

Lesson 10

Control Debt—Use Credit Wisely

Lesson Description

In this lesson, students, through a series of interactive and group activities, will explore the concept of credit and the impact of liabilities on net worth, a monthly budget and an individual's balance sheet. Working in groups, 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 credit on a balance sheet.
- Analyze the effects of debt payments on a budget.
- Evaluate the advantages and disadvantages of financing various purchases.

Time Required

One 50-minute class period

Materials Required

- SmartBoard (optional) *If using a computer and projector, please click when procedure says touch.*
- Interactive PDF file
- Copies of Activity 1: Use Credit Wisely, cut apart
- Copies of Handout 1: The Impact of Debt (optional)

Warning

The first time you teach the lesson, save a master copy to your computer or a flash drive. If you do not, you will not be able to save notes from each class. Before each class, reload the master copy of the notebook file to be certain that all of the elements on each page are ready for use.

Procedure

1. **Display Slide 1.** Tell students the topic of the lesson is using credit wisely.
2. **Display Slide 2.** Review the instructional objectives for the lesson.
3. **Display Slide 3.** Use the interactive on the slide and the information below to review net worth.
 - Touch “Assets” to display the definition and examples of assets. Ask students for other examples
 - Touch “Liabilities” to display the definition and examples of liabilities. Ask students for other examples.
 - Touch “Net Worth” to display the definition of net worth. Explain that net worth is a measure of wealth and that increasing net worth is the way to build wealth.

Use the equation to remind students of the two ways that a person can build wealth: increasing total assets or reducing total liabilities.

4. Display Slide 4. Use the Flash application on the slide to lead a discussion of how adding liabilities to a balance sheet impacts net worth.

- Point out where net worth is located on the balance sheet.
 - Point out that there are currently no liabilities on this balance sheet.
- Touch the “Generate Liability” button on the slide.
 - The button will add a new liability to the balance sheet each time it is pressed (up to four). The liabilities and their values are, in order:
 1. Car loan—\$3,800
 2. Student loans—\$12,000
 3. Credit card balance—\$450
 4. Balance on new furniture—\$650
- As each liability is added, point out the change in the net worth of the individual.
 1. Remind students that net worth is a proxy for wealth and adding liabilities decreases wealth.
- Touch the “Reset” button at any time to return the application to its initial state.

5. Display Slide 5. Use the budget to explain to students how adding liabilities affects a monthly budget.

- Using the pen, circle the monthly payments of the debts (liabilities) that were added to the balance sheet in the previous slide (Slide 4). They are marked “New.”
- Add up the payments and compare them to our individual’s overall budget.
 - Ask students how giving up \$345 of their budget to make monthly debt payments might impact the decisions they make in the future.
 - Explain that once an individual has taken on a debt, the payments are often not negotiable.
 - To continue a savings or investing plan while debt payments are impacting their budget, the individual must find other ways to modify their expenses.

6. Divide students into groups of two to four and give one scenario from Activity 1: Use Credit Wisely to each group (depending on class size, a scenario may need to be assigned to more than one group). Each group should decide if the person described in the scenario should borrow by considering the advantages and disadvantages and the impact on the person’s balance sheet and budget.

7. Display Slide 6. Have one member of each group come to the board and find out the advantages and disadvantages of the purchase and the recommendation for the person in the scenario.

Use the Activity 1 suggested discussion points to assist students if necessary.

8. Display Slides 7-10 and repeat the process outlined in step 7 until all five scenarios have been discussed.

Closure

1. How does a loan affect a borrower's balance sheet?
The debt increases the person's liabilities, which reduces their net worth, or wealth.
2. How does a loan affect a borrower's budget?
Loans require repayment. A borrower must decide if the payments are affordable, considering all other obligations.

Assessment

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

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?

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

Tony's car is becoming increasingly unreliable. Twice in the past month, he has paid for expensive repairs. Tony 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 Tony's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should he borrow?

Carlos 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 Carlos expects the value to increase steadily over the next several years. Carlos 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 Carlos's balance sheet and budget. What are some advantages and disadvantages to borrowing? Should he borrow?

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

Suggested Discussion Points

Activity 1: Use Credit Wisely

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 Debra 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:

- Debra should research the terms of the student loan and calculate the total cost of borrowing.
- Can Debra 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 Tony 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 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?

Suggested Discussion Points

Activity 1: **Use Credit Wisely**

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

Should Veronica 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 _____

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

Balance sheet
Budget

Debt
Debt service

Loan
Net Worth

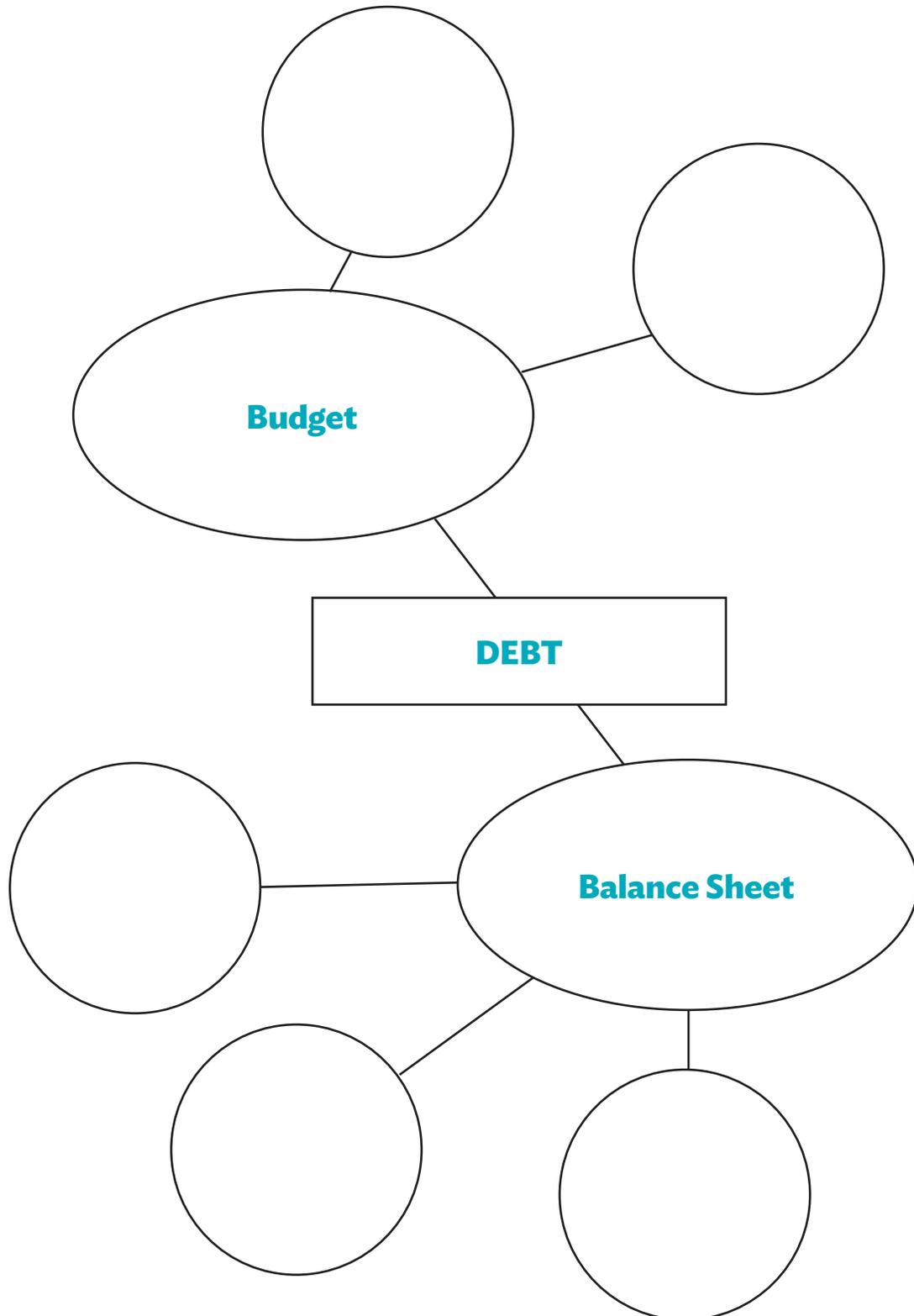
1. _____ is the difference between the total assets and total liabilities of an individual.
2. _____ is the amount owed on a loan or credit card or the amount in a savings or investment account.
3. _____ is the periodic payment of the principal and interest on a loan.
4. _____ is money that is owed. 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 with 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?

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

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

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.



Suggested Answers

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

Balance sheet
Budget

Debt
Debt service

Loan
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 with 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