

***The Three Account System<sup>SM</sup> -  
Translating Financial Planning Theory Into Reality***

Life is simple for nine year olds in many ways, including cash flow management. To a nine year old the ability to buy something and its affordability are the same thing. Calculating affordability for a nine year old requires only the ability to count and add. That calculation becomes much more complicated the minute you get your first credit card. Long-term goals and wealth accumulation further complicate the affordability calculation. The difference between affordability and the ability to buy gets bigger and bigger until the day before you die and then you can again afford whatever you can buy.

The difference between the ability to buy and the ability to afford is at the heart of financial planning. So much so that defining what can be afforded may be the most essential function of financial planning. Goals are established in the financial planning process and computer simulations are run to examine the steps required to achieve these goals. These computer simulations are dependent on numerous assumptions and many of these assumptions are beyond our control. However, there is one very powerful assumption over which we have considerable control – spending.

Significant expenditures like homes, automobiles and charitable contributions can be specifically planned. However, for many people, the biggest purchase is the combination of thousands of little purchases that comprise standard of living. Obviously, it would be impractical to contact your financial planner every time you go to Starbucks and splurge on a Grande Latte. But to paraphrase a famous political line – a Grande here and a Grande there and pretty soon you are talking real money.

Financial plans establish affordable spending, but they do not tell us whether we can afford to splurge on a latte. To be effective, financial plans need a mechanism to tell us whether we can afford a latte today. Some people should watch their latte spending more closely. Others should treat themselves and a friend to a latte and enjoy with complete peace of mind that their spending is well within the plan.

Financial plans are only valuable to the extent that they help make better financial choices. Talking about a cup of coffee in the context of financial planning may seem silly, but it is often thousands of little decisions like that that make the difference between achieving or not achieving goals.

The Three Account System<sup>SM</sup> was developed by Resource Consulting Group to manage these thousands of little decisions and some of the bigger decisions. The three accounts in the system are really three categories of accounts established to fund three types of spending – month to month, short-term savings and long-term

wealth accumulation. It can be confusing to refer to short-term savings and long-term wealth accumulation as spending, but these funds are accumulated for the purpose of meeting a future spending goal. For this purpose, transferring wealth to another person or charity is considered a type of spending.

Month to month spending can be funded through a single checking account, but often couples will divide these expenses between them using two or three checking accounts. Short-term savings can be as short as funding quarterly estimated income tax payments, or annual real estate taxes, or as long as college education funding. Short-term savings can also be a single money market account or several separate accounts for various designated purposes. Long-term wealth accumulation normally includes IRAs, 401(k)s and various taxable investment accounts. These accounts are funded with amounts determined in the financial planning process.

The Three Account System<sup>SM</sup> makes a financial plan real on a day to day basis – or, more accurately, on a month to month basis. Monthly account statements become monthly reminders to watch your pennies or pats on the back and liberation to splurge on a latte. Both are important. Three dollars a day over a 40 year working career could accumulate to over \$200,000. This could mean the ability to send a grandchild to college or the ability to afford some luxury travel. Or it could mean an extra \$200,000 left over at death after a lifetime of unnecessary stressing about money. The Three Account System<sup>SM</sup> helps to keep a handle on where you stand month by month.

The system can be as tight or as loose as is appropriate for the relevant planning objectives. The person who is mildly interested in retiring at 50 but is willing to work to 65 or 70 if necessary may want a loose system. Somebody else who is determined to retire at 50 will want a tighter system. A retiree who lives at the very limit of affordability will need a tighter system than one who lives well below their means. All will benefit by having a system that is appropriately designed for their needs.

This system can seem to be the reverse of the traditional financial planning advice “pay yourself first”. The traditional advice calls for saving an amount determined in the financial planning process and spending the rest. This advice has the obvious merit of making sure savings goals are met. However, it has the impracticality of fighting lifestyle inertia. It sounds great to say I will save my target amounts regardless of what happens and live within the remainder. It may even be the better system for the average Joe living paycheck to paycheck. However, it does not work well for high income earners, especially those with variable income and it does not work at all for those who have already achieved financial independence. Most of us settle into a lifestyle and it takes months or years to change it.

In the real world, establishing a reasonable spending plan that is expected to result in the desired savings works much better. This allows gradual, planned adjustments to the new level of spending. Savings is monitored, of course, and adjustments are made as appropriate as part of the financial planning update and monitoring process. For most of us, this works much better than the idealistic call for paying yourself first.

To construct this system, spending goals are allocated into three categories – monthly, short-term and long-term and resources are allocated accordingly. Ultimately, all resources are consumed either during your lifetime or at death in the form of wealth transfers to persons or charities. Wealth can only be used to fund your spending goals. Inheritance, charity and financial peace of mind are forms of spending goals.

Once these spending goals have been established, accounts are designated for each purpose and funded at a level consistent with a plan. As long as the spending can be maintained by the funds in the appropriate accounts, the plan is being followed. Unplanned borrowing or transfers from long-term accounts are signals that the plan is not being followed. That does not mean borrowing and transfers are blocked. Access to accounts and borrowing is not affected by the plan. A structure is constructed that makes it clear what spending is consistent with the plan and what spending is not.

It is a virtual certainty that spending that is inconsistent with the plan will happen. Nobody can foresee all future spending. A well-designed plan will consider and allow for unplanned spending, but will not likely account for it all. The purpose of The Three Account System<sup>SM</sup> is to call attention to this spending, not to prevent it. The purpose is to facilitate conscious spending choices and to avoid spending regrets later in life. The objective is to arrive at age 90 having consumed just the right number of lattes. Not so many that no more are affordable and not so few that the skipped ones are regretted.

If you would like to learn more about how The Three Account System<sup>SM</sup> can provide you with greater financial peace of mind, please contact us.