

# Understanding Financing

What is financing? Financing is borrowing money to buy something; buying something "on time"; buying something with credit cards; or basically acquiring anything without paying the entire purchase price up front.

Is financing a good idea? It depends. Are you buying a house? A car? A new cell phone? Using the money to go on vacation?

A home purchase is generally considered a good investment, but most people don't have enough cash saved to purchase a house outright. A car is a necessity for many, but again most people don't have the funds on hand to purchase a car outright. Financing is likely a good idea in these scenarios.

Now consider a new cell phone or a vacation. Is a new cell phone a need? Or a want? If you have no cell phone at all, it may be a need, but if you are just upgrading to the latest model... don't kid yourself, it's a want. What about that vacation? You may need some time off from work, but if you don't have funds saved up to travel, a staycation is in order. Financing should only be used for needs, not wants. Financing "wants" is what gets most people into financial troubles.

Now, all that being said, if and when you decide to finance something, you need to understand the underlying costs. Have you had a salesman ask "What would you like your monthly payment to be"? Or "How much can you afford to pay each month"? While you need to be sure you can afford the monthly payment, the three key ingredients to financing are: Principal, Interest Rate, and Term.

- The Principal is the amount you are borrowing.
- The Interest Rate is the annual rate of interest you are being charged.
- The Term is how long you will take to pay the money back.

This is a bit of a complicated calculation, and thus people used to be at the mercy of the sales people, but with the advent of cell phones and the internet, the answer is at your fingertips. (I just searched for "monthly payment calculator" and several came up. A few wanted me to provide personal information and sign in. I skipped those, and found easy to use calculators at usaa.com and creditkarma.com that requested no personal information). You enter the Principal (or Loan) amount; the Interest Rate; and the Term (be careful to note whether the term is requested in years or months), and there's your monthly payment amount. If the salesperson is giving you a different amount, you need to understand the details.

Let's try a sample car purchase (try it on your cell phone):

**Principal: \$25,000**

**Interest Rate: 3%**

**Term: 5 years (or 60 months)**

**Payment: \$449.22**

**Did you get the same result?**



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What if the salesperson tells you a higher payment amount? Ask why. Maybe the \$25,000 did not include the sales tax. Maybe the \$25,000 doesn't include the "dealer handling" fee. If the sales tax rate is 7.5% (\$1,875) and the dealer handling fee \$525, now you are financing \$27,400 not \$25,000. Plug your numbers in again. Do you get \$492.34? Do you and the salesperson match on the monthly payment now? There is generally nothing you can do about sales tax, but maybe you can negotiate on the dealer handling fee. Protect yourself. Don't sign the papers until you can verify the monthly payment amount using your calculator. I've seen car dealerships try to add numerous items into the financed amount (bogus fees, additional insurances, GAP coverage). Those additional amounts are not required. Don't let them trick you into adding those amounts to your total financed amount.

## The Cost of Financing

Here's more you need to understand about financing. Financing costs you money. How much you ask? It depends on the Interest Rate and Term. It's obvious that a higher Interest Rate is going to cost you more, but what about the Term? Let's look at three scenarios based on the \$25,000 principal from above.



This is the trick the salesperson is using when he focuses on the monthly payment amount. Yes, he can get the amount of your monthly payment down, but you stay in debt longer and your financing costs are much higher.

Be very aware of the cost of financing. The scenarios presented above use a low interest rate of 3%. Credit cards have much higher rates. Do you know the interest rate(s) on your credit card(s)? If not, go take a look. You can plug any balances into the same monthly payment calculators. Enter different Term lengths, and see how much you would have to pay monthly to pay your balance off in the Term selected. Keep in mind that you will only pay the balance off in that timeframe if you put

no new charges on the card. Similar information may be included on your monthly statement.

Other places you will encounter high financing costs are cash advances, pay day loans, pawn shops, and rent-to-own stores.

## In Summary

Use financing sparingly and wisely. If you don't, you'll end up with an additional cost of financing - A low credit score. A low credit score costs you in higher interest rates, higher insurance rates, security deposits, and the loss of housing and job opportunities.

The highest cost of financing however may be its affect on your mental well-being. Not having enough money to pay all your bills is stressful! While being debt-free doesn't guarantee a stress free life, it definitely eliminates a big burden.

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Scenario 1	2 Year Term	
Principal	\$25,000.00	
Interest rate	3.000%	\$788.73 (Total Interest)
Term (months)	24	
Monthly payment	\$1,074.53	\$25,788.73 (Total Payments)
Scenario 1 - You pay the loan off in 2 years (24 months). You pay a total amount of \$25,788.73. Your monthly payment is \$1,074.53. Your financing cost is \$788.73.		
Scenario 2	4 Year Term	
Principal	\$25,000.00	
Interest rate	3.000%	\$1,561.19 (Total Interest)
Term (months)	48	
Monthly payment	\$553.36	\$26,561.19 (Total Payments)
Scenario 2 - You pay the loan off in 4 years (48 months). You pay a total amount of \$26,561.19. Your monthly payment is \$553.36. Your financing cost is \$1,561.19 (almost double the amount of Scenario 1!).		
Scenario 3	5 Year Term	
Principal	\$25,000.00	
Interest rate	3.000%	\$1,953.04 (Total Interest)
Term (months)	60	
Monthly payment	\$449.22	\$26,953.04 (Total Payments)
Scenario 3 - You pay the loan off in 5 years (60 months). You pay a total amount of \$26,953.04. Your monthly payment is \$449.22. Your financing cost is \$1,953.04 (about 2.5 times the amount of Scenario 1).		