	Credit Card Debt @ 16%	5,000
Total Current Assets	\$ 100	Store Credit Cards @ 9%	<u>2,000</u>
		Total Liabilities	\$23,000
Car	\$ 8,000	<u>Equity</u>	
Furniture (mainly music/TV)	2,000	Car	\$ 2,000
Insurance Policies	-0-	Gifts from Grandparents	<u>1,000</u>
Total Long-Term Assets	\$10,000	(savings bonds)	
		Total Equity	\$ 3,000
<b>TOTAL ASSETS</b>	<b>\$10,100</b>	<b>TOTAL LIABILITIES</b>	
		<b>AND EQUITY</b>	<b>\$26,000</b>
		<b>NEGATIVE NET WORTH</b>	<b>\$15,900</b>

Because total assets must equal total liabilities and equity, the difference between the total assets of \$10,100 and the total liabilities and equity of \$26,000 is a negative \$15,900. This individual owes \$15,900 more than she or he owns and therefore has a *negative net worth* or *no net equity*.



## EXAMPLE 2

## BASIC FINANCIAL LITERACY

<u>Assets</u>		<u>Liabilities</u>	
Cash—Checking Account	\$ 500	Car Loan @ 9%	\$ 1,000
Cash—Savings Account	2,000	Student Loan @ 4%	10,000
Investments	<u>3,000</u>	Credit Card Debt @ 12%	500
Total Current Assets	\$ 5,500	Store Credit Cards @ 9%	<u>200</u>
		Total Liabilities	\$11,700
Car	\$ 5,000		
Furniture (mainly music/TV)	2,000	<u>Equity</u>	
Insurance Policies	<u>10,000</u>	Car	\$ 4,000
Total Long-Term Assets	\$17,000	Gifts from Grandparents	1,000
		Total Equity	\$ 5,000
		TOTAL LIABILITIES	
TOTAL ASSETS	\$22,500	AND EQUITY	\$16,700
		POSITIVE NET WORTH	\$ 5,800

Because total assets must equal total liabilities and equity, the difference between the total assets of \$22,500 and total liabilities and equity of \$16,700 is a positive \$5,800. This individual owns more than he or she owes and therefore has a *positive net worth* or *net equity*.

Let's look at the similarities and differences in these two examples. Both students have \$10,000 in student loans, \$2,000 in furniture, and four different liabilities. The difference is that the financially literate student has a smaller car loan, smaller credit card balances, and smaller store credit card debt. The financially literate student bought a lower-priced car and made a larger down payment, therefore resulting in a smaller car loan and monthly payment. This student has been smarter and more disciplined and therefore has larger balances in his or her checking and savings accounts. And this student has been able to develop \$3,000 in investments. *This student is investing in assets!*

These are both large and small differences, but they add up to a big difference. The student in Example 1 has a negative net worth of \$15,900, and the student in Example 2 has a positive net worth of \$5,800. The difference is \$21,700! The student in Example 2 has incurred many of the same liabilities but due to financial literacy has managed to save and invest, spend wisely, and minimize liabilities. This student has put to use Rule #1: Invest in assets. Although these investments start small, they are a beginning and have resulted in the student having a positive rather than a negative net worth. This student's asset column is growing.

Another valuable concept in the management of assets is the importance of building **principal**. Principal is the amount of money invested in income-producing assets. It is money that is **earning** money. For example, \$1,000 invested in a savings account is \$1,000 of principal that can earn **interest** or **dividends**. If the interest rate is 3% per year, this principal of \$1,000 will earn \$30 of interest per year.

There are three primary ways that principal can grow. First, an individual can contribute her or his own money to the principal each paycheck or make monthly contributions. This demonstrates Rule #1, investing in assets. Second, a company can make matching contributions to an individual's account and therefore increase the principal. *This is the most important concept to understand in creating individual wealth and personal equity—take advantage of company contributions in addition to individual contributions to increase the principal.* Third, the principal can grow if the person reinvests interest and dividends that the principal earns. The larger the principal or higher the interest or dividend rate, the faster the principal will grow.

## Managing Personal Finances

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### The Rat Race

Kiyosaki has described the rat race as individuals spending more money than they earn. They are not able to decide or control their money because they have continually overspent their income resulting in higher monthly expenses than their monthly income. They will then probably take on a second job to pay off their debts. But they use the additional income to continue spending rather than paying off their credit cards, which was their original intent—thus the rat race, which occurs when people do not have control of their money, continue to overspend, do not make progress in paying off debt, and are not able to invest in assets.

These individuals do not know about Kiyosaki's Rule #1 or they do not have the discipline to follow Rule #1. The first step that they must take to get out of the rat race is to realize that they are spending more than they are earning and that they must change their financial habits and how they use and manage money.

## Evaluating Your Personal Financial Position

Every individual establishes a pattern for earning and spending money. Until one starts learning about managing money and developing financial literacy and discipline, the person will continue to earn and spend, totally unaware of the value of saving and unable to invest in assets. Financial literacy starts with changing this pattern to a pattern of earning, investing, and then spending. The investment part comes before the spending part. People who have financial literacy and financial discipline reduce their expenditures on expenses to the amount remaining after they have invested.

Take a look at your own pattern of managing your money. Do you spend more than you earn each month? Are you unable to save or invest? Are your debts getting larger each month rather than smaller each month? Do you continually use your credit card to buy things that you do not need or cannot afford? If your answers are yes to some or all of these questions, you are caught up in the rat race!

The most important point to understand at this time is that it is never too late to learn and to start managing your money. It doesn't matter what your age is, the amount of money you make, or the amount of debt that you have. You can always learn about managing money, the need to change your spending habits, and the importance of starting to manage your money in ways that will enable you to invest, build a principal, and to be able pay all your expenses. This is called financial freedom.

## Taking Control

It is important that individuals make the effort to analyze their current financial position and then learn and apply smart money management principles. It will require discipline and a change in an individual's habits and lifestyle. But it will be worth the change as an individual regains control of her or his financial situation and has the freedom to choose how to invest and spend rather than be controlled by debt obligations. The important thing is to change, even if it is in small steps.

Kiyosaki offers six steps or lessons that will lead to financial independence and the ability to manage and control money and finances:

1. Remember that the rich don't work for money—the poor and middle class work for money, the rich have money work for them.
2. Teach financial literacy, the ability to read numbers. The rich buy assets. The poor only have expenses. The middle class buys liabilities they think are assets.
3. Mind your own business. Invest your income in assets that will earn additional income for you.
4. Learn the history of taxes and the power of the corporation.
5. Remember that the rich invent money. They understand numbers, develop investment strategies, understand the market, and understand the law.

6. Work to learn—don't work for money. Be able to manage cash flow, be able to manage systems including time, yourself, and your family, and be able to manage people.

These steps form an effective guideline for getting out of the rat race and controlling your income.

## Overcoming Obstacles

Many individuals have the knowledge and resources to build equity and net worth. Yet they never make the effort to apply their financial knowledge to building their financial resources.

Once people have studied and become financially literate, they may still face roadblocks to becoming financially independent. There are five main reasons why financially literate people may still not develop abundant asset columns. Asset columns that could produce large sums of cash flow. Asset columns that could free them to live the life they dream of, instead of working full time just to pay bills (p. 147).

Kiyosaki's five obstacles for individuals in managing their finances are the following:

1. Fear
2. Cynicism
3. Laziness
4. Bad habits
5. Arrogance

Does any of these apply to you? What are you going to do to overcome these obstacles and start to effectively manage your money?

## Getting Started

Following are Kiyosaki's activities to get an individual started and on the track to learning and gaining financial literacy. An individual can start these one at a time or work on many of them at the same time. What is important is to do each one thoroughly.

1. Have a reason to start. If not, there is no sense reading further. It will sound like too much work.
2. Choose daily—the power of choice.
3. Choose friends carefully—learn from them.
4. Master a formula, then learn a new one—continue to change and grow.
5. Pay yourself first—self-discipline.

6. Pay your brokers well—their advice and experience are worth it.
7. Be an “Indian Giver”—get something for nothing.
8. Use assets to buy luxuries—use the earnings from assets or principal to buy luxuries.
9. Don’t forget the need for heroes—look up to someone and strive to be like your hero.
10. Teach and you shall receive—share your time, resources, and knowledge and you will be rewarded.

The point that Kiyosaki emphasizes throughout his book is to take the time to learn the basics of managing money. Once financial literacy is obtained, then an individual can intelligently manage his or her money to build wealth and obtain financial freedom. Financial literacy with discipline can get people out of the rat race and in control of their finances and their lives.

## Evaluating Assets and Sources of Income

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### Company Programs

Many companies offer retirement plans (**401K accounts**) for their employees that include the company making matching financial **company contributions** to an employee’s individual retirement account. These programs are generally based on the amount of employee contributions to the 401K plan. The company will contribute anywhere from 25 cents per \$1 of employee contribution to \$1 per \$1 of employee contribution. This represents a return to the employee of 25% on a 25 cent company contribution and a 100% return to the employee on a \$1 contribution. This is the reason that company retirement programs should be the number one priority for an employee in investing in assets, increasing principal, and creating equity and net worth. Whereas returns from interest and dividends are in the 1% to 3% range, the company contribution is generally in the 25% to 100% range.

Companies can also provide stock purchase programs where employees can purchase company stock with no commission and often at a discounted price. Contributions to these plans can be made conveniently with payroll deductions that avoid commissions and other fees. This is another way for individuals to build wealth at nominal expense.

An equally important benefit that most companies provide is employee health **benefits**. This includes providing health and dental insurance at group rates which are generally lower than individual rates. Often the company will pay a small or large part of this cost, thereby reducing the amount that employees have to pay for health insurance.

Companies also might offer life insurance, disability insurance, and salary continuation to help employees when they have emergencies or accidents that require expensive medical care. It is important to take advantage of these programs because they enable employees to participate and receive these benefits at a lower cost than they could on their own.

Understanding and enrolling in these savings and benefit programs can be a significant step in the process of building wealth and staying out of the Rat Race. They not only offer significant returns or cost savings, but they also provide a convenient and disciplined way to consistently save and invest for the future. Most large companies offer these programs, so it is up to the employee to learn about them and demonstrate the financial literacy that will enable an individual to benefit from them.

## **Ownership**

In addition to company investment accounts, it is important for individuals to have their own investment or savings accounts. This is because company retirement programs are controlled by the company. They are good in that they provide both employee and company contributions. But they also have restrictions that are intended to ensure that the money is available for retirement. Therefore, access to company retirement accounts is restricted, and there are often penalties and fees for early withdrawal of money from these accounts. These company retirement or investment accounts offer a long-term component for investing.

An individual account is controlled by a person and is available to use or not use as appropriate. It offers the flexibility of saving and investing while continuing to have access to those funds as needed. The access to and control of these individual accounts should be an important part of any investment strategy. The individual has the control to make the principal increase with contributions or decrease with withdrawals. These individual investment accounts offer a short-term component for investment.

## **Retirement**

Another valuable part of financial literacy is understanding the importance of planning for retirement at the beginning of an individual's career, not at the end. It is a fact that the sooner individuals start making contributions to retirement or 401K accounts, the more money they will have working for them for when they retire. Time is in favor of those who invest early in their careers. That is because these contributions steadily increase the principal and therefore the interest that the principal earns. Equally important is the time span that the principal is earning interest, dividends, and appreciating. It is common sense that money contributed by individuals and the company over a 25-year period will be larger than over a 15-year period because it represents more money working longer!

Retirement should be a key part of any individual's investment strategy. There are so many options available to assist in achieving retirement goals. An important part of financial literacy is understanding the retirement options and programs available and choosing the best ones that match your retirement strategy. A small amount of money invested over a long period of time will result in a much larger retirement account than larger amounts of money invested over a short period of time. Knowledge and discipline are the starting points to a comfortable and satisfying retirement.

## **Summary**

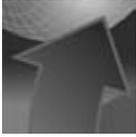
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Individuals can utilize many of the same business concepts to manage their personal finances. Financial literacy is the ability to understand and use numbers in financial planning. It is important because it gives individuals control over their finances and the freedom to be able to afford and be able to do what they want to do.

There are many books on managing personal finances. *Rich Dad, Poor Dad* by Robert Kiyosaki is one book that clearly presents the fundamentals of personal financial management. It is important that individuals take the time to learn these money management fundamentals at an early age so that they can have their money work for them rather than having them work for their money.

A key point of financial literacy is understanding the importance of investing in assets. Assets put money in your pocket. Investment assets involve building a principal amount in dollars that earns interest or dividends and contributes these earnings to increasing the principal. Liabilities and expenses take money out of your pocket and are typically what most individuals do with the money they earn from their paycheck. They lack the financial knowledge and personal discipline to invest some amount in assets before paying off liabilities and expenses.

Individuals can invest in both company and their own investment accounts. Company investment accounts such as 401Ks and retirement accounts offer the advantage of having a company contribute money to these accounts. However, they are for the long term and contain restrictions and penalties for early withdrawal before retirement. Individual investment accounts offer the advantage of ownership, flexibility, and control. They are more short term in nature and the money in these accounts is available to use when needed without penalties. A financially literate individual will take advantage of both of these types of investment accounts.



## Hospitality Manager Takeaways

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1. It is important for hospitality managers to understand the management of money so that they can take advantage of company programs and individual accounts that can help them create equity and build net worth.
2. Assets put money in your pocket; liabilities take money out of your pocket.
3. Equity is the amount of assets, primarily investments and real estate, that an individual accumulates and is not encumbered by liabilities or debt.
4. Financial literacy provides individuals with control over their money and the freedom to do what they would like to do because they have the financial resources necessary to pay for those activities.
5. Time and discipline are two key components of a strong investment strategy.
6. Retirement should be a part of an individual's investment strategy at the beginning of one's career and not at the end.



## Key Terms

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**Asset (Kiyosaki)**—Puts money in your pocket.

**Benefits**—Programs offered to employees by a company that provide savings programs to invest in and health and insurance programs at reduced costs.

**Company Contribution**—The dollar amount that a company contributes to an employee's retirement account or benefit expenses.

**Dividend**—The return on the principal invested in a company stock or mutual fund.

**Earnings**—Money that is produced from an asset in the form of dividends or interest.

**Equity**—The difference between an individual's assets and liabilities.

**Financial Literacy (Kiyosaki)**—The ability to understand numbers.

**401K Accounts**—Company long-term retirement accounts that include both employee and company contributions.

**Interest**—The return on the principal in a savings account.

**Liability (Kiyosaki)**—Takes money out of your pocket.

**Net Worth**—What an individual has in investments that are unencumbered with corresponding liabilities or debt. Similar to equity.

**Principal**—The dollar amount of money in an account that is earning interest or dividends and that has the potential to appreciate or increase as well as decrease.



## Review Questions

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1. Define an asset and a liability according to Kiyosaki.
2. Describe the Rat Race including how you get in it and how you get out of it.
3. Why are company 401K programs so important to employees?
4. Why are company benefit programs so important to employees?
5. Why is planning for retirement at the start of a career so important?
6. What is the difference between principal and interest?
7. Name the five obstacles to investing.
8. Choose three activities that are important to you in getting started.