



## Helping Employees Make the Most of Their 401(k)/403(b) Plans

### Do You Have Too Much Debt? Calculating Your Debt to Income Ratio

#### A Basic Indicator of Your Financial Health

Getting out of debt and staying out of debt is simple: All it takes is spending less than you earn. Although the solution is simple, putting it into practice is hard for many people. The first step is assessing where you are right now.

#### Assessing Where You Are

Businesses regularly calculate key ratios that indicate their financial health, and so should you. Two of the most basic personal finance calculations are

1. your net worth, which is a snapshot of your current financial situation and tells you what you're worth
2. your Debt to Income Ratio, which is your total debt payments compared to how much money you earn and tells you if you're carrying too much debt.

Some debt to income calculations includes your mortgage or rent and others don't.

I recommend the method used by mortgage lenders, which includes mortgage payments in debt to income ratios, because it gives a better overall picture of your finances. Because many people with ratios within the standard guidelines still struggle with their payments, I recommend that ratios somewhat lower than those accepted by the mortgage industry should be the goal, as reflected in the Financial Health Barometer, below.

Chas. P. Smith & Associates, PA, CPA's  
1509 South Florida Avenue, Lakeland, FL 33803  
Telephone (863) 688-1725; Fax (863) 688-0692  
[www.my401kpilot.com](http://www.my401kpilot.com)  
email [pgolotko@my401kpilot.com](mailto:pgolotko@my401kpilot.com)

## Calculate Your Debt to Income Ratio

Monthly mortgage payment (including property taxes and insurance) or rent  
Monthly home equity line of credit or loan payment  
Monthly car payments  
Monthly revolving credit payments (furniture, appliance loans, etc.)  
Monthly student loan payments  
Monthly minimum credit card payments times two  
Other monthly loan amounts  
Monthly child support payments  
TOTAL MONTHLY DEBT PAYMENTS

Monthly net (take-home) pay  
Annual bonuses and overtime, divided by 12  
Other annual income, divided by 12  
TOTAL MONTHLY INCOME

Total Monthly Debt Payments Divided by Total Monthly Income = Debt to Income Ratio

## Evaluate Your Debt to Income Ratio

Most lenders will tell you that a 36% or lower debt to income ratio is good. In reality, it's difficult to apply a one-size-fits-all formula to everyone. Your personal situation, such as number of dependents, unusual expenses, and spending habits will affect how much debt you can reasonably handle, but as a general guideline, let's assume that anything over 36% would be uncomfortable for the average person.

Example: Your mortgage is \$750 per month (\$125,000 mortgage at 6%, not including taxes and insurance). You have a \$300 per month car loan (\$15,000 loan at 7% for 5 years) and a \$100 student loan payment per month. The total minimum payments on your credit cards are \$100 per month, times two equals \$200 per month (making just the minimum payments on your credit cards is financially unhealthy. Shoot for at least double the minimum if you want to have any hope of ever paying off the balance). To have a debt to equity ratio of 36% or less, your total income in this example would have to be \$3,750 per month (\$1350 in monthly payments divided by .36), or \$45,000 per year.

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## **Financial Health Barometer**

If your debt to income ratio is:

Less than 30%: Excellent!

30% to 36%: Good: You won't have any problem with lenders, but work to bring it down below 30%.

36% to 40%: Borderline: Some lenders will still give you a loan but you may struggle to make your payments.

40% or higher: Red flag: Your credit situation requires attention.

**Call for a free half-hour analysis of your retirement account.**

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