Why most people don't budget

When I meet a prospective client, I always ask them what they spend on general living expenses. Approximately 19 out of 20 people don't know the answer to this question! Even if you're not interested in building wealth, surely you want to ensure your hard-earned money is being spent wisely – that is, that you're achieving maximum pleasure per dollar – don't you?

When I ask clients to review their expenditure, they commonly find they're spending money on things that really don't improve their enjoyment in life. They quickly realise they can eliminate these expenses without ever regretting their decision or missing these items. You can't make these decisions, however, unless you have a clear idea of where your money is going.

Also, under- and over-estimating how much you are spending on certain areas is very common. That's why you need to sit down and add it all up – this gives you a more realistic perspective. In more than 90 per cent of cases, people are surprised by the results. That proves that most of us really don't have a clue how much we are spending on certain things and categories.

Measuring your surplus cash flow

Your surplus cash flow is how much money you have left over after you pay for all expenses and outgoings. Your income is typically easy to measure or ascertain, you can simply look at your pay slips or tax return. However, expenses and outgoings can be a little more difficult to get a hold on.

Typically, I find the best way to measure your expenditure is to go over your last three months of transactions from your bank accounts and credit card statements and allocate your expenditure into seven categories.

The easiest way to do this is to download the last three months of transactions into a spreadsheet via internet banking (most banks provide this functionality). You can then sort the spreadsheet by 'description'. This will typically group similar expenses together. In a spare column, you then can enter the expense category you want the transaction to be allocated to. (I outline possible categories in the following list.) When you have allocated each expense to a category, sort the spreadsheet by category and add the total for each category. This high-level approach should be sufficient to give you a good handle on your expenditure levels and where your money is going.

The seven categories I recommend are:

1. Financial commitments – for example, rent, mortgages, car lease and child support.
2. Utilities – including costs for gas, electricity, rates, phone, water, internet and contents insurance.
3. Health and education – such as school fees, health insurance, medical expenses and child care.
4. Shopping and transport – for example, food, clothing, beauty, petrol, car maintenance and public transport expenses.
5. Entertainment – include here costs for holidays, gifts, eating out, movies and coffees.
6. Cash – include all withdrawals from ATMs. (If this figure is high, stop using ATMs and start using EFTPOS or credit cards more often because doing so makes tracking where you are spending your money much easier. Remember, you can't manage what you can't measure.)
7. Other – include here anything that doesn't fit in the preceding categories.

For further help with recording and organising your expenses, go to www.investopoly.com.au, where you can find a video that takes you through the process.

When you start to analyse your expenditure by category, no doubt you will come across non-reoccurring and/or extraordinary items. Non-reoccurring items are once-off expenses that are unlikely to reoccur in the future – such as major surgery or your child's wedding. An extraordinary item is one that is unusually high for that expense category, such as major motor vehicle repairs. It is necessary to adjust for non-reoccurring and extraordinary items by excluding them when determining your future maintainable surplus cash flow. However, if some 'lumpy' items do seem to reoccur spasmodically a few times over the year, you probably need to make an annual allowance for them. For example, if you have an old home or car that tends to require maintenance and you have had to pay for many 'once-off' breakdowns and repairs over the last few years, this is likely to be an ongoing expense.

Once you have completed this analysis you should be able to calculate what you spend each month on average. You can then work out what your annual surplus investable cash flow is – that is, income left over after paying for all expenses.

What about unforeseen expenses?

Life is full of surprises – including financial surprises – good and bad! A large bill could arise from time to time without warning or you may need to travel unexpectedly. You can accommodate or prepare for these nasty surprises in one of two ways:

1. When you allocate surplus cash flow towards an investment strategy, don't allocate all of it. For example, if a client has $2,000 of surplus cash flow per month, I would recommend that they don't embark on an investment that commits

(maybe due to borrowings) any more than, say, $1,200 per month. This leaves a buffer of $800 per month.

2. Ensure you hold cash savings equal to six months of living expenses. These cash savings can consist of savings in a bank account or extra repayments you have made into your home loan that can be redrawn if needed at any time.

The preceding two options should provide you with the necessary financial resources to weather most storms.

Perhaps a more detailed analysis might be required

Sometimes reviewing the past three months of expenses doesn't provide a reliable indication of your expenditure. This might be because the past three months have included a lot of changes or unusual expenses, or perhaps because you're surprised by the result. That is, if you review the last three months and the results show you are spending a lot more (or even a lot less) than you expected, you should review a longer period to ensure your findings are reliable. Simply select a longer period of time (say, the last 12 months) and allocate each expense. If using the spreadsheet method already described becomes a little tricky with the increased number of transactions, you can use some of the budgeting tools covered in the following section.

Budgeting tools

The Australian government's Australian Securities & Investments Commission (ASIC) operates a website called MoneySmart, which contains a number of useful calculators including a budget planner. Go to www.moneysmart.gov.au and, under the 'Calculators & resources' tab, select 'Budgeting, saving & tax calculators'. You will find the Budget Planner tool here, which allows you to track your historical expenditure using a web-based calculator