Jan 13, 2025

<u>LEC 02 - Financial Statements and Budgeting</u>

<u>Learning Objectives:</u>

1. Recognize relationships among financial statements and money management activities
2. Create a system for maintaining personal financial records
3. Develop a personal balance sheet and cash flow statement
4. Create and implement a budget
5. Calculate savings needed to achieve financial goals

<u>Key Terms:</u>

Assets: A resource with economic value that an individual, a company, or a country owns or controls with the expectation that it will provide a future benefit.

- Car (Only if you own it, ie. not leased or rented)
- Watch
- House

Liabilities: Something that a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services.

- Mortgage
- Loan
- Credit Card
- Student Loans

Budget: An estimation of revenue and expenses that's made for a specified future period of time. Budgeting usually occurs on an ongoing basis, with individual budgets being re-evaluated regularly.

Insolvency: When an individual or company can no longer meet their financial obligations to lenders as debts become due. Before an insolvent company or person gets involved in insolvency proceedings, they may be involved in informal arrangements with creditors, such as setting up alternative payment arrangements. Insolvency can arise from poor cash management, a reduction in cash inflow, or an increase in expenses.

Net Worth: The value of assets an individual or corporation owns minus the liabilities they owe. It’s an important metric to gauge a company’s health, providing a useful snapshot of its current financial position.

Take-home Pay: The net amount of income received after the deduction of taxes, benefits, and voluntary contributions from a paycheck. It is the difference resulting from the subtraction of all deductions from gross income.

- Income tax
- Pension plan
- Employement insurance

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Importance of Maintaining Financial Records:

An organized system of financial records provides:

- Handling of daily business affairs
- Planning and measuring of financial progress
- Completing required tax reports
- Making effective investment decisions
- Determining available resources

Most financial records are kept in:

- Home files, home computer, online
- Safe deposit box or fireproof home safe
- Computer, tablet, phone

Purposes of personal financial statements:

- Balance Sheet: Summarizes the value of items you own and owe
- Cash Flow Statement: Track your cash inflows and outflows
- Identify strengths and weaknesses in your current financial situation
- Measure progress towards your financial goals
- Provide data for use in filing your income tax return or applying for credit

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Balance Sheets:

- Reports what an individual or family owes and owns
- Also called a net worth statement
- $Net\ Worth = Owned - Owed$

Steps:

1. Listing Items of Value (Assets → Cash and other property with a monetary value)
    - Liquid assets
    - Real estate
    - Personal possessions
    - Investment assets
2. Listing Debts (Liabilities → Amounts owed to others)
    - Current liabilities → Debts to be paid in a short time (usually less than 1 year)
    - Long term liabilities → Debts that do not need to be paid until more than a year from now

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3. Calculating Net Worth → The difference between total assets and total liabilities

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Cash Flow Statements:

- A cash flow statement (also known as income statement / personal income and expenditure statement) is a summary of cash receipts and payments for a period of time, such as a month or year
- Provides data on your income and spending patterns, which is helpful when preparing a budget
- $Total\ Income\ -\ Total\ Outflow\ =\ Cash\ surplus\ OR\ defecit$

  Steps:

  1. Record income
  2. Record cash outflows
     - Fixed expenses that do not vary from time period to time period
     - Variable expenses are flexible payments
  3. Record cash inflows
     - Incomes such as salary
  4. Determine net cash flow
     - Net cash flow can be a surplus (+) or a deficit (-)
     - Used as a basis for creating a spending, saving, and investing plan

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Case Study:

1. What would Ben and Yolanda learn by sorting their expenses into various categories? What categories should they use?
   - They would learn where exactly their money is going, which would allow them to identify unnecessary spending
   - The categories they could use are:
     - Utilities
       - Electricity
     - Nessessicities
       - Groceries (eating out vs. eating at home)
     - Transportation
       - Car payments
       - Car maintenance
       - Gas
     - Leisure
       - Movies
       - Entertainment
     - Shelter
       - Rent

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        - Home payments
    - Clothing

2. How can knowing where their money goes help Ben and Yolanda plan their spending?
    - Helps you take corrective action

3. What financial goals might Ben and Yolanda consider to address some of their money management concerns?
    - Developing savings plan
    - Removing unnecessary spending

Measuring Financial Sustainability:

- A person with high net worth may still have financial difficulties
    - High income but high spending
- Net worth is an indication of your financial position on a given date

  Net worth can be increased by:
    - Increasing savings
    - Reducing spending
    - Increasing value of possessions and investments
    - Reducing amount of debt

  Ratios:
    - $Debt\ Ratio = \frac{Liabilities}{Net\ Worth}$ → Shows relationship between debt and net worth
    - $Current\ Ratio = \frac{Current\ Assets}{Current\ Liabilities}$ → A high current ratio is desirable to have available cash to pay bills
    - $Liquidity\ Ratio = \frac{Liquid\ Assets}{Monthly\ Expenses}$ → Indicates the number of months in which living expenses can be paid in the event of an emergency
    - $Debt\ Payments\ Ratio = \frac{Monthly\ Payments}{Take-Home\ Pay}$ → Indicates how much of a person's earnings go to debt payments
    - $Savings\ Ratio = \frac{Amount\ Saved\ Each\ Month}{Gross\ Income}$ → Financial experts recommend monthly savings of at least 10%

Budgeting:

- A budget is a specific plan for spending income for a certain lifestyle
    - Spend less than your income
    - Understand your sources and uses of cash
    - Prioritize and attain your financial goals

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  - Prepare an emergency fund
  - Develop wise financial management habits
- Lifestyle is influenced by…
  - Career
  - Family
  - Values

Creating and implementing a budget can be achieved in seven steps:

1. Setting financial goals
2. Estimating income
3. Budgeting emergency fund and savings
4. Budgeting fixed expenses
5. Budgeting variable expenses
6. Recording spending amounts
7. Reviewing spending and saving patterns

A successful budget should be…

- Well planned
- Realistic
- Flexible
- Clearly communicated