Burn Rate

ASSESSMENT GUIDE

Burn Rate (Br) is the percentage of a client's annual gross income being spent on personal living expenses. This guide will help you understand more about it and how to use it for client assementment.

Elements®
Financial Planning System

Burn Rate

Assessment Guide

What is it?

Burn Rate (Br) is the percentage of a client's annual gross income being spent for personal living expenses.

Calculation

Annual Living Expenses
÷ Total Personal Income

Burn Rate

30%
Br
Burn Rate

Living Expenses excludes debt payments, savings, and taxes (in other words, expenses already included in Debt Rate, Savings Rate, and Tax Rate).

Example: If a client spends \$10,000/month and their household annual gross income is \$200,000, their Burn Rate is 60%. If part of the \$10,000 is a \$1,200 mortgage payment, they spending value would be \$8,800/month and their Burn Rate (Br) would be 52.8%.

Why is it important?

Spending habits affect clients' ability to save and pay down debt. It affects their ability to make work optional. It affects the amount of insurance they should apply for. It affects the risk they should take in their investments. And in Elements, it's one of the main inputs into several other Elements scores (the "Term" scores).

So, tracking spending is an essential part of a client's financial health, and accurately knowing a client's spending habits could be the single most important piece of financial data. At the same time, we know it can be difficult for clients to provide an accurate spending number.

How can we resolve this?

What's important here is simply **awareness** of spending habits, be it the absolute dollar amount or where the money is going.

Clients often conflate budgeting and tracking. "Budgeting" is a specific spending plan, whereas "tracking" is awareness.

Budgeting is optional. Tracking is necessary.

The reality is that healthy spending doesn't always require detailed budgeting. But at a minimum, advisors should track their clients' spending habits over time. This helps you truly understand where you are, how you got there and what needs to change.

How do I use it?

Use this process to assess whether a client's Burn Rate is appropriate or if they need to make improvements:

1. **Score Accuracy**—ensure the accuracy of the Burn Rate inputs.
2. **Score Assessment**—assess whether the given Burn Rate is appropriate.
3. **Score Improvement**—identify areas of improvement.

STEP 1

Score Accuracy

1. Gather a Monthly Spending Estimate

Gather an estimate of the client's monthly spending. While an initial spending estimate is often inaccurate, it reveals important information about the client's understanding of their spending habits.

> **Example:** A client gives you a monthly spending value of $9,000. Then, after conversation and maybe transaction analysis, you discover that they are actually spending around $12,000 per month. This gives you the opportunity to dig in and find out why there was a discrepancy.

Many clients include debt payments in their estimates which need to be excluded from Burn Rate, so clarify what their estimate includes.

2. Track Actual Spending to Verify Estimate

After getting a spending estimate from your client, you may want to have them track spending over a few months and get a more accurate spending number. This can be accomplished by having the client start free services like Mint, Personal Capital, or even their own bank's dashboard.

Alternatively, checking a bank and/or credit card statement a few months later is another method.

STEP 2

Score Assessment

To assess this score:

1. Determine whether the score is too high, too low, or just right.
2. Identify roadblocks to improvement.

Score Ranges

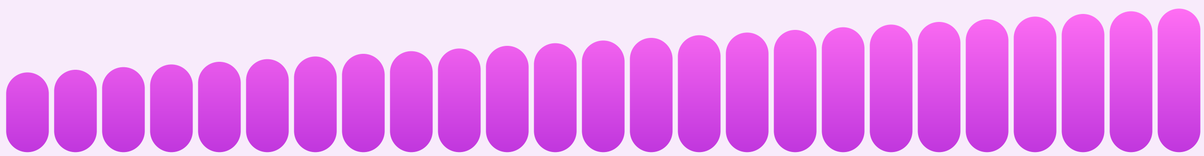
Average Burn Rate scores depend primarily on the ranges of annual gross income a client earns. The following graph presents average Burn Rates based on income ranges.

Income Range	Br Scores
$0–$100,000	50%–70%
$100,000–$250,000	45%–65%
$250,000–$500,000	40%–60%
$500,000 and up	30%–50%

Generally, a client's Burn Rate should **decrease or remain the same** as their income rises. Since most of their personal living expenses early in their career are non-discretionary, a client's Burn Rate has the potential to become a smaller percentage of their income during their high-earning years if they can control their discretionary spending.

CORRELATING FACTORS

Understanding the correlation between these factors and your clients' spending habits will help you determine if the given Burn Rate is appropriate or not.



Lower Br Scores	**Higher Br Scores**
Higher Savings Rate	Higher Cost of Living
Older Clients	Larger Family
	More Healthcare Needs

Roadblocks to Improvement

Before you determine steps a client can take to improve their financial health, you'll need to identify the functional and emotional hurdles holding them back.

Functional hurdles include quantitative reasons a client may not move forward. For example:

- **High Fixed Expenses:** The client spends very little on discretionary spending and a lot on fixed expenses. This may be a result of their costs of living in certain areas
- **Spending not Tracked:** The client may not track spending which results in little awareness around their spending habits. This may be the result of just not know how or where to track, or even past emotional experiences

Emotional hurdles are qualitative reasons a client may not move forward. For example:

- **Social Circle:** Clients often adopt the spending behaviors of those closest to them
- **Family History**: There may be an experience in their family that influences how they feel about spending today.
- **Past Experiences**: These include any experiences that may affect spending habits today.

STEP 3

Score Improvement

After you identify functional and emotional hurdles that may be hindering the client from moving forward, you can begin creating a plan to make improvements. As you create your plan, consider the following:

- Are they maintaining a healthy savings rate?
- Do they track spending? Or can you gain access to this data?
- Should the client create and follow a detailed budget?
- Does their Burn Rate follow a consistent pattern? Or is there a spike or dip due to other circumstances?
- Are they intentionally spending their money to match what is most important to them?

As you review these questions, you'll be able to guide the client toward good financial behaviors that ultimately improve their financial health.

Case Study

Let's look at the following example and apply the principles presented above. This case study assumes you've already ensured that you have a good estimate.

> **Example:** Given a Burn Rate of 60% and considering the following information, you begin your assessment of whether a client's Burn Rate is appropriate:

Annual Income	**$175,000**
Age	**45**
Savings Rate	**12%**
Cost of Living	**Resident of New York City**
Family Size	**Single**
Healthcare Needs	**Low**

Step 1 – Determine Score Appropriateness

By first considering this client's income, you determine their score of 60% is high, but not above average ranges.

Then, considering the additional information you find the only factor that justifies a high burn rate is their high cost of living. All other factors oppose a high burn rate including:

- Higher Age
- Low Savings Rate
- Small family size
- Low healthcare needs

Given this assessment, you determine the client’s Burn Rate of 60% is too high given their situation.

Step 2 - Identify Improvements and Roadblocks

Through conversations with the client you discover they’ve had a lot of negative family experiences around detailed budgeting, and they now have a strong aversion to careful tracking and budgeting.

Knowing this, you decide to focus your time on just tracking spending with the client, so you can begin to identify spending patterns. You help them to see if they are intentionally spending on things that matter to him which will help him begin to start to change behavior.