Lesson 9

Take Control of Debt: Use Credit Wisely

Lesson Description

In this lesson, students review the balance sheet (Lesson 1) and the budget worksheet (Lesson 2) and consider ways to use these two documents to analyze a decision to use credit. Working in pairs, students analyze a borrowing scenario and evaluate the wisdom of using credit in the situation.

National Standards in K–12 Personal Finance Education (www.jumpstart.org)

Credit and Debt
Standard 1: Identify the costs and benefits of various types of credit.

Instructional Objectives

Students will:

- Analyze the impact of purchases financed with debt on a balance sheet.
- Describe the effect of debt payments on a budget.

Time Required

One 50-minute class period

Materials Required

- Class set of *Building Wealth* books
- Copy of the following activity, cut into five sections
  - *Activity 1: Use Credit Wisely*
- Copies of the following handouts for each student
  - *Handout 1: The Impact of Debt*

Procedure

Building Wealth, pages 19–24, and the **Take Control of Debt** section of the CD-ROM contain information and visuals related to this lesson.

1. Review balance sheet concepts such as assets, liabilities, net worth and wealth using material from *Building Wealth* (pages 2–3). Discuss the impact of using credit on the balance sheet.
   - How does a loan or a purchase made with credit affect the liability side of the balance sheet?
     When a person assumes a debt by taking out a loan or charging a purchase on a credit card, the debt increases the person's liabilities. Increased liabilities reduce a person's net worth or wealth.
   - How does a loan or a purchase made with credit affect the asset side of the balance sheet?
     Debt can be used to purchase items, such as a house or a car, that add value to the asset side of the balance sheet. New assets increase a person's net worth or wealth. If a new liability is matched with an increase in total value of assets, total net worth or wealth is not affected.

- What are some consumable items that might be purchased using credit that never add to the asset side of the balance sheet?
  Answers will vary but might include restaurant meals, entertainment and daily living expenses.
- What is depreciation? How does it affect net worth or wealth?
  Depreciation is the loss in value of an asset due to age, wear and tear, or falling market price. As the value of a particular asset falls, total assets on the balance sheet are reduced and net worth falls. For example, a new car is purchased for $20,000. As the car is used, the age and increased mileage reduce the potential resale value. This loss of value reduces net worth.

2. Review the budget worksheet by discussing Lynne's budget found on pages 8–9 of *Building Wealth*. Also, students could refer to the personal budget that they developed in Lesson 2. Discuss the impact of using credit on the budget worksheet.
   - How does debt affect a person's budget?
     Credit card purchases and loans obligate a borrower to a series of payments until the loan is paid off.
   - Look at Lynne's budget on page 8. If she decides to buy a house with a monthly mortgage and insurance payment of $1,100, what must change about her budget?
     She will not pay rent of $680 or renter's insurance of $20, but the other $400 must come from some other budget line, such as clothing or meals out.

3. Divide students into five groups and give one scenario from *Activity 1: Use Credit Wisely* to each group. Each group should decide if the person described in the scenario should borrow by considering the impact on the person's balance sheet and/or budget worksheet.

4. Have one member of each group read the scenario to the class. Other members of the group should explain their borrowing decision and the reasons for that decision. The teacher can use information from *Suggested Discussion Points* to guide the discussion and provide additional information.

Closure

5. Review the major concepts of the lesson using the following questions:
   - How does a loan affect a borrower's balance sheet?
     The debt increases the person's liabilities, which reduces a person's net worth or wealth.
   - How does a loan affect a borrower's budget?
     The loan requires payments. A borrower must decide if the payments are affordable considering all other obligations.

Assessment

6. Distribute *Handout 1: The Impact of Debt* to each student. Allow students to complete the activity in class or as homework.

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Activity 1: Use Credit Wisely

Patrick is planning for his senior prom. He is taking the girl he has been dating since homecoming. He would like to take her to a nice restaurant before the dance, but he only has enough money in savings to rent his tux and buy the tickets to the dance. Dinner at the dance is included in the price of the prom tickets, but he really wants to go to a fancy dinner. He recently got a credit card to use for emergencies. Should he use the credit card to buy dinner?

Think about Patrick's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should Patrick borrow?

Carla graduated from high school and is halfway through a program to become a dental hygienist. She expects to earn about $55,000 after she graduates, but right now she needs a student loan to finish the last year of her associate's degree. She is confident that her summer internship in a dentist's office will lead to a full-time job.

Think about Carla's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should Carla borrow?

Joe's car is becoming increasingly unreliable. Twice in the past month, he has paid for expensive repairs. Joe drives almost 20 miles to work each way, and public transportation is not located close to his house or job. He has been saving to buy a more reliable car, but the repair bills have kept him from saving in the past month. He has found a reliable used car. When he talked to the loan officer at his bank, he found that he could get a loan with payments that are well within his budget.

Think about Joe's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should he borrow?

Alex has collected comic books for years. He regularly attends conventions and trade shows and is knowledgeable about the books' value on the open market. At the latest show, a dealer that he knows well showed him a particularly rare edition that is in mint condition. The dealer has offered him a fair price, and Alex expects the value to increase steadily over the next several years. Alex does not have the money right now, but if he charges the purchase, he can pay off the balance in three months and pay less than $5.00 in finance charges.

Think about Alex's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should he borrow?

Activity 1: Use Credit Wisely

Susan graduated from college last month, and she has a great new job. She has just moved into her new apartment and bought some furniture. She has been driving the same car since her freshman year, but it is still in good shape. She would like to buy a new car, but the furniture purchase used up her savings. She could still get a loan, but she will have to finance the car for 72 months, resulting in several thousand dollars in extra finance charges.

Think about Susan's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should she borrow?

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Activity 1: Use Credit Wisely

Suggested Discussion Points

Should Patrick borrow?

Advantage—his ability to consume something that he cannot presently afford
Disadvantage—negatively impacts his balance sheet by adding a new liability with no new asset

Considerations:

- He got the credit card for emergency situations, not for consumption. By using the card for dinner, he will be changing his initial strategy. Is this advisable? Why or why not?
- How will he adjust his budget in the future to pay off the credit card? Does he have sufficient income?
- How much will it cost to borrow the money? What interest rate will he pay? How long will it take to pay off the charge? How much will the dinner eventually cost him?

Should Carla borrow?

Advantage—the opportunity to complete her degree and possibly earn more money
Disadvantage—the burden of the student loan payment if she does not get the expected job

Considerations:

- Carla should research the terms of the student loan and calculate the total cost of borrowing.
- Can Carla manage the required loan payments with her expected new salary? How will the payments affect her anticipated budget?
- If she fails to get the job that she expects, does she have a plan to make the loan payments in a different employment situation?
- The higher income she expects could allow her to begin to save, thus positively affecting her balance sheet by increasing her assets and net worth.

Should Joe borrow?

Advantages—reduction of repair expenses, thus, freeing money for affordable loan payments
Disadvantage—obligation of a monthly car payment, which may be burdensome if other expenses arise or his income decreases

Considerations:

- Has he considered all of the possible budget implications of the car purchase? In addition to the new payment, he should consider other expenses that might change, like insurance or fuel costs.
- Rather than buying a car, could he move closer to work so that he can walk or use public transportation, thus enabling him to continue saving for a car?
- Will the down payment deplete savings that he needs for unexpected expenses? Will the new payment allow him to continue some saving?
- Is his job secure? Could he make the payment if he lost his job?

Activity 1: Use Credit Wisely

Suggested Discussion Points

Page 2

Should Alex borrow?

Advantage—the opportunity to purchase an asset that may increase in value over time
Disadvantage—the risk of misjudging the market and purchasing an asset that loses value

Considerations:

- Investing in collectables requires knowledge of the market and careful consideration of purchases. If the asset increases in value, his net worth will increase. However, Alex could have misjudged the market, and the asset could lose value.
- What has Alex done to minimize the finance charges that he will incur? What if he takes longer to repay the loan?
- Investing in collectables can limit liquidity. If he needs cash, could he quickly sell the books? Is this an important consideration for Alex?

Should Susan borrow?

Advantage—ability to buy a car that she probably cannot afford
Disadvantage—negatively impacts her balance sheet and adds additional constraints to her ability to handle unexpected expenses

Considerations:

- Borrowing enables her to buy a new car, but can she reasonably afford such a purchase? How will the new payments affect her budget and her ability to save? How could unanticipated expenses affect her budget if she does not have savings?
- How does the car purchase impact her balance sheet? With no down payment, the entire cost of the car will be added as a liability. While the car is an asset, the value of a new car begins to depreciate immediately.
- To have affordable payments, she has to finance the car for a longer period of time, thus increasing the total cost of purchasing the car.

Name:____ Date:______________

Lesson 9 – Take Control of Debt: Using Credit Wisely

Handout 1: The Impact of Debt

Use the words below to complete each sentence. Each term is defined in the glossary of *Building Wealth*.

Asset	**Balance sheet**	**Debt**	**Loan**
Balance	**Budget**	**Debt service**	**Net Worth**

1. ___________________ is the difference between the total assets and total liabilities of an individual.

2. ___________________ is the amount owed on a loan or credit card or the amount in a savings or investment account.

3. ___________________ is the periodic payment of the principal and interest on a loan.

4. ___________________ is money that is owed. It is also known as a liability.

5. ___________________ is a general name for anything an individual or business owns that has commercial or exchange value.

6. ___________________ is an itemized summary of probable income and expenses for a given period.

7. ___________________ is a sum of money lent at interest.

8. ___________________ is a financial statement showing a "snapshot" of the assets, liabilities and net worth of an individual or organization on a given date.

9. How does the purchase of a car with a loan affect the liability side of a buyer's balance sheet? How does the purchase affect the asset side of the balance sheet? What is the effect on net worth? How does the loan affect the budget?

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10. How does a credit card purchase of a concert ticket affect the buyer's balance sheet?

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11. What is depreciation? How does it affect net worth or wealth?

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Name:____ Date:____________

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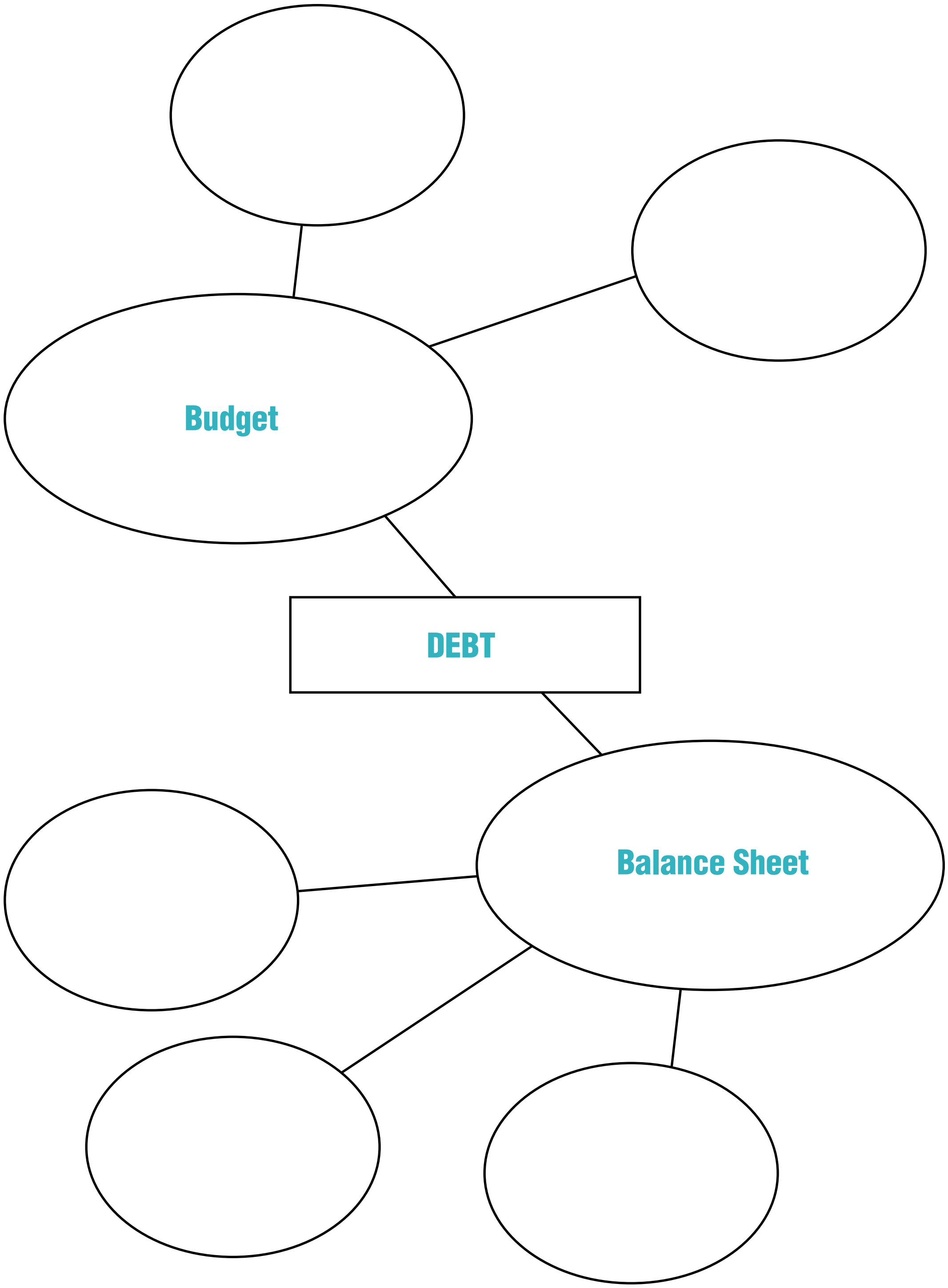
Handout 1: The Impact of Debt

Page 2

Complete the graphic organizer with information about the impact of debt on a borrower's budget and balance sheet. Add additional cells as needed.



Lesson 9 – Take Control of Debt: Using Credit Wisely

Handout 1: The Impact of Debt

Suggested Answers

Use the words below to complete each sentence. Each term is defined in the glossary of *Building Wealth*.

Asset	**Balance sheet**	**Debt**	**Loan**
Balance	**Budget**	**Debt service**	**Net Worth**

1. **Net worth** is the difference between the total assets and total liabilities of an individual.
2. **Balance** is the amount owed on a loan or credit card or the amount in a savings or investment account.
3. **Debt Service** is the periodic payment of the principal and interest on a loan.
4. **Debt** is money that is owed. It is also known as a liability.
5. **Asset** is a general name for anything an individual or business owns that has commercial or exchange value.
6. **Budget** is an itemized summary of probable income and expenses for a given period.
7. **Loan** is a sum of money lent at interest.
8. **Balance Sheet** is a financial statement showing a "snapshot" of the assets, liabilities and net worth of an individual or organization on a given date.
9. How does the purchase of a car with a loan affect the liability side of a buyer's balance sheet? How does the purchase affect the asset side of the balance sheet? What is the effect on net worth? How does the loan affect the budget?
   The car loan increases the liabilities on the balance sheet, decreasing net worth. The car is an asset, which will increase net worth, but the value of the asset declines as the car gets older and is driven. The payments on the loan will become a new expense in the budget, requiring other adjustments, such as reduced spending or decreased savings.
10. How does a credit card purchase of a concert ticket affect the buyer's balance sheet?
    The credit purchase increases the liability side of the balance sheet, but since the concert ticket will be used (or will have no value after the concert), there is no corresponding increase on the asset side.
11. What is depreciation? How does it affect net worth or wealth?
    Depreciation is the loss of value in an asset as it becomes older or is used. As assets such as cars or electronics lose value, net worth is decreased.

Graphic Organizer – student responses will vary in content and organization but should include information related to the following concepts:

- Budget worksheet – revenues, expenses, income, expenditures
- Balance sheet – assets, liabilities, net worth or wealth