THE YNAB WAY

Simple. Effective. Simply Effective.

Jesse Mecham, CPA

Introduction

I'm not yet desperate enough to do anything about the conditions that are making me desperate.

- Ashleigh Brilliant

Desperate

I had just emptied my savings account on an engagement ring. A few days later I blundered the proposal. Luckily, Julie said yes anyway.

It was November of 2002, and there I sat, at a computer in the university library (between the two of us, we didn't own a computer), a few minutes before taking the bus to work, (between the two of us, we didn't own a car either), wondering about the future of our financial situation. Our take-home pay was going to be approximately $1,200 per month, (between the two of us).

To make matters worse, I had seven semesters of school left to obtain my master's degree. Fortunately, Julie would be finishing her degree in the next six months in the very lucrative field of social work (you know -- investment banking, but with heart). I felt a bit desperate.

You?

I'm going to speculate that you might be having similar feelings.

And why shouldn't you? Since my story's setting is on a university campus, let's start there. The cost of obtaining a degree from a public or private institution increased 29 and 26 percent respectively, from 2000 to 2006.[1] Considering the fact that the pre-2000 price tag for higher education was already staggering, these increases are nothing to shrug off lightly.

The issue becomes more problematic when you consider the inconvenient reality that tuition bills start coming about the time you really should be worrying about your own retirement. In light of the fact that nearly half (48 percent) of all workers have total savings and investments (excluding the value of their primary residence) of less than $25,000[2], retirement starts to look less than golden.

And we've failed to mention that a sizable chunk of that "less than $25,000" is earmarked for an ever-increasing debt load. In 2004, the average credit card debt per household reached $9,312, increasing 116% over the past ten years![3]

As long as I've got you feeling upbeat about tuition costs, retirement savings, and the (your?) debt load, let's consider health care. In a report issued by the Kaiser Family Foundation we find that, "Since 2001, premiums for family coverage have increased 78 percent, while wages have gone up 19 percent and inflation has gone up 17 percent."[4]

Needless to say, it's not uncommon for things to look a little bleak.

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[1] "Average Undergraduate Tuition and Fees and Room and Board Rates Charged for Full-Time Students in Degree-Granting Institutions, by Type and Control of Institution: 1964–65 Through 2005–06." National Center for Education Statistics. Sept. 2006. US Dept. of Education, Institute of Education Sciences. 10 Jan. 2008 <http://nces.ed.gov/programs/digest/d06/tables/dt06_319.asp>.

[2] Macdonald, John. "How Much Money Do Americans Have in Savings, Investments?" Employee Benefit Research Institute. 19 Apr. 2007. 10 Jan. 2008 <http://www.ebri.org/pdf/publications/facts/fastfacts/fastfact041907.pdf>.

[3] Kelley, Rob. "Debt: Consumers Juggle Big Burden." CNN. 10 Oct. 2005. 10 Jan. 2008 <http://money.cnn.com/2005/10/07/pf/debt/debtmeasures/index.htm>.

[4] Palosky, Craig, and Larry Levitt. "HEALTH INSURANCE PREMIUMS RISE 6.1 PERCENT IN 2007, LESS RAPIDLY THAN IN RECENT YEARS BUT STILL FASTER THAN WAGES." Kaiser Family Foundation. 11 Sept. 2007. 10 Jan. 2008 <http://www.kff.org/insurance/ehbs091107nr.cfm>.

Solution

Due to the generosity of friends and family when we married, we were able to purchase our first car with cash. She was a beauty--a 1998 Chevrolet Prizm--barely used except for 90,000 miles. We also found a basement apartment to rent. It was tiny, but all utilities were paid for and the rent was only $350 per month. (I think the apartment had some issues though, as both Julie and I had constant respiratory problems the entire time we lived there ... symptoms which mysteriously disappeared when we moved out).

I was feeling particularly in control of the situation. Driven by that keen sense of desperation I felt several months before, I seized the financial reigns and set up a spreadsheet. My timing couldn't have been better: I approached Julie with my idea for a family budget while we were still undeniably in the "Honeymoon Phase" of our marriage and she consented to use my creation.

My idea was simple. Leveraging an Excel 100 course I had taken during the previous semester, I set up one massive, intimidating, color-coded spreadsheet. I planned to record everything we spent. Each of the spreadsheet's rows represented a day of the year. All of our spending and saving categories were lined up across the top. I had included the usual: groceries, textbooks, eating out, phone, gasoline, etc. The spreadsheet was beautiful to me in the way that any ordinary bit of matter is always beautiful in the eyes of its creator.

Julie played along with my experiment, we diligently recorded everything we spent, and we benefited greatly. (More on that later.)

I soon realized it would be useful to track our income and budget it in the spreadsheet. Immediately after deciding to record income and budget it each month, I ran into a problem. Julie and I both had variations in our income depending on how much time we could work for the week. Since we hadn't yet earned the money, we couldn't know how much we'd have to budget. So we decided to live off of last month's income in the current month[1]. This allowed us to know exactly how much we had to budget at the beginning of every month.

[1] This is Rule One.

As money came in during the month, it was put into what I called the next month's "Available" bucket. With that feature in place, we could sit down and plan what we wanted to do with every single one of our dollars[1]. Recording spending had been purely reactive (but excellent for raising awareness). Now we were gleaning something entirely new and helpful from our budget: the benefits of *pro*actively planning. (More on that later.)

The great thing about proactive planning? We didn't need to limit ourselves to just the coming month. We were able to foresee upcoming expenses that happened less frequently (i.e. property taxes, car insurance, life insurance, etc.) and allocate money toward each of those. When they came due, the money was there[2].

Immediately after we began to plan where our money would be spent we realized that things never went exactly according to plan. A final tweak of our budget ensured that we could easily roll with the punches and be flexible when overspending occurred[3].

We didn't truly appreciate what we had until I tried to sell it a year and a half later.

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[1] This is Rule Two.

[2] This is Rule Three.

[3] This is Rule Four.

Shortfall

One year later we found ourselves with three months to prepare for the birth of our first child. I was crunching numbers again, and again, and again.

Julie and I were both firmly committed to the idea that she would be a full-time mom, and that I would get through school as efficiently as possible. I still had four intense semesters standing between me and my diploma, so jumping into my chosen profession of accounting and actually earning an income was a ways away.

Thanks to the prior year's budgeting, we had saved a chunk of money for just this situation. The only problem was that despite my savviest calculations, I couldn't get it to work. The savings weren't going to last unless I worked full-time and went to school full-time simultaneously.

I came to the painful realization that we wouldn't earn enough money to pay for our expenses. We weren't living high on the hog either--cutting back further wasn't an option. I remember feeling resentful of the situation. I felt that we "deserved" to be able to make ends meet. We had worked so hard at recording our earnings, planning our spending, tracking our expenses, etc. and there I sat with *my* budget telling me that my plan wasn't going to work. It was a hard pill to swallow, but it finally went down.

Several weeks later we had some friends over for dinner and games. The chatter consisted of the usual among married students: school, money, how we would eventually have more money, and then what we would do with that money. Somehow, the subject of our budget came up.

The nice thing about being a broke person surrounded by similarly broke people is that money isn't a taboo subject. It seems that it is only when you have it that it becomes forbidden, (regrettably sometimes), to talk about it. We had no qualms about sharing our budget with friends. I booted up the computer (we owned one by this time) and loaded the spreadsheet.

My friend's reaction was one of bewilderment--to put it kindly. The color-coded-rainbow, mile-long spreadsheet scared the ability to respond right out of him. I had "grown accustomed to [my budget's] face", so I was offended that he didn't think it was the greatest idea--ever.

"Wow. It's really colorful," he managed.

"Yeah, well that's because each category belongs to a certain "master" category. See here? Pink means it's in the "Personal" category." If a tone could speak for itself, mine was saying, "Duh!"

He spoke honestly: "It looks confusing."

"It's really not. I can show you more some other time though," I responded.

That was the result of my first budget show-n-tell. Much needed redemption came serendipitously the next day though, when I broke out my budget for one of my good friends in the accounting program.

"Wow! This is awesome!"

That was more like the response I had hoped for!

A few other wanna-be accountants gathered around and as soon as one asked for a copy, they all echoed similar requests.

I came home that night with a solution to our income problem.

"Hey Julie, do you think I could sell the budget?"

She stopped what she was doing for a moment and thought about my question, finally responding, "I don't think so. I don't think people would buy it." She most likely chalked up the day's positive feedback to the fact that all my devotees were accounting geeks; of course they'd get googly-eyed over a spreadsheet.

Luckily, I was stubborn.

Methodology

I spent the next three months making our budget public-ready. Launched as YouNeedABudget.com (because you do) in September of 2004, sales for the first six months were meager. At best. In trying to convince people that they needed not just a budget, but *my* budget, I had explained every intricate detail of my creation. The explanation went on and on (much like this Introduction). Luckily, for my own self-confidence, some people were able to divine the potential and purchased it. (They were all probably accountants. If you're one of them and you're reading this ... thank you.)

By February of 2005, I knew I was going about it all wrong. I decided I would revamp my approach from all sides. For several days I wrote, scrapped, and rewrote the site. It ended up being a process of discovery that culminated in a unique methodology rather than just a rainbow spreadsheet. It all boiled down to Four Rules of Cash Flow:

1. Stop Living Paycheck to Paycheck
2. Give Every Dollar a Job
3. Save for a Rainy Day
4. Roll with the Punches

The Rules had been there the entire time. I just hadn't recognized them.

Now thousands of people are using this methodology (affectionately called YNAB, pronounced Y-NAB) to get out of debt, save for retirement, strengthen their marriage, and find financial contentment--regardless of income level--in much less time than they ever thought possible.

In seeing the power of these principles improve people's lives, the scope and impact of these Rules have become clearer to me. This book is my continuing discovery of the YNAB Methodology.

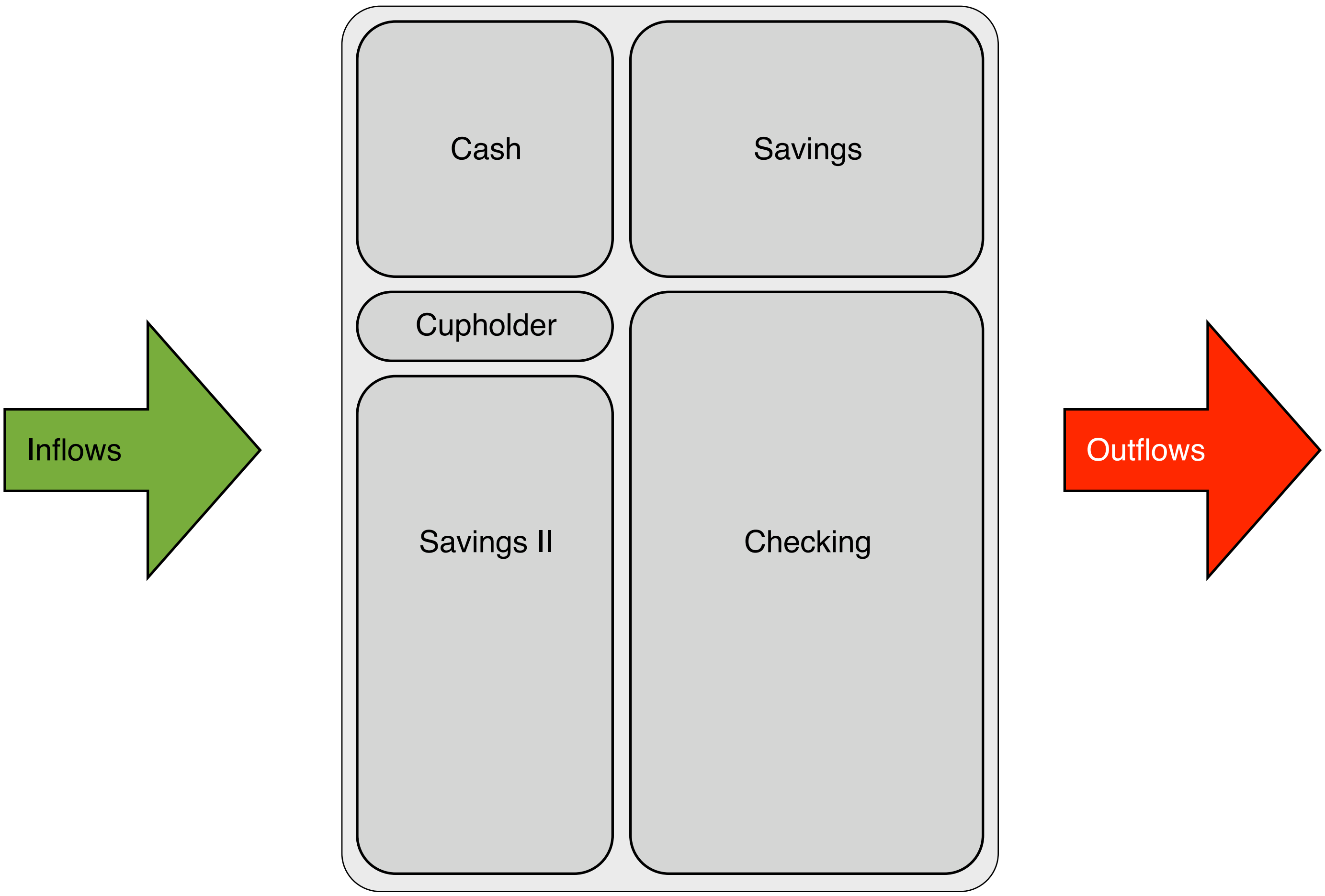
Out with the Old

If you have always done it that way, it is probably wrong.

- Charles Kettering

Old

The old (tedious, ineffective, inefficient) way of handling money is to think about your money in terms of your account balances. Money goes in, it's put into some type of account, and it goes out:



This system is old, inadequate, and inefficient. Put simply, it's a waste of time.

Under the old method, spending decisions are made based on how much money is in an account, creating a false reality which ignores large, upcoming obligations. Because these larger obligations are rarely planned for, unnecessary stress arises. It's not that we don't want to set aside money for that large tuition bill, Christmas, or our semi-annual car insurance premium...we're just pressed to use our funds earlier for something else. The apparent urgency and the designation of priorities is a tricky balance.

Using the old method, paychecks are timed to match upcoming bills. The electricity bill is due in one week...when are you paid again? Waiting to pay your bills until you have money is a necessary evil under the old method. Not only do your stress levels increase, but the amount of time necessary to “manage” your money increases as well because you’re having to focus so hard on the timing of paychecks. There’s an easier way.

Using the old method, people look to account balances to see how much money is available to spend. If there’s a habitual “spender” in a marriage, they’ll see a healthy balance and go purchase something that’s “needed”. Meanwhile, the one that pays the bills knew the electricity bill was due and already sent off the check. Do you smell that overdraft fee? Since it was the spender’s “fault”, a fight ensues and stress levels increase. As this problem becomes recurring, the spouse that does the bills decides to stick away some money somewhere else so the spending spouse won’t know its there. A noble intention right? They’re making sure the bills are paid...at the cost of integrity in the marriage. There’s a more harmonious way.

Using the old method, with the number of financial crises rising, the use of credit cards as an escape hatch is almost inevitable. As a result, debt loads increase, minimum payments increase, disposable income decreases, and stress mounts.

Using the old method, there’s never enough money to meet all obligations. As a result, important items--retirement contributions, tuition saving, and climbing out of debt-- are sacrificed at the altar of urgency. According to a study done by ACNielsen, one in four Americans say they have *no* extra money.[1]

Using the old method, our money behaves much like a teenager. Unless guided carefully, it does whatever it wants because it thinks it knows everything. As funds are frittered away, our overall contentment with money drops to discouraging levels.

With people and institutions clawing for our precious dollars at every turn, it is vital that we begin to approach the management of our money in a smart, effective, time-efficient way.

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[1] Burt, Erin. "Escape the Credit Card Trap." Kiplinger.Com. 6 Oct. 2005. 11 Jan. 2008 <http://www.kiplinger.com/columns/starting/archive/2005/st1006.htm>.

In with the New

People are very open-minded about new things – as long as they're exactly like the old ones.

- Charles Kettering

New

As with all new things, there is a tendency to resist a new money management system (though it may be a stretch to call what you've been doing previously a "system"). While we may not necessarily like how things are, we certainly don't want to bother with something new. New means learning, focus, studying, and reading. New inherently means change and the possibility of feeling lost. New has a touch of the unknown, and we're scared of that.

New also means progress.

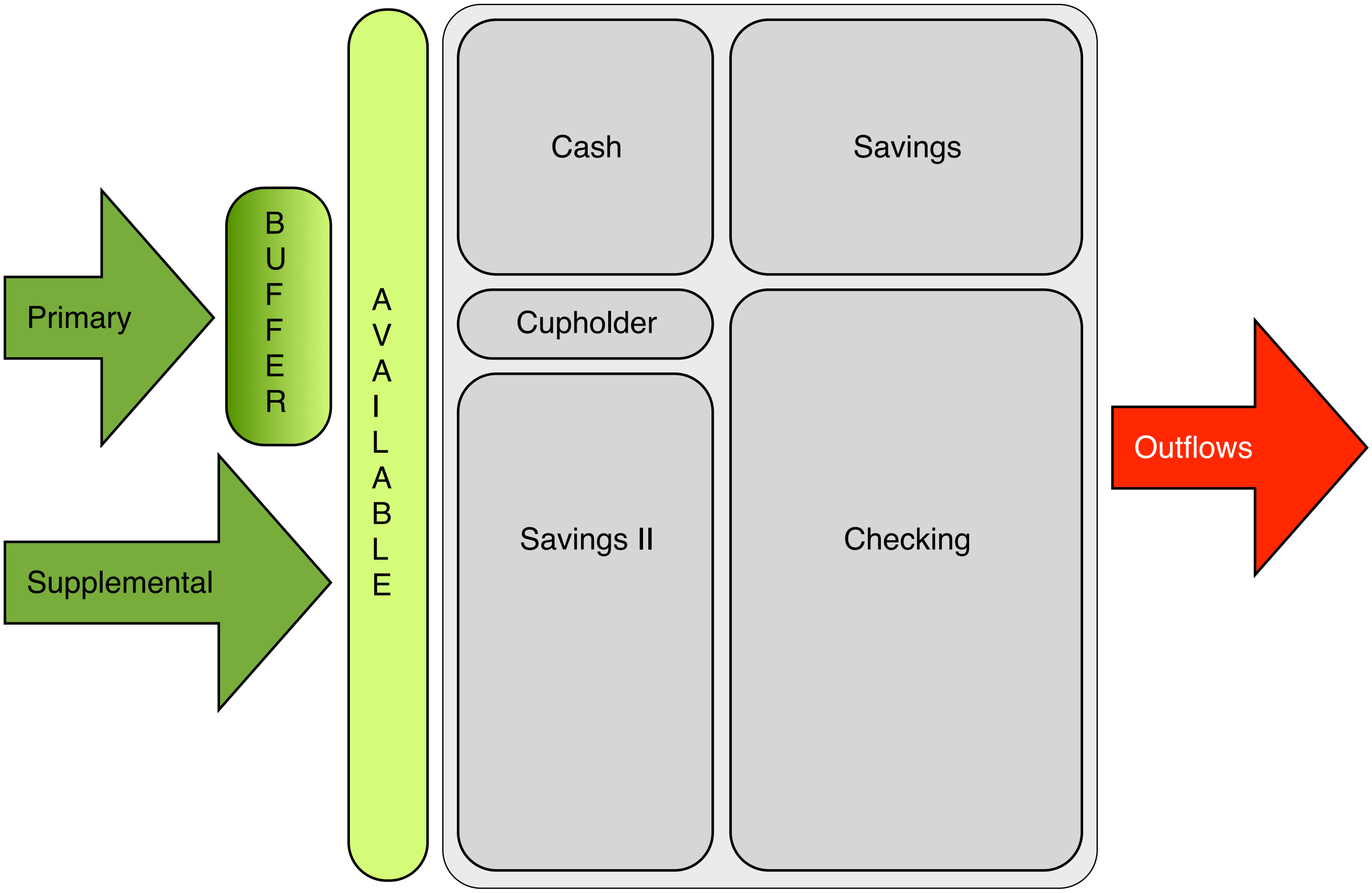
I'm going to walk you through a new way of managing your money. My hope is that you'll have frequent "light-bulb" moments. The Four Rules of Cash Flow are basic steps that you can take toward changing the way you manage your money for the better.

Consider how you will implement these concepts in your own life. If you're married, share these principles with your spouse; the teaching will engrain it in your own mind.

Out with the old. In with the new.

Rule One

Let's revisit our diagram, making a few changes that we'll explain in just a moment:



The goal is to live by Rule One, or, in other words, to stop living paycheck to paycheck. The bare-bones mechanics of it all is that your primary income (your main source(s) of income) that you earned *last* month is what you will spend in the current month.

In the diagram above you can see that Primary Income flows into your Buffer where it waits until the next month. Breaking the paycheck to paycheck cycle means you will live on last month's income this month. (More to come on how to make that possible.)

Supplemental income is money that is, by definition, supplemental. If it weren't there, you wouldn't worry. Supplemental income may include cash gifts, money you found, a rebate, a gift card, etc. We don't worry about delaying our use of supplemental income because we don't *depend* on it as we do our primary income.

The crux of Rule One is a simple (ha!) switch to living on last month's income. I'll spend the next little while trying to persuade you to accept it. It will completely revolutionize the way you think and feel about your money. Rule One is, in three words, peace of mind.

Timing

A simple change in the timing of the spending of your income will have profound effects on your financial situation. You will:

- Experience significantly lower amounts of stress.
- No longer be required to time bill paying with the arrival of a paycheck.
- Budget your income, regardless of its variability, with 100% accuracy.
- Have the breathing room necessary to make better financial decisions.

Stress Levels Down

Consider the experience of Martyn, a recent adopter of the YNAB methodology:

> *When we got our tax refund this March we were able to set aside one month's expenses for the first time and stop living paycheck to paycheck.*
>
> *This past week it came in handy when my company missed a payroll for the first time. While others panicked and ran about securing cash and delaying payments, I was able to cruise on through the week without worries.*
>
> *The check has come a week late but six months ago a one week delay would have been disastrous.*

What Martyn described above is a significant financial victory; one that most people wouldn't have been so fortunate to experience. Whether it's your employer's delay in payroll or some unexpected expense, the idea that what you are spending now was earned *last month* is absolutely liberating. Suddenly cash flow becomes your strength instead of your weakness.

When you're no longer operating on the financial edge, your "need" to have plastic save the day will decrease significantly. Some of the 'others' in Martyn's situation undoubtedly had to call on a credit card or two to help them get through the pay delay. The inevitable consequence, however, is that the debt they accumulated because of the financial crisis will cost them much more than the amount they actually borrowed due to interest charges. Where others are dealing with what are now compound crises, you will be operating as if nothing happened at all.

Bill Paying a Breeze

The large bulk of "money management" time is currently spent checking account balances, determining bill dates, and coordinating the arrival of paychecks with the paying of bills. An inordinate amount of time is wasted when a bill comes in and it must be filed, organized or stuck to the fridge to wait. Every time you see the bill, you're reminded that it must be paid, but the money still isn't there, so you push it out of your mind again (more time wasted in each of these instances). You may even set up a reminder in your calendar to pay the bill once the paycheck comes in. Another waste of time.

Contrast the complication of the process above to the simplicity of the following method: a bill arrives, you put it in a folder. On one or two specific days each month (maybe when you're preparing to budget for the month, and halfway through), you pay *all of the bills in the file*. Done. There's no need to check account balances, figure out paydays, and contrive some complicated system of procrastinated payment. A bill comes in, it's filed. Some time during the month, all of the bills in the file are paid.

With the advent of automatic bill pay, one of the greatest conveniences of all time, this process is even more slick. A bill arrives, you might give it the once-over to see if there are any discrepancies, but then you file it (if you're the filing type) or throw it away (there's an online record of it anyway). You know it will be paid automatically and you also know -- and this is the key -- that there will be enough money to pay it. Why? Because you're living one month behind your earnings. The money necessary to pay that bill was earned a while ago.

I can't overemphasize the time savings you will experience when you no longer are required to time the payment of your bill with the arrival of your paychecks. Using the YNAB methodology, people report cutting the time spent working and worrying about their money to a tenth of what it was before. Imagine that! Where you used to spend four hours per week, you're now spending 20 minutes.

Variable Income? No Problem

When you add the uncertainty of a variable income to the stress of living right on the edge of a paycheck that you're trying to stretch between all of your expenses (planned an unplanned), you have yourself what I like to call a headache.

One of the biggest deterrents for people who are considering a more effective money management system is the issue of variable income. "How can I plan what I'll spend? It fluctuates from month to month." The answer lies, again, in living on last month's income.

Many financial advisors will suggest that you set up a prioritization schedule so that if a lot of money comes in, you can go do some things that are more discretionary, but if only a little bit of money ends up being available, you take care of the essentials first (those at the top of the list): rent, utilities, food, clothing, etc.

This idea works fine, but the time you need to dedicate to setting up the priorities and then managing to follow them isn't insignificant. And it still feels to many like they can't get a grasp on the planning. Also, the money does the planning right then--you don't get to plan ahead what you'll do with the money because you just don't know how much there will be until it's actually there.

If you're a realtor, your commission fluctuates based on how many houses you sell and at what price. Imagine if at the beginning of February you could look back and say, "Well, in January my commissions were $5,450. That's what we have to work with this month." It's the most effective, stress-relieving, time-saving way to handle a variable income. Live on it the *next* month. The alternative is that you continue living paycheck to paycheck, accept higher levels of stress, and waste unnecessary amounts of time organizing your bill paying.

Breathing Room

No longer having to time your bill paying with your paychecks, and knowing exactly what you have to work with for the coming month are both tangible benefits to following Rule One. One intangible benefit is the advantage that a bit of breathing room affords you.

Think back--you probably won't have to go back very far--to the last time you had a financial crisis. An unexpected bill came up, whether it was the car breaking down or needing to fly somewhere on short notice. When we're living on the edge of financial ruin (remember, most Americans couldn't last *more than a month* without their paycheck), our financial decisions in these moments of crisis tend to be poor and desperate. Why? We have no room to breathe. And no time to think.

In financial markets, there's a financial instrument that is bought and sold every day called an "option". There are both call and put options, and for the sake of this example, we'll talk about a call option. A call option is basically the right, but not the obligation, to buy an underlying asset at a fixed price. I might have an option to buy 100 shares of Apple Inc. (AAPL) stock at $150 per share. My option to purchase those 100 shares will expire in six months. These options have value, correct? Now what if I told you that my option won't expire for *six years* (for the sake of our example)? Would the value of these options be worth more or less? The obvious answer is that the longer the time period, the greater the value.

This large-scale fiscal illustration can be likened to your personal financial decisions. The longer you can keep your *options* open, the more valuable they become. So when you're confronted with the fact that your car's brakes are shot and it's going to cost $500 to repair them--and you're living on the very edge of financial ruin--how much time do you have to make your choice? In other words, how soon will your options expire? The answer: very soon. In essence, you have no viable options because you have no choices. Your hand is forced--most likely forced to reach for your credit card, running up your personal debt and furthering your (long term) cash flow crisis.

Consider the same situation, but now let's say you're living on last month's income. You *have an entire month* to decide where that $500 is going to come from, how you're going to get it, where you can cut back in your spending, increase your earning, work overtime, etc. You have a whole bunch of options and you have *time* to think about your decision. That time is valuable.

Over the long term, operating with time on your side, the quality of your decisions will increase. This increased quality will lead not only to less stress on you and your marriage, but also to more money in your pocket.

Buffer

BUFFER

Hopefully you're convinced that Rule One is something you want to live by! Now we're brought to the obvious predicament of how to get ourselves from "scraping by" to "putting away for the future." Regarding difficult changes, Ralph Waldo Emerson stated, "That which we persist in doing becomes easier--not that the nature of the task has changed, but our ability to do has increased." This transition for some will be as easy as transferring some money from their savings account. For others, it's going to be an uphill marathon.

The YNAB Methodology works best when all Four Rules are combined. However, you will make significant strides *on your way* to Rule One as you follow the other Rules. Do not put off all four because the first one seems difficult to implement. I receive emails daily from users who have finally transitioned to living on last month's income. For most, it takes about four months. For some, it takes an entire year. Regardless of how long it takes you, know that the process and the end result are well worth the sacrifices you'll make. If you don't begin doing something different, nothing will ever change.

The key here will be to make it an entire month without spending a single penny of that month's paychecks. You'll want to get to a point where, at the beginning of the month, you can look into your account and say, "There is all the money I earned last month." It will certainly be a day for celebration.

You can tackle the task by cutting frilly expenses, creating additional income, or both. For the fastest result, you'll probably want to try for both. Here are some things people have done to quickly establish their Buffer.

Increasing Income

1. Work overtime. If your job allows it, put in as many hours as you possibly can until you reach your predetermined Buffer amount. Remember, this is a temporary fix for a long-lasting solution. You may see a bit less of your family for a short time--that's okay. What you're doing for your family in terms of getting your finances in order has a much more profound and far-reaching impact than the few hours of togetherness that you'll sacrifice.

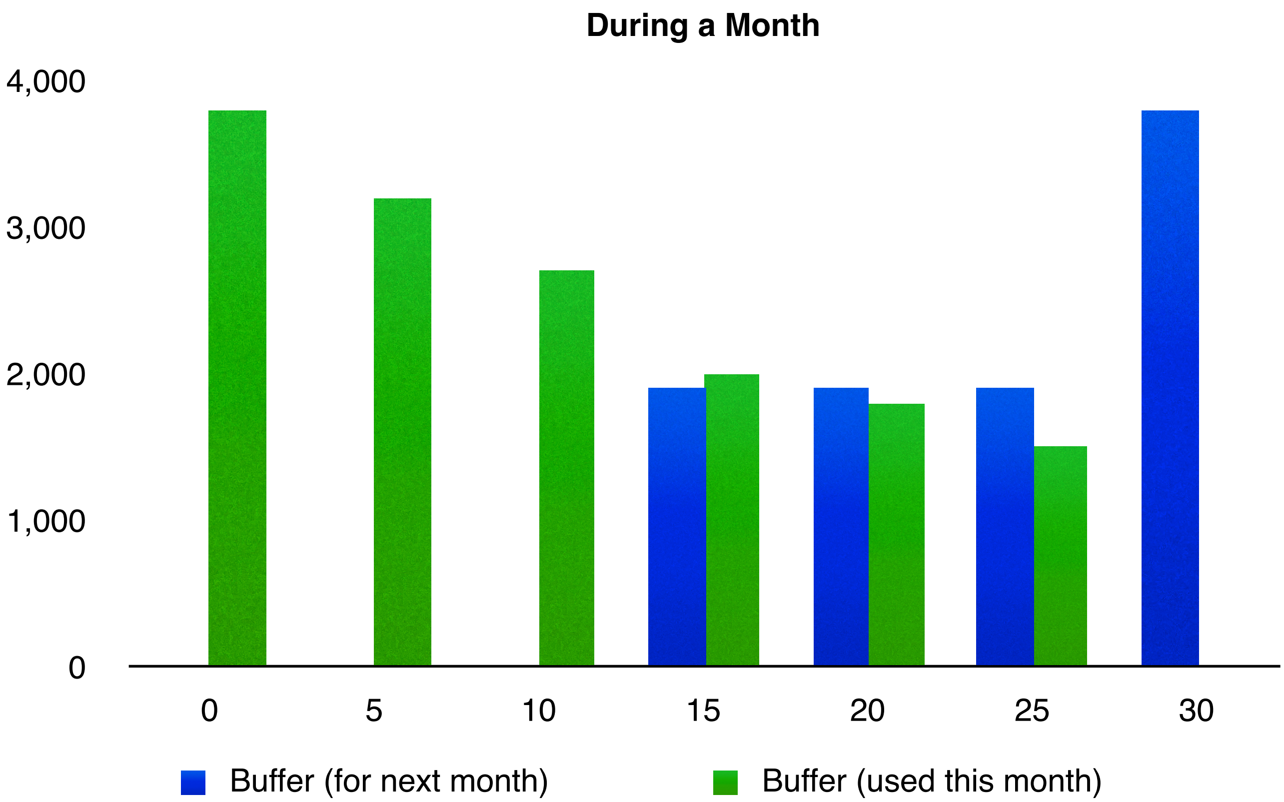
2. Get a part-time job. You can make a thousand bucks a month delivering pizzas. Do that for three or four months and you'll have your Buffer. Be conscientious and have a smile on your face (more tips)! Investigate possible temp jobs, graveyard shifts, UPS, etc.
3. Start a small business. Some people laugh when I share this idea with them. I don't say it to be funny. I have a cousin that built up a lawn care business in one summer. It's been a couple of years since he's put anything into it, and it still makes him money every month (his brothers do the work). Imagine what it could be doing if he were actively going after it? If you mow eight lawns for eight weekends at $20 a pop you'll have a nice stash. Don't underestimate car washing, window washing, dog walking, etc.
4. Have a garage sale. That's right. Sell everything you forgot you had. People sometimes make enough from their garage sale to save some major money toward their Buffer. An average yard sale makes between $500 and $800.
5. Ebay. Like a garage sale, but with a wider audience. If you don't know how to ebay, ask the person next to you. They'll most likely know how and will be able to help you.

Decreasing Expenses

1. Car pool and save a dime on gas expenses.
2. Brown-bag your lunch to work. Twenty workdays in a month, at $5 per day for lunch, over three months and you'll have $300 to go toward your Buffer.
3. Cut your phone bill. Consider cutting your phone down to the very basics. Remember, this is a short-term solution for long-lasting peace.
4. Skip the bottled water.
5. Don't eat out.
6. Cancel your cable, satellite, etc. Short-term solution for long-term peace!

The key in all of this is your intensity.

Once you have your Buffer saved, make it last through the entire next month. As the month goes by, you'll be making money from your normal paycheck, replenishing your Buffer:

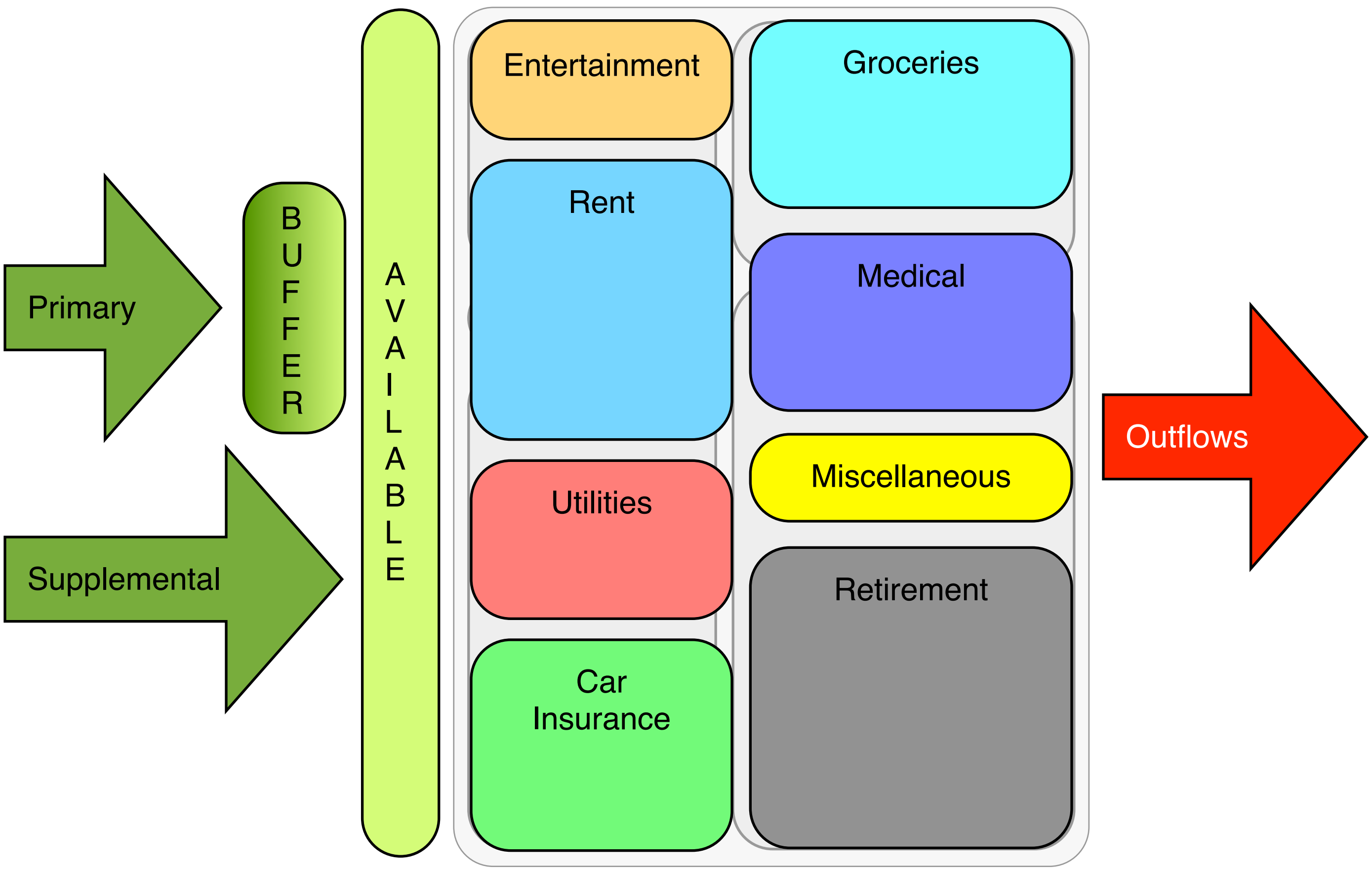


As you can see from above, the green Buffer represents the money you worked so hard to save. Throughout the month it is spent down to zero (or thereabouts). In our chart above, the person is paid on the 15th and 30th of each month. The Buffer is built back halfway on the 15th, and is completely replenished on the 30th, ready to be used for the next month. And the cycle continues.

Rule One is a timing change. It's simple, but its effects on every aspect of your money management cannot be overstated. Rule Two, as you'll see, will have you budgeting your money. Yes, I said budget. And by the end of the next section, you're going to wonder how you ever got by without one--although perhaps "getting by" is what brought you here in the first place.

Rule Two

As we discussed earlier, the old method had your money organized among your bank accounts, and maybe a change jar. That won't suffice any longer! You will begin to proactively *plan* what your money will be doing before it leaves your hands. In the end, you'll see that your money will work harder for you every chance it gets.



This colorful diagram has a very important purpose. Rule Two is "Give Every Dollar a Job" and each of those brightly colored shapes above are potential jobs (spending/savings categories) for your money. Everyone obviously creates different categories for their unique situation. Mine here are simplified for illustrative purposes.

Notice that we still maintain the physical account structure from the old method, but only because that's how the world works. What we're really concerned with is the *budgeting methodology* that is now being applied to your money.

To illustrate the importance of assigning every dollar a job, I'll draw an analogy to a real world business. Imagine a corporation where there are no established job descriptions. Everyone just kind of comes and goes as they please. One day you might find an engineer working on a marketing plan. The next day he could be over in the finance department figuring out how to account for a lease. The marketing employees love spending time on the factory floor because of the intrigue of the big, shiny machinery. The accountants (with all their personality) enjoy spending their time trying to sell the product to customers (imagine how well that's going). Occasionally you might find a purchasing agent in discussion with the product design team about a cheaper, stronger material he read about on the internet...

I think you get the picture. This is not a company that has mastered cross-functional team theory. This is a company lacking defined employee responsibilities. You wouldn't want to work there--and you couldn't count on much career longevity if you did. It is only a matter of time before a company without properly defined employee roles goes under.

A household where the dollars' roles are not properly defined is destined to a similarly dim fate. This is just a fancy way of saying that you need a budget which will assign each of your dollars to a specific and predetermined purpose.

Up to this point, you may have been operating under a "decide as you go" strategy. As chances to purchase or crisis situations came up, you look at your current dollars and allocate them to the most urgent or appealing jobs. You're already giving your dollars jobs, you're just doing it on the fly, and not in a methodical, effective, stress-reducing manner.

Rule Two necessitates foresight and planning, but the mechanics of this Rule are simple. As money comes in, it becomes Available. These Available dollars then wait for their assignment, and it's up to you to give it to them. You might assign some to pay for groceries, the rent, or gasoline for the car. Others may be assigned to *sit and wait for an emergency to happen* (your emergency fund). Some may be given the job to pay for some entertainment. The important part about this step is that *no dollar* is left unassigned.

When Rule One (your buffer) is in place, your Available dollars are waiting for you at the beginning of the month--every single one of them. Until you are living under Rule One, you'll be assigning jobs to your dollars *as they come in*.

As you begin to give every single one of your dollars a purpose, you'll experience some wonderful, wonderful things:

- Acknowledgement of a scarcity of resources.
- The wonders of two-way communication (about money!) with your spouse.
- The advantage of living within your means.
- Contentment.

A Scarcity of Resources

It seems fitting that the word scarcity and scary both begin with the same four letters--the first seems to beget the second. While I can sit here and, in hindsight, point out the great blessing that came from our own experience with scarce resources, the fact of the matter is that at the time, I was scared.

As I mentioned at the beginning of this book, we had been using the Four Rules with great success for about eighteen months when I arrived at the scary realization that our expenses were going to exceed our income once our first child arrived. I remember sitting in our $350/month apartment at the desk (which was very close to our bed, which was very close to all four walls of our bedroom) looking again and again at our budget. My wonderful budget, the thing that had brought my budding family so much peace and contentment during the past several months, was now telling me straight up that we would not have enough money to cover our basic expenses.

Turns out that was a blessing.

Imagine the more common scenario in which a person is using the old method of managing money, reacting compulsively and instinctively to situations as quickly as they arise. What would our result have been if that were the case? This whole exercise of looking at the past, understanding our spending, and then looking toward the future and *planning* would never have been done. The scenario would have played out where a very new family with a very new baby would have ended up going into a very large amount of debt (unnecessarily). This would have put a very large amount of stress on that very new (already stressed) mother who, in turn, would be looking to that very new and equally stressed father for a financial fix. This would have caused a lot of strife.

Instead, because we had been operating with a budget and assigning every dollar a job, I knew that resources would not be sufficient given our current projections. I *knew* that I would need to change something. I *knew* that I would need to increase our income. The budget gave me a healthy dose of reality.

As a direct result of that reality check, my mind began working on how we could increase our income. Several weeks later I decided to try and sell our budget to earn the extra income we would need. Not only were we able to earn the bit of extra income that was needed, but I was able to eventually find my niche--the guy that's trying to get the world on a budget.

In the moment, those reality checks are scary! You're faced with a bit of despair, and things feel pretty hopeless. Though you may not, then and there, be counting your lucky stars, that moment may actually become a defining one for you -- a moment where necessity truly will breed invention. These are the moments where your survival instincts can kick in and produce viable ideas. In hindsight, you may count that first big (frightening) reality check as your first big financial blessing.

Two-Way Communication

The moment where you sit down at the beginning of the month and decide what to do with your Available funds is called your Budget Meeting. When you're married, these meetings are absolutely critical. You'll find they become something you and your spouse look forward to, something you can't feel at ease without.

The first time Julie and I sat down to decide what to do with our Available funds, I was envisioning some hard-nosed negotiations. She'd stare over the table at me, and I'd stare back. The first person to say a number would give up some precious ground...

It was actually nothing like that. It was simply two people sitting down, coming together to figure out the best way to handle their money. I was able to understand what was important to Julie, and she was able to understand what was important to me. There is an inevitable closeness and trust that this kind of financial candidness and mutual understanding engenders. It is empowering and calming--a stark contrast to the way most couples would describe the financial climate of their marriage.

That said, not every Budget Meeting is going to be blissful. At times, there are tough decisions that need to be made (the scarcity of resources necessitates sacrifice and compromise) and this requires emotional honesty and frank/thorough communication. In financial matters, this kind of forthrightness and transparency can be a foreign concept to many couples.

As you work together during these meetings you'll find that you become unified in purpose when it comes to your money and what it should be doing. Goals will develop naturally from these discussions and you'll find that progress will be made regarding debt reduction, contributing to retirement savings, and overall contentment with your money. Your marriage, regardless of where it's at now, will improve, at least in this one regard.

Living Within Your Means

A while ago I remember sitting around a table with several coworkers during our lunch break. One of my coworkers mentioned that he had purchased some stock in a high-flying company and the stock's value had quadrupled in 18 months. He lamented, "I only wish I had bought more!" (a common lamentation from the 20/20 vantage point of hindsight). It was the comment of another coworker, however, that has remained with me. He said, "You were lucky you had any money to invest at all."

In reality, luck had very little to do with it. A lot of times when we're looking to excuse our own laxness or lack of initiative, we try and downplay another person's admirable efforts. In this instance, the unlucky coworker wrote off his colleague's initiatives by saying that he was "lucky" to have money to invest. The truth of the matter is that the money was available because coworker number one had lived within his means. Though we like to console ourselves into thinking otherwise, there's very little luck involved in frugal living.

A friend of mine was "lucky" enough to get in on the ground floor of a startup about five years ago. He worked on a commission basis, earning very little for a quite a while (several years). His "lucky" situation was made possible because he had been living within his means. When he finished school, instead of taking the easy route with a full-time salaried position, making multiples of what he was making with the startup, he stuck with it. Now, this lucky guy owns his home and his cars outright, and earns more in a month than what he would have been making annually with a normal just-out-of-school salaried position.

There is an element of luck in his story, but his chances for success would have been drastically reduced if all through the lean, commission-only years he had been strapped with an expensive car payment, or steep monthly rent for a place that was more luxurious than he needed. It was, to a large extent, living within his means which enabled him to seize the opportunity when it arose.

Living within your means is not some cute way of turning a phrase. It is a principle which brings flexibility and has a potentially profound impact on every other part of your life. If you've successfully demonstrated to yourself that you can live within your means then, when you have a business idea, you can make it happen. You can take your dream job when it comes along, even if it's for 15 percent less than what you're currently making. Living within your means potentially allows you to retire a bit earlier, give more to charity, or simply donate more of your time.

Contentment

When your money is flowing in and out of your life without a plan and without a purpose, seeds of discontentment are sown. You feel as if you're on an escalator, always having to climb, but never getting anywhere. Instead of looking inward for change, you look outward, hoping to find a solution in a better-paying job, or the next raise. When the better job or next raise comes along, expenses rise to the extent of the new income, and the cycle continues.

When you don't have a purposeful plan for what your money will be doing, even legitimate purchases leave you with pangs of guilt. However, as you begin assigning purpose to every single dollar that comes into your life, it is only natural that your budget (your plan) begins to reflect what you truly value. The important part about the budgeting process is the conscious decision to have your money do what *you* actually want it to do. Not what your coworkers want it to do. Not what the bank loan officer wants it to do. Not what anyone wants it to do except *you*. When your money is following your plan, then you find you are living in peace. Finally. You and your money are in alignment. Amazingly, there's always enough money for that.

Recording

Now that you're assigning a job to every dollar that comes in, it follows as an obvious next step that you'll keep a record of when those dollars leave (i.e. do their job).

When I was eighteen I decided I was going to make a written note of every single time I spent any money. I was working part-time at a retail store, going to school part-time, living at home, borrowing my parents' car to get around, and eating their food. In other words, I had very few fixed expenses. (In fact, I can't think of one).

I was stocking shelves at a store for $7 an hour, so I wasn't getting rich, but the paychecks that came every two weeks were certainly large enough to give me discretionary income.

Getting back to the original goal: I recorded every transaction, how much and what for. I sat down at the computer and made something similar to this:

Date	Description	Amount

And then I just let the magic happen.

The result after one month? I had spent $434. On what? I honestly can't remember the specifics. But I do remember going through a thought process something like this: "Wow. That's a lot more than I thought it would be. Oh my gosh! I ate out a ton." That was the gist of it.

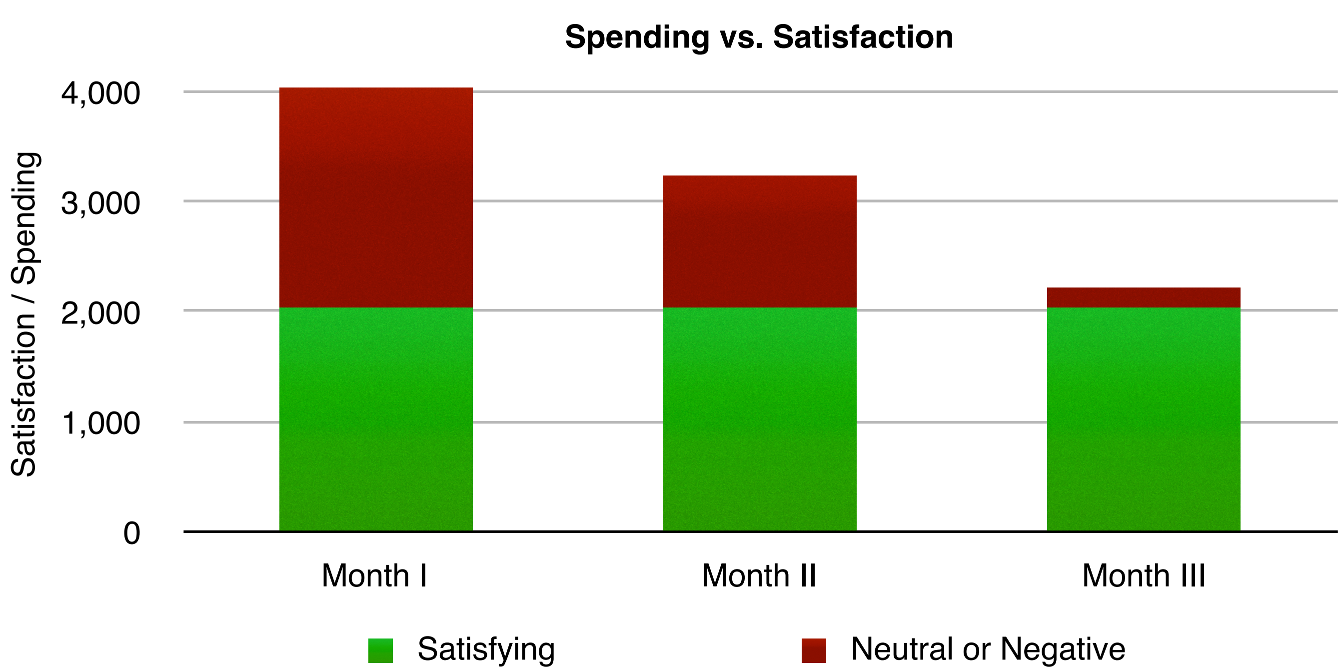
The next month brought better results. I had cut my spending in half.

The following month was even better. I whittled my spending down to $120. I got to a point where I'd be driving somewhere and see a place where I wanted to grab some food (I was eighteen, so hunger was a constant companion), and I'd talk myself out of it because I didn't want to have to write down that I had spent any money. Genius.

The magic really happened though, when I considered how I *felt* about my new situation. Though I had cut my spending to a fourth of what it was, I didn't feel any sense of deprivation. I felt absolutely content. The exercise of writing down what I spent forced me to go through the parallel exercise of evaluating what my money was doing. It created accountability. Although I wasn't following a plan set out at the beginning of the month (Rule Two), I *was* keenly aware of what my dollars were doing after the fact. This awareness kept my spending in line with my values and that was the source of my contentment.

There are really only two types of purchases: those that bring satisfaction and those that don't. Satisfaction may come because you're providing food, shelter, and the necessities of life for yourself or your family, or it may come from purchasing something for a hobby that you have, something that brings you pleasure. Only you can truly discern what brings you satisfaction and what doesn't. Frequent recording of your purchases forces you to address this question of satisfaction again and again and again.

From the chart below you can visually see what I experienced. While the numbers are arbitrary, the idea is sound. The green spending bars represent money spent that truly brought me satisfaction. The red spending bars represent times where I spent money that brought me zero or negative satisfaction. From month one to month three, the overall satisfaction I felt



stayed the same, while my overall spending declined dramatically. This same thing will happen to you.

Many first-time budgeters will say:

“There’s finally enough money to go around.”

“I feel like I’ve gotten a raise.”

“We never knew we actually made this much money!”

The amount of money made hasn’t increased. Their money is simply following a plan that reflects their true value system and it feels like more.

Rule Three

Rule three is simply to save for a rainy day. We implemented this rule after paying the state of Utah $120 to renew the registration of our Chevy Prizm. In our university student world, anything over--eh--ten dollars was seen as significant. The day we received that notice in the mail we were floored. Neither of us had ever owned a car before, so as far as we were concerned, these little taxes just didn't exist.

During the next Budget Meeting we set up a category called License and Taxes and we put ten dollars into it. Twelve months later, when that bill arrived, we were going to be ready for it.

Amusement

If you're like most people, when asked to assign a metaphor to your financial life, you'd say that it's something akin to the scariest roller coaster at an amusement park. These peaks of joy (paycheck!) and valleys of despair (bill!), with a few loops and corkscrews throw in for good measure, supposedly just come with the territory of money management. Your current situation may look something like this:

This cannot possibly be healthy. There is a better way.

Probable	
Known Amount	**Unknown Amount**
Car Insurance	Car Repairs
Life Insurance	Home Repairs
Property Taxes	Car Replacement
Vehicle Registration	Medical Bills

The essence of Rule Three is to plan ahead for probable large expenses of both known and unknown amounts. We call these events Rainy Days.

By no means is this list exhaustive--yours will probably be quite a bit longer. Handling large expenses in the known column is straightforward. If your car insurance premium is due every six months, and it's $600, then you would budget (during Rule Two's Budget Meeting) $100 to the Car Insurance category every month. At the end of the six months, the bill would come and you'd have the money available--cash crunch crisis averted.

Handling large expenses of an unknown amount takes a bit more foresight, but it's also fairly straightforward. These are expenses that you *know* will come up but you can't anticipate exactly the timing or amount. This is where you guess. When you're just getting started, a guess is the best you can do, so don't be bothered by that. If you guess that you spend $1,200 per year on car repairs, then budget $100 per month into the Car Repairs category. Over time you'll begin to see trends from *actual* spending. These trends will help you be uncannily accurate when it comes to estimating the unknown.

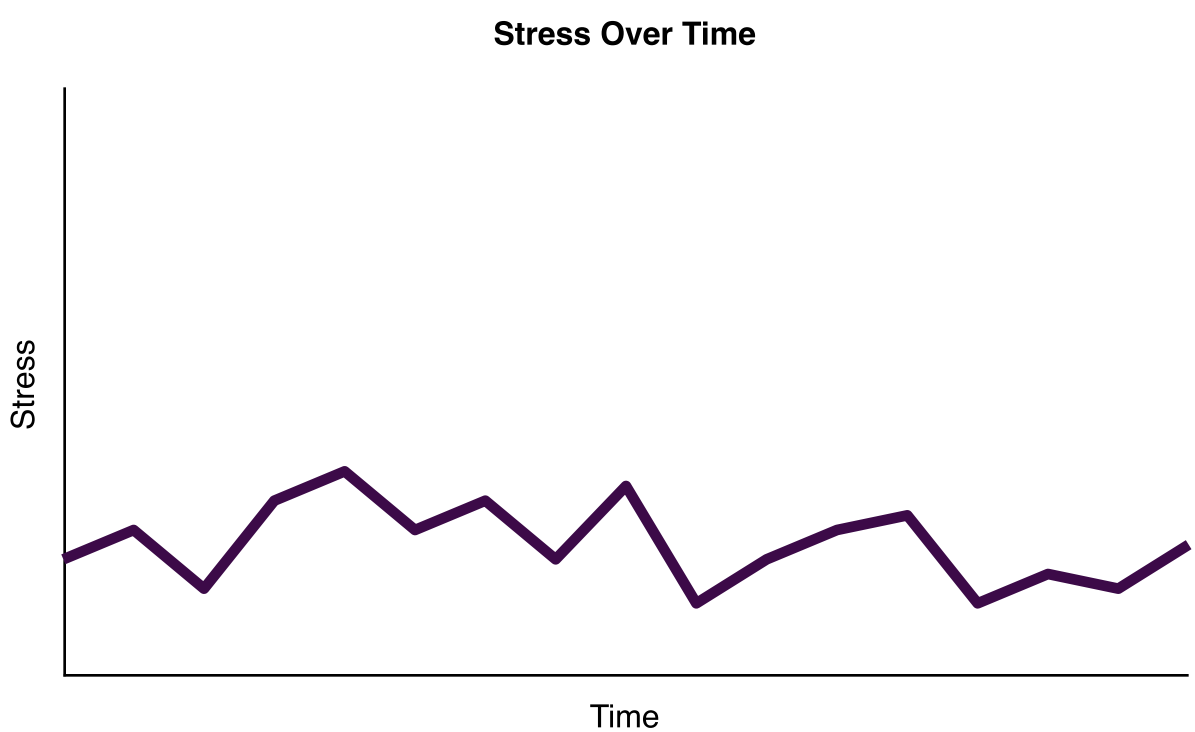
Occasionally, a large expense will crop up that you aren't ready for. We'll cover how that is handled when we discuss Rule Four.

When all pistons are firing, your checking account will start to look as healthy as it ever has. Your Car Insurance, Life Insurance, Car Repairs, and Medical Bills categories will be flush with cash. Considering the fact that you'll be spending *last month's income* during the current month, it won't be unusual to have several thousand dollars in your checking account at any given moment. Welcome to life with YNAB; that's just the way you roll!

If you're looking at a potential for very large balances, you may consider opening a separate high-interest online savings account; I'm a big fan of ING. Though they don't boast quite the highest rates, their customer service is phenomenal and their interface is extremely simple to use. With the click of a few buttons you can open up separate accounts for your Christmas, Vacation, and Property Taxes categories. Suddenly you become your own escrow service. Interest will accrue and your money will not only be giving you peace of mind, and sitting ready for the call of duty when those bills arrive, it will also be making you a bit of money as well.

Events that used to throw you into panic mode never happen anymore, and when a *real* crisis comes, its impact is mitigated substantially. You'll probably see the vast majority of bumps coming long before they arrive.

Suddenly, your roller coaster of yore looks more like a pleasant weekend drive with the top down and the sun on your face.



To Thine Own Self Be True

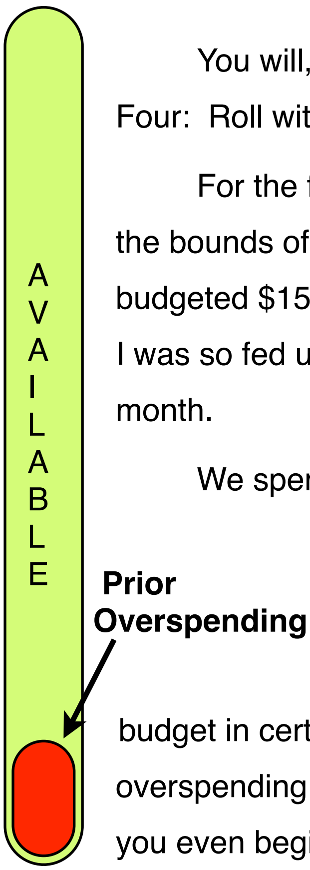
People get hung up on Rule Three with the honesty factor. During your Budget Meeting you'll be looking at what you have Available to spend and you'll be assigning jobs to each of your dollars. Our tendency is to focus on the here and now, alleviating pain as quickly as possible. With Rule Three you're really forced to take a longer-term look at what your dollars need to be doing. A chunk of them will need to be building up for these Rainy Days.

It is crucial that you look at your situation and assess it with complete honesty. If a bill is coming up, you need to have a plan. Do not fall into the trap of saying that you'll set aside more next month, unless part of your plan is to earn more money to create the extra that will be needed. If income is going to stay constant, the money will need to come from somewhere.

This dishonesty is what gets a lot of people into debilitating credit card debt. They don't look at their situation and draw the proverbial line in the sand. They attempt triage and then when another (could-have-been-averted) crisis comes along, their hand is forced into their wallet after the plastic. This cycle continues until the inevitable result is a mountain of debt and one stressed out individual or family at the foot of it.

Take stock in the power of Rule Two to guide you toward making a plan with your money that encompasses your values. Following Rule Two you'll more than likely find that you actually have more than enough for the here and now *and* for these future Rainy Day expenses. Go ahead. Relax your white-knuckle grip and hop off of that roller coaster.

Rule Four



You will, without a doubt, fail. Knowing this, it's important that you learn Rule Four: Roll with the punches.

For the first two years of our marriage, we could not for the life of us stay within the bounds of our grocery budget. If we budgeted $130 we'd spend $150. If we budgeted $150 we'd spend $160. If we budgeted $120 we'd spend $135. One month I was so fed up with going over budget that we budgeted $200 to groceries for that month.

We spent $215.

During the past two years we've been able to beat back the gremlins that were riding along in our shopping cart.

Inevitably, and especially when first beginning, you will go over your budget in certain categories. Some categories lend themselves easily toward overspending (food and entertainment seem to consistently be the top two). Before you even begin implementing the YNAB Methodology, accept this. I don't believe there's been a single month (at the time of writing, we're talking about 58 months) where we haven't gone over in at least one category. Why? Because as you're following your budget, you're also continuing to live life, and the only certainty in life is that it is filled with uncertainty.

Rule Four stipulates that you "roll with the punches". In boxing, the idea is to move your body in the same direction as your opponent's punch to lessen the blow. This ensures that the fighter can *stay on his feet to continue the fight.* The focus of Rule Four is to lessen life's blows to your wallet and keep you on your feet and in the fight. In other words, when your first month comes to a close and you see several categories with spending overages, I don't want to see you throw in the towel.

Looking above at what has now become a familiar image, you see your Available funds. At the beginning of each month you will sum all of the category overages from the previous month and deduct the total from current month's Available funds. This little maneuver does two things:

1. Pays back the surplus categories so their amounts are correctly stated (your surplus categories are what made it possible for you to overpsend and not over*draft* your bank account).
2. Allows you (if you so choose) to spread the damage of your overspending across all of your money instead of forcing you to try and rebuild a category that took a big hit. This is more for the psyche than anything else.

Rule Four is very mechanical and is there as a conservative safety mechanism. It basically forces you to address mistakes of the previous month *before* you begin budgeting for the coming month.

The Disaster Effect

After finishing school we moved to the great state of Texas. Sixty miles east of El Paso, we ran over something in the road that put several holes in our (beloved) Chevy Prizm's engine. The car was completely totaled. El Paso had experienced severe flooding during the previous two weeks, so there was no shortage of cars needing engines rebuilt. The auto shop let us know they could begin looking at putting in a new engine in three weeks. We grabbed a rental and continued our trek to Dallas.

Driving a rental is like flushing money down the toilet. Moving is also like flushing money down the toilet. It seemed that everywhere we turned there was another expense to be met. The deposit for our apartment was higher than we had expected, we were out of food staples, every utility company we were using required a security deposit, our internet installation cost an extra $100 because of their "startup" fee, etc.

I noticed over the course of several days that we were spending money left and right, but *not just for the essentials.* It seemed that as long as I was in that rental car, I could justify buying anything that popped into my mind. I was experiencing the Disaster Effect.

The Disaster Effect is when your sensitivity to spending is lessened because of a *necessary* cost in relation to any type of disaster. In our case, the disaster was a totaled car in El Paso. As a result, my spending radar went completely haywire. This doesn't happen all at once, but it does happen very rapidly and if you aren't aware of it, you'll end up spending an unnecessarily large sum to recover from said disaster. Rule Four will make you keenly aware of this phenomenon and mitigate it as much as possible.

The Elusive Perfect Month

A few weeks after we were settled in to our new place in Texas, my wife approached me about possibly buying a couch (we didn't bother bringing the couch we'd had in school. It had cost $20 and I believe we were the fourth owners).

My answer: "Let's wait until we have a normal month, after things settle down a bit with the expenses." (This was, in large part, due to the Disaster Effect mentioned previously).

She replied brilliantly: "Well then we're never going to get a couch."

My wife instinctively knew that there would never be a perfect month. It's just a part of life. There will always be some exception to the rule that will derail even the best-laid plans. There's no such thing as that normal, perfect month. Rule Four will help you make progress *in spite* of life coming at you from every direction.

WrapUp

Rule One

It's all about the timing. Begin now by taking the steps necessary to build your Buffer. You'll get out of the paycheck to paycheck cycle and will benefit from a whole new way of thinking about your money. Begin following all of the other Rules even before you have Rule One in place. As soon as you do, your stress levels will decrease and the time necessary to manage your bills will shrink as well.

Rule Two

Assign each dollar a job. Begin now with what you have on hand. Take your cash, checking, and saving accounts (less any credit cards that you pay off in full) and assign jobs to that money. Then follow your plan. As you begin doing this exercise (at least) monthly, your spending will begin to align itself with what you truly value and you'll experience contentment with your income and your spending.

Rule Three

Save for rainy days. Set aside fixed amounts each month for large (known and unknown) expenses. Consider insurance premiums, birthdays, anniversaries, Christmas, charitable giving, car repairs, home repairs, property taxes, etc. The roller coaster that was your financial situation will come to a stop and you'll find the number of "crises" that you're forced to deal with decline dramatically.

Rule Four

Just roll with the punches. Accept the fact that life will always be changing and that you'll most likely always go over budget somewhere. Just keep moving forward and make sure you pay yourself back from your Available funds for each overage. It's forced conservatism, and most of the time you won't even feel it making its gentle corrections.

Choice

You may never know what results come of your action,

but if you do nothing there will be no result.

- Mahatma Gandhi

Mythology

I take offense when people speak ill of budgeting. It irks me when they talk about "the dreaded 'B' word." There's nothing dreadful about it. A budget is the foundation of every financial decision you make. It is a liberating financial tool. If your budget is in your head, (i.e. non-existent), your decisions will reflect that. If your budget is written down every single month and you strive to live by it, you'll be making high-quality financial decisions. You'll reach your goals. All pistons will be firing.

Budgeting would solve a lot of governments' problems.

Budgeting would solve a lot of marital problems.

Budgeting *will* solve a lot of your problems.

Spontaneity

Budgeting will not destroy your claim to spontaneity. You'll still be considered the life of the party. You'll just have a plan going in. Yes, you can plan for spontaneity. Heck, setup a Spontaneous spending category and throw money in there every month. When you're feeling spontaneous, the money will be there.

I Already Know There's Not Enough

Inevitably someone will mention to me how they already know where they stand with their money and they're certain they don't have enough. I remember one sweet lady in particular telling me that it was only by the grace of God that she had enough to make ends meet. A budget would only have confirmed what she already knew.

For those who say they already know there isn't enough money to last through the end of the month...what have you got to lose in making an attempt?

I Make Enough Money

I received an email a while back from a man who "was blessed to make plenty of money early in my life." He related to me how a decade later--still earning well into the six-figures--he had nothing to show for it. He had written to thank me for convincing him that he needed a budget. His closing line of the email was particularly poignant: "I thought earning was my greatest blessing and it ended up being my greatest curse. I wish I would have learned that it's much more about what you keep."

Regardless of your income, you will benefit from the process that is required to implement a functioning budget. If I made half a million dollars per year, I'd probably make my budget more general. Instead of my personal category containing diapers, hair care, gifts, etc. it might just be called "Other". I'd make sure I had a category for investing, housing, and transportation. But I maybe wouldn't have a category called "Registration Renewal". The higher income would afford me to be more general in my budgeting approach.

On the flip side, if I were making an average salary of $40,000 per year, I would be much more granular in how I approached my budget. This would force me to rethink purchases with a bit more scrutiny and would ensure that my dollars were doing exactly what I needed them to do.

The key is that in either case, a budget is in place so that the value of a dollar is maximized. Most importantly, it is there to ensure that your money is doing what you consciously want it to be doing.

A Budget Keeps Me From Having Fun

I guess that all depends on how you define the word "fun". Is it fun to see your net worth heading south instead of north? Is it fun to think that you'll be making debt payments for the rest of your life? Are vacations fun when you're wondering the whole time how you're going to pay for everything? Is it fun on Christmas morning when you realize that you're still making payments on *last year's* Christmas?

I guess I hope you'll choose a budget over that kind of fun.

Conclusion

It all comes down to your willingness to choose. If you're feeling overwhelmed, forget everything I said *except for the part about writing down what you spend*. Begin there and your experience will reinforce these ideas in your mind. You'll find the desire to continue the experiment and on some evening you'll sit down and set up your first budget.

As I think back on that desperate day in November--maybe I can chalk it up to inspiration, but even that seems a little too glamorous for what it was. In the moment my only thought was, "I think we need a budget."

We did.

And so do you.

THE YNAB WAY

Early in 2003 Jesse and Julie Mecham married. Some people say when you're newlyweds you live on love. While it's true that the couple were (and still are) in love, they also needed food, shelter, and textbooks for school... so that "living on love" idea is really only half true. As a result of their efforts to allow Julie to be a full-time mom (two kids arrived before Jesse finished school) and graduate debt free, Jesse developed a unique methodology to manage their money. It turns out that all they needed was a budget. You do too.

"Forget the folks who tell you budgets don't work. Their budgets didn't work for one reason, and one reason only: They were doing it wrong. Jesse Mecham has made living within your means about as foolproof (and rewarding) as it can get."
Michael M. *MoneySpot.org*

"YNAB is an absolutely unique personal budgeting system. It's not about where your money went, but where you want your money to go. When it comes to my personal finances, I'll choose being proactive over reactive any day."
Dr. Peter Gallant *Kingston, Ontario, Canada*

"The YNAB methodology has given me back my life. I have gone from borrowing money from friends and family and wondering how I will pay things off, to savings 30% of my salary each month. The YNAB methodology helps you fix your finances once and for all!"
Corey Kent *Sydney, Australia*