

5.6: Budgets, Financial Statements and Financial Decisions

Learning Objectives

1. Describe the budget process as a financial planning tool.
2. Discuss the relationships between financial statements and budgets.
3. Demonstrate the use of budgets in assessing choices.
4. Identify factors that affect the value of choices.

Whatever type of budget you create, the budget process is one aspect of personal financial planning, a tool to make better financial decisions. Other tools include financial statements, assessments of risk and the time value of money, macroeconomic indicators, and microeconomic or personal factors. The usefulness of these tools is that they provide a clearer view of “what is” and “what is possible.” It puts your current situation and your choices into a larger context, giving you a better way to think about where you are, where you’d like to be, and how to go from here to there.

Mark has to decide whether to go ahead with the new roof. Assuming the house needs a new roof, his decision is really only about his choice of financing. An analysis of Mark’s budget variances has shown that he can actually pay for the roof with the savings in his money market account. This means his goal is more attainable (and less costly) than in his original budget. This favorable outcome is due to his efforts to increase income and reduce expenses and to macroeconomic changes that have been to his advantage. So, Mark can make progress toward his long-term goals of building his asset base. He can continue saving for retirement with deposits to his retirement account and can continue improving his property with a new roof on his house.

Because Mark is financing the roof with the savings from his money market account, he can avoid new debt and thus additional interest expense. He will lose the interest income from his money market account (which is insignificant as it represents only 0.09 percent of his total income), but the increases from his tutoring and sales income will offset the loss. Mark’s income statement will be virtually unaffected by the roof. His cash flow statement will show unchanged operating cash flow, a large capital expenditure, and use of savings.

Mark can finance this increase of asset value (his new roof) with another asset, his money market account. His balance sheet will not change substantially—value will just shift from one asset to another—but the money market account earns income, which the house does not, although there may be a gain in value when the house is sold in the future.

Right now that interest income is insignificant, but since it seems to be a period of rising interest rates, the opportunity cost of forgone interest income could be significant in the future if that account balance were allowed to grow.

Moreover, Mark will be moving value from a very liquid money market account to a not-so-liquid house, decreasing his overall liquidity. Looking ahead, this loss of liquidity could create another opportunity cost: it could narrow his options. Mark’s liquidity will be pretty much depleted by the roof, so future capital expenditures may have to be financed with debt. If interest rates continue to rise, that will make financing future capital expenditures more expensive and perhaps will cause Mark to delay those expenditures or even cancel them.

However, Mark also has a very reliable source of liquidity in his earnings—his paycheck, which can offset this loss. If he can continue to generate free cash flow to add to his savings, he can restore his money market account and his liquidity. Having no dependents makes Mark more able to assume the risk of depleting his liquidity now and relying on his income to restore it later.

The opportunity cost of losing liquidity and interest income will be less than the cost of new debt and new interest expense. That is because interest rates on loans are always higher than interest rates earned on savings. Banks always charge more than they pay for liquidity. That **spread**, or difference between those two rates, is the bank’s profit, so the bank’s cost of buying money will always be less than the price it sells for. The added risk and obligation of new debt could also create opportunity cost and make it more difficult to finance future capital expenditures. So financing the capital expenditure with an asset rather than with a liability is less costly both immediately and in the future because it creates fewer obligations and more opportunities, less opportunity cost, and less risk.

The budget and the financial statements allow Mark to project the effects of this financial decision in the larger context of his current financial situation and ultimate financial goals. His understanding of opportunity costs, liquidity, the time value of money, and of personal and macroeconomic factors also helps him evaluate his choices and their consequences. Mark can use this decision and its results to inform his next decisions and his ultimate horizons.

Financial planning is a continuous process of making financial decisions. Financial statements and budgets are ways of summarizing the current situation and projecting the outcomes of choices. Financial statement analysis and budget variance analysis are ways of assessing the effects of choices. Personal factors, economic factors, and the relationships of time, risk, and value affect choices as their dynamics—how they work and bear on decisions—affect outcomes.

Summary

- Financial planning is a continuous process of making financial decisions.
- Financial statements are ways of summarizing the current situation.
- Budgets are ways of projecting the outcomes of choices.
- Financial statement analysis and budget variance analysis are ways of assessing the effects of choices.
- Personal factors, economic factors, and the relationships of time, risk, and value affect choices, as their dynamics affect outcomes.

Exercises

Analyze Mark's budget as a financial planning tool for making decisions in the following situations. In each case, how will other financial planning tools affect Mark's decisions? For each case, create a new budget showing the projected effects of Mark's decisions.

1. Mark injures himself on the cross-trainer, and the doctor recommends a course of physical therapy.
2. A neighbor and coworker suggest that he and Mark commute to work together.
3. The roofers inform Mark that his chimney needs to be repointed (removing and replacing the decaying mortar with new mortar) and relined.
4. Mark wants to give up tutoring and put more time into his memorabilia business.
5. Mark wants to marry and start a family and needs to know when would be a good time.

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