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Client Update

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Yes, You CAN Get Out of Debt

1. Yes, You CAN Get Out of Debt - In America today; carrying some debt is unavoidable, and even desirable, for most households. But between mortgages, car payments, and credit cards, many Americans find themselves over their heads unable to dig out from under a growing debt burden that consumes an ever growing portion of their resources.

The Average U.S. household now has credit card debt of more than \$9,300. Credit card companies have made running up that balance deceptively convenient. What's lost when you're on that spending spree is the realization that paying off your debt can be costly, in terms of both cash on hand and your overall financial health.

2. Assessing Your Debt - How much debt is too much? The figure varies from person to person, but in general, if more than 20% of your take-home pay goes to finance nonhousing debt or if your rent or mortgage payments exceed 30% of your monthly take-home pay, you may be overextended. Other signs of overextension include not knowing how much you owe, constantly paying the minimum balance due on credit cards (or worse, being unable to make the minimum payments), and borrowing from one lender to pay another.

If you find that you're overextended, don't panic. There are a number of steps you can follow to eliminate that debt and get yourself back on track. Working your way out of debt will, of course, require you to adjust your spending habits and perhaps be more judicious in your spending.

3. Begin With a Budget - The first step in eliminating debt is to figure out where your money goes. This will enable you to see where your debt is coming from and, perhaps, help you to free up some cash to put toward debt. Track your expenses for one month by writing down what you spend. You might consider keeping your ATM withdrawal slip and writing each expense on it until the money is gone. Hang on to receipts from credit card transactions and add them to the total. At the end of the month, total up your



expenses and break them down into two categories: Essential, including fixed expenses such as mortgage/rent, food, and utilities, and nonessential, including entertainment and meals out. Analyze your expenses to see where your spending can be reduced. Perhaps you can cut back on food expenses by bringing lunch to work instead of eating out each day. You might be able to reduce transportation costs by taking public transportation instead of parking your car at a pricey downtown garage. Even utility costs can be reduced by turning lights off, making fewer long-distance calls, or turning the thermostat down a few degrees in winter. The goal is to reduce current spending so that you won't need to add to your debt and to free up as much as possible to cut down existing debt.

4. Three Steps to Reduce Debt - Once you've got your budget settled, you can begin to attack your existing debt with the following steps:

- *Pay off high-rate debt first* - The higher your interest rate, the more you wind up paying. Begin with your highest-rate credit cards and eliminate the balance as aggressively as possible. For example, assume you have two separate \$2,000 balances, one charging 20% interest, the other 8%, on which you can pay a total of 6% per month. If you were to pay 4% per month on the higher-rate card and 2% on the lower-rate card (which is typically the minimum monthly payment), you would save \$961 in interest and 18 months of payments over allocating 3% to each balance.
- *Transfer high-rate debt to lower-rate cards* - Consolidating credit cards debts to a single, lower-rate card saves more than postage and paperwork. It also saves in interest costs over the life of the loan. Comparison shop for the best rates, and beware of "teaser" rates that start low, say, at 6%, then jump to much higher rates after the introductory period ends.

If you can only find a card with a low introductory rate, maximize the value of that low-interest period. By paying off your balance aggressively, you will reduce the balance more quickly than you will when the rate goes up.

You can also contact your current credit card companies to inquire about consolidation and lower rates. Competition in the industry is fierce, and many companies are willing to lower their rates to keep their customers. Even a percentage point or two can make a difference with a sizable balance.

- *Borrow only for the long term* - The best use of debt is to finance things that will gain in value, such as a home, an education, or big-ticket necessities, like a washing machine or a computer, which will still be around when the debt is paid off. Avoid using your credit card for concert tickets, vacation expenses, or meals out. By the time the balance is gone, you'll have paid far more than the cost of these items and have nothing but memories to show for it.

By analyzing your spending, controlling expenses, and establishing a plan, you can reduce all and perhaps eliminate all your debt, leaving you with more money to save today and a better outlook for your financial future.

Our Credit Crunch

What's in your wallet? Scratch that. Let's rephrase the question: Who's in your wallet? Or even more of the point—how much of what's in your wallet is yours? Don't know? Try this quick calculation:

Add up the following to come up with your total monthly debt obligations (do not include mortgage or rent and utilities):

- Your minimum monthly credit card payments
- Other loan obligations (e.g., car, student loan, doctor's bills)

Next, add the following to calculate your total monthly income:

- Your annual gross salary, divided by 12
- Other regular monthly income that you can count on (babysitting bucks, eBay profits, bonuses, etc.)

Now, divide your monthly debt obligations by your total monthly income. That number is a rough debt-to-income ratio—the lending industry's oft-used measure of fiscal health. Since this brief calculation does not take into account long-term loans, like a mortgage, and savings, like retirement or your short-term stash, don't rely on this as the end-all be-all assessment of your overall financial stability.

According to Gerri Detweiler, author of "The Ultimate Credit Handbook," a debt-to-income ratio of 10 percent or less is considered great. And that's not a bad rule of thumb for Fools, either. If your debt-to-income ratio is hovering in the 20 percent or higher range, there could be trouble ahead.

One fender bender, leaky roof, or embarrassing happy-hour catastrophe that ends in a visit to the emergency room, and you could be facing a mountain of debt that could take years to eliminate. Still, far be it for the credit card industry to poo-poo your request for a line of credit. Even if your debt-to-

income ratio is 50 percent or more, you'll probably have little trouble qualifying for a credit card.

Nevermind that mortgage lenders preach that your debt level—including mortgage and all revolving unsecured debts—should not exceed 36 percent of your gross monthly income. In their eyes, that leaves just 8 percent of your income for non-mortgage debts.

Going for Broke

A long time ago, we were a nation of cash-rich, house-poor people. Then, we became house rich and cash poor. Today, we're a nation that's credit dependent and cash broke. That's right: Broke. Completely bust. According to a *BusinessWeek* report, total household debt—including car loans, mortgage, and student loans—topped 100 percent of disposable annual income last year for the first time ever. Contrast that to 20 years ago when the nation's debt stood at just two-thirds of our disposable income.

On average, we carry eight cards per person and have a balance of \$8,400 in credit card debt. Twenty percent of our cards are maxed out, reports *CardWeb.com*, which tracks the lending industry's machinations. And just 40 percent of Americans pay off their accounts in full at the end of the month.

The average line of credit is around \$3,500. (A decade ago it was \$1,800.) The average household pays their lender \$1,000 a year in finance charges. That might not sound like much, but consider that the amount of interest we paid as a nation last year alone could have purchased the entire inventory of 5000 jaguar dealerships. Or a 2,000-year endorsement deal with Tiger Woods. Or IBM, the entire company, with \$55 billion to spare.

It's not just that we're borrowing more money and paying it back more slowly; it's that we're spending money we used to consider off-limits. Home equity loans are more popular than ever as people borrow against their home to feed their spending binge.

Today, average homeowners owe nearly 50 percent of their home's value. Twenty years ago that figure stood at 30 percent. Can't you just picture the modern-day needlepoint plaque? "Home, Sweet Credit Line."

Perhaps it's time to heed the words of Dickens, who wrote in David Copperfield: "Annual income twenty pounds, annual expenditure nineteen nineteen and six, result happiness. Annual income twenty pounds, annual expenditures twenty pounds ought and six, result misery."

