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Budgeting

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What is budgeting?

Budgeting is a process for tracking, planning, and controlling the inflow and outflow of income. It is a process that we all begin soon after we get our first spending money. Relying on our overloaded minds to manage such a complex process has many shortcomings. The solution is to analyze your current situation, determine your goals, and develop a written plan against which you'll measure your progress.

How does the budgeting process work?

The budgeting process begins with gathering the data that makes up your financial history. Next, you use this information to do a cash flow analysis. You will calculate your net cash flow, which tells you whether cash is coming in faster than it's going out, or vice versa. Then you will determine your net worth. Simply stated, this is the sum of everything you currently own less the sum of everything you currently owe. Having a snapshot of your present financial situation, you'll then define your financial objectives and create a spending plan to achieve them. Finally, you will periodically check your progress against the plan and make adjustments as needed.

Analyzing cash flow is little more than adding and subtracting

Add up your income, then your expenses, and subtract the latter from the former. The result is your net cash flow. If it is positive (hopefully), you're earning more than you're spending. If not, then budgeting is not really an optional process. You must do it to avoid losing more ground financially. To the extent that you can make cash flow strongly positive, you will be able to save for upcoming needs and investments.

Is net worth growing or declining?

Your net worth shouldn't be a mystery. To determine what it is, you simply add up the current value of your assets (the things you currently own), and then subtract the total of your liabilities (what you currently owe). The idea, if you haven't guessed it, is that your net worth should grow from year to year, barring unforeseen setbacks.

Know where you stand, turn to the future, and set your goals

You might have one or more major savings needs goals in mind, but now is the time to look at all your anticipated financial needs, including your cash reserve, and determine your goals. Knowing what all of your goals are enables you to create the best plan to achieve those objectives over the long term. While you may not be able to achieve all of your goals simultaneously, having a plan in place will help as you work toward your future goals.

Create a spending plan that fits your resources and objectives

Once you know where you stand financially and the goals you hope to achieve, you are in a position to design a plan that will move you expeditiously in that direction. You will know how aggressive you need to be in order to achieve the objectives you set, and therefore you can design a plan that fits both your resources and objectives.

Just as with a plan that falls short of delivering on your goals, a plan that is overly aggressive relative to your resources is likely to lead to budget frustration. Keeping goals aligned with objectives is a critical part of the process and essential to budgeting successfully.

Remember that it is a plan and that plans change as needed

Flexibility is always an important ingredient in the planning process. As life's circumstances change, as they inevitably will, you will need to adjust your spending plan accordingly. The important point is that the budgeting process keeps you abreast of how these changes are occurring and allows you to make changes as you find them appropriate to your needs and resources.

Budgeting can be a temporary or a permanent habit

It may be that your present financial situation calls for the short-term control that budgeting can provide. Alternatively, you may find that budgeting gives you a level of control over your finances that you'd prefer to maintain over the long term. If the latter is true, you should make it a lifelong habit.

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