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**Understanding Personal Financial**

**Statements**

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## ABOUT GREENE CONSULTING ASSOCIATES, LLC

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## Introduction

In the financial planning process, financial professionals accumulate a great deal of data and information about their client. In order to analyze the client's current financial position relative to their goals, the professional needs to assimilate this information and data into interpretive, workable pieces. Two of the fundamental tools used by professionals to create a clear snapshot of the client's current financial resources and obligations are the following two financial statements:

1. **The Statement of Current Financial Position (or Balance Sheet)**
2. **The Statement of Cash Flows (or Income and Expense Statement)**

These are not "official" names for these statements. The names will vary by practitioner as well as the layout of the statements. However, each of these two statements has a common purpose by all financial professionals and provides a great deal of information. For a variety of reasons, a financial professional may prepare several other financial statements for a client, such as a retirement income analysis, a retirement accumulation plan, an educational funding plan, a personal budget evaluation, an asset allocation analysis, a hypothetical probate for estate planning, etc. However, the Balance Sheet and the Statement of Cash Flows provide critical fundamental information about the client's financial position that serves as the foundation upon which analyses can be created.

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| **Objectives**  In this course, we will focus our attention on the two primary personal financial statements and also how to apply those statements to ratios financial professionals can use to evaluate liquidity and provide feedback for their clients.  The two key personal financial statements are:   * **Statement of Financial Position (Balance Sheet)** * **Statement of Cash Flows**   The financial statements can be interpreted through:   * **Liquidity Ratios** |

## Statement of Financial Position

The ***statement of financial position*** (a.k.a. ***balance sheet***) is a snapshot of a person’s financial position at a specific point in time. The following are a few common characteristics of a balance sheet.

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| **Common Balance Sheet Characteristics**   * All assets and liabilities in the statement are valued as of a specific date. This date should always be included in the heading of the statement. * Assets and liabilities in a personal financial statement are listed at the fair market value as of the date of the statement unless otherwise noted. * Assets will be listed, usually broken up into subcategories, and a sum of all assets calculated. * Liabilities will be listed, usually broken up into subcategories, and a sum of all liabilities calculated. * It will total assets and liabilities and calculate net worth:   **Assets - Liabilities = Net Worth**  **Liabilities + Net Worth = Assets**   * The assets and liabilities traditionally are listed side-by-side in two columns. However, financial professionals often prefer a single column format so that additional information or pro-forma projections (e.g., projected values resulting from recommendations and/or projected values in future years) can be added to the right in additional columns. |

The assets and liabilities are typically broken down into subcategories and subtotaled. The subcategories will vary by practitioner preferences and the characteristics of the client's situation.

As noted above, financial professionals will present their Financial Statements according to their own preferences or client characteristics. We have structured two different Balance Sheets for Jack and Jill Client with the same data. Go to the next page to review the first example.

## Example One - Personal Balance Sheet

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Jack and Jill Client**  **BALANCE SHEET**  **As of December 31, 2015** | | | | |
|  | Owner (1) | Value | Subtotals | TOTALS |
| **ASSETS:** |  |  |  |  |
| Cash & Cash Equivalents:(2) |  |  |  |  |
| First Bank Checking | JTWROS | $11,000 |  |  |
| Elm S&L CD | Jack | 26,000 |  |  |
| SWB MMF | JTWROS | 32,500 |  |  |
| U.S. Treasury Bill | Jill | 9,500 |  |  |
| ***Subtotal:*** |  |  | $79,000 |  |
| Investments: |  |  |  |  |
| Growth Fund (3) | JTWROS | $16,500 |  |  |
| Amer Funds IRA (Jill) (4) | Jill | 12,000 |  |  |
| Elm S&L IRA (Jack) (4) | Jack | 8,000 |  |  |
| TRS 403(b) Plan (Jill) (5) | Jill | 128,000 |  |  |
| Rental Property (6) | JTWROS | 250,000 |  |  |
| Partnership Interest (7) | Jack | 87,000 |  |  |
| 529 Plan (8) | Jack | 6,500 |  |  |
| ***Subtotal:*** |  |  | $508,000 |  |
| ***Personal Use Assets:*** |  |  |  |  |
| Residence (9) | Jill | $450,000 |  |  |
| Jack's Auto (10) | Jack | 11,000 |  |  |
| Jill's Auto (10) | Jill | 15,000 |  |  |
| Jack's Personal Assets (10) | Jack | 10,000 |  |  |
| Jill's Personal Assets (10) | Jill | 20,000 |  |  |
| Joint Personal Assets (10) | JTWROS | 30,000 |  |  |
| ***Subtotal:*** |  |  | $536,000 |  |
| **TOTAL ASSETS:** |  |  |  | $1,123,000 |
| **LIABILITIES:** |  |  |  |  |
| ***Short-Term:* (11)** |  |  |  |  |
| Master Card | Jill | $1,500 |  |  |
| Visa Card | Jack | 300 |  |  |
| Auto Loan | Jill | 4,500 |  |  |
| ***Subtotal:*** |  |  | $6,300 |  |
| ***Long-Term:*** |  |  |  |  |
| Res. Mortgage (9) | Joint | $185,000 |  |  |
| ***Subtotal:*** |  |  | $185,000 |  |
| **TOTAL LIABILITIES:** |  |  |  | $191,300 |
|  |  |  |  |  |
| **NET WORTH:** |  |  |  | $931,700 |

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| **Owner**  It is particularly important to determine ownership for estate planning purposes, but also to determine insurable interest and in the event divorce planning becomes necessary. It may also be helpful to "flag" tax-deferred accounts as "trust" ownership since these assets have limited accessibility and/or tax ramifications and possibly penalties if withdrawn. |

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| **Cash & Cash Equivalents**  This is a very common heading and an important factor in determining the client's liquidity or access to ready cash in an emergency. |

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| **Investments**  This subheading is often broken down into additional categories based on the preferences of the practitioner and the characteristics of the client's situation. Examples could include Personal Investments, Retirement Plans, Education Funds, Real Estate, Financial Assets, etc. |

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| **Footnote (1):**  36-month CD; matures 11/15/2016; 4.2% |

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| --- |
| **Footnote (2):**  6-month T-Bill; matures 3/31/2016; 1.2% |

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| **Footnote (3):**  Jack and Jill invest $500 per month into this fund via bank draft from their joint account. Cost basis is $18,500. The FMV is from the 12/31/2015 mutual fund statement. |

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| **Footnote (4):**  These are older IRAs that Jack and Jill are not currently funding. The FMV is from the 12/31/2015 IRA statements. |

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| **Footnote (5):**  Jill allocates 5% of her earnings to the Teacher's Retirement System 403(b) plan that has an employer match of 7%. The FMV is from the 12/31/2015 TRS statement. |

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| **Footnote (6):**  This is the Clients' former residence that they rent to Jack's parents. The mortgage was paid off a few years ago when Jill inherited some money from her mother. The value is estimated by the client. |

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| **Footnote (7):**  The book value of Jack's partnership account with his CPA firm. Tends to grow each year. Would be paid to Jack only in the event of his termination of employment with the firm. |

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| **Footnote (8):**  Invested in the Iowa 529 Plan. $500 per month is drafted from the joint account into the plan. The beneficiary is the Client's three-year old son, Charlie. |

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| **Footnote (9):**  Residence purchased 6 years ago for $300,000. 15-year mortgage at 5.5%. Capital improvements to house are unknown. The value is estimated by the client by recent sales in neighborhood. |

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| **Footnote (10):**  Values are estimated by the client. |

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| **Footnote (11):**  Accounts payable, taxes payable, credit card debt, and any loans totally due and payable within 12 months are included as current liabilities. In this hypothetical case, the auto loan is will be paid off in five months. |

Go to the next page to review a second example of a Balance Sheet.

## Example Two - Personal Balance Sheet

Note the advantages and disadvantages of each format. In this case, the ownership is made clear at a glance. On the other hand, this format makes pro-forma statements difficult to do. Which do you prefer? Why? Notice how the footnotes add additional insight to the assets and liabilities.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Jack and Jill Client**  **BALANCE SHEET**  **As of December 31, 2015** | | | | | |
|  | Jack | Jill | Joint | Trust (1) | TOTALS |
| **ASSETS:** |  |  |  |  |  |
| Cash & Cash Equivalents: (2) |  |  |  |  |  |
| First Bank Checking |  |  | $11,000 |  |  |
| Elm S&L CD | $26,000 |  |  |  |  |
| SWB MMF |  |  | 32,500 |  |  |
| U.S. Treasury Bill |  | $9,500 |  |  |  |
| ***Subtotals:*** | $26,000 | $9,500 | $43,500 | $0 | $79,000 |
| Investments: |  |  |  |  |  |
| Growth Fund (3) |  |  | $16,500 |  |  |
| Amer Funds IRA (Jill) (4) |  |  |  | $12,000 |  |
| Elm S&L IRA (Jack) (4) |  |  |  | 8,000 |  |
| TRS 403(b) Plan (Jill) (5) |  |  |  | 128,000 |  |
| Rental Property (6) |  |  | $250,000 |  |  |
| Partnership Interest (7) | $87,000 |  |  |  |  |
| 529 Plan (8) |  |  |  | 6,500 |  |
| ***Subtotals:*** | $87,000 | $0 | $266,500 | $154,500 | $508,000 |
| ***Personal Use Assets:*** |  |  |  |  |  |
| Residence (9) |  | $450,000 |  |  |  |
| Autos (10) | $11,000 | 15,000 |  |  |  |
| Personal Assets (10) | 10,000 | 20,000 | $30,000 |  |  |
| ***Subtotal:*** | $21,000 | $485,000 | $30,000 | $0 | $536,000 |
|  |  |  |  |  |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **TOTAL ASSETS:** | $134,000 | $735,000 | $340,100 | $154,500 | $1,123,000 |
|  |  |  |  |  |  |
| **LIABILITIES:** |  |  |  |  |  |
| ***Short-Term: (11)*** |  |  |  |  |  |
| Master Card |  | $1,500 |  |  |  |
| Visa Card | $300 |  |  |  |  |
| Auto Loan |  | 4,500 |  |  |  |
| ***Subtotal:*** | $300 | $6,000 |  |  | $6,300 |
| ***Long-Term:*** |  |  |  |  |  |
| Res. Mortgage (9) |  |  | $185,000 |  |  |
| ***Subtotal:*** |  |  | $185,000 |  | $185,000 |
|  |  |  |  |  |  |
| **TOTAL LIABILITIES:** | $300 | $6,000 | $185,000 | $0 | $191,300 |
|  |  |  |  |  |  |
| **NET WORTH:** |  |  |  |  | $931,700 |

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| **Trust/Ownership**  It is particularly important to determine ownership for estate planning purposes, but also to determine insurable interest and in the event divorce planning becomes necessary. It may also be helpful to "flag" tax-deferred accounts as "trust" ownership since these assets have limited accessibility and/or tax ramifications and possibly penalties if withdrawn. |

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| --- |
| **Cash & Cash Equivalents**  This is a very common heading and an important factor in determining the client's liquidity or access to ready cash in an emergency. |

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| --- |
| **Investments**  This subheading is often broken down into additional categories based on the preferences of the practitioner and the characteristics of the client's situation. Examples could include Personal Investments, Retirement Plans, Education Funds, Real Estate, Financial Assets, etc. |

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| --- |
| **Footnote (1):**  36-month CD; matures 11/15/2016; 4.2% |

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| --- |
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| **Footnote (3):**  Jack and Jill invest $500 per month into this fund via bank draft from their joint account. Cost basis is $18,500. The FMV is from the 12/31/2015 mutual fund statement. |

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| --- |
| **Footnote (10):**  Values are estimated by the client. |

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| **Footnote (11):**  Accounts payable, taxes payable, credit card debt, and any loans totally due and payable within 12 months are included as current liabilities. In this hypothetical case, the auto loan is will be paid off in five months. |

On the next page, we will look at assets more closely.

## A Few Notes about Assets

An ***asset*** is any property owned by an individual or company that may have been purchased with cash or borrowed funds, received as a gift or inheritance, or acquired by a combination of these means. It may also be an employee benefit paid for partially or totally by an employer. Assets are listed on the balance sheet atfair market value (FMV) and are generally divided into at least three classifications: cash and cash equivalents, investments, and personal use assets.

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| **Fair Market Value (FMV)**  Fair market value is the value a well-informed buyer is willing to accept from a well-informed seller when neither is compelled to buy or sell. As a practical matter when creating Financial Statements for purposes of financial planning, it is easier to determine market values of some assets versus others; for example, a publicly-traded common stock is easy to look up versus a residence, which may require an appraisal. Appraisals are generally unnecessary for planning purposes. (For insurance purposes, it may be appropriate to recommend appraisals of certain collectibles, antiques, valuable jewelry, etc.) In any case, it may be helpful to include in the footnotes how market values of assets on the Balance Sheet were determined. |

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| **Cash/Cash Equivalents**  ***Cash and cash equivalents*** are the most liquid of the assets, meaning they can easily and quickly be converted into cash, with little or no risk of loss of principal. This can be a controversial subject of debate - but in general, the following are considered cash and cash equivalent assets:   * Cash/Currency * Checking Accounts * Savings Accounts * U. S. Treasury Bills * Money Market Accounts (bank) * Money Market Accounts (mutual fund) * Certificates of Deposit (that mature in less than one year) |

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| **Investments**  ***Investments*** are generally assets that are held for income, growth, or capital appreciation. This can include a wide variety of asset types and the planner will often wish to divide the assets into subcategories. There is no "correct" method. In fact, "investments” may not even be an asset classification itself. For example, it could be replaced by Marketable Securities, Retirement Assets, Education Funds, Business Assets, Real Property, Collectibles, etc. Assets in the general category of "investments" could include at least the following:   * Marketable Securities: stocks, bonds, options, debentures, warrants, etc. * Investment real estate * Limited partnership interests * Ownership of business interests * Retirement accounts * Employee Benefits with future value such as stock options, deferred compensation, restricted stock, etc. * Annuities * Cash value of life insurance * Loans/notes receivable * Collectibles |

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| **Personal Use Assets**  ***Personal use assets*** are used for the personal enjoyment or benefit of the client rather than held for investment purposes. They are generally the least liquid of the assets. In some cases, however, these assets may be significant factors in retirement planning because of substantial value and/or appreciation or even income potential. Examples of Personal Use Assets are:   * Primary Residence * Other residences * Automobiles, recreational vehicles * Furniture * Jewelry * Artwork * Miscellaneous collectibles * Personal effects |

## A Few Notes about Liabilities and Net Worth

Liabilities are any debt, claim, or potential loss. They are typically classified as either current or long-term. With extensive liabilities, they may be further broken down by repayment completion dates, types of debt, etc. It is generally far too tedious to list current outstanding bills unless they are substantial. It would be appropriate to list significant and long overdue bills such as past-due income taxes. Each individual situation will dictate what liabilities are included on the financial statement or at least mentioned in the footnotes. Contingent liabilities, such as co-signing a car loan for a child, should be included in the footnotes.

Net worth, as its name and position on the statement imply, is an indicator of a person’s total wealth, but does nothing to reveal the nature of the assets and liabilities.

|  |  |
| --- | --- |
| **Overview** |  |
| **Current Liabilities** | ***Current liabilities*** are all liabilities that are currently due. Examples include taxes payable, credit card debt, notes due within a year, etc. |
| **Long-Term Liabilities** | ***Long-term liabilities*** are liabilities that generally come due beyond one year from the present. Examples of long-term liabilities include a home mortgage, car loan, or student loans. |
| **Net Worth** | ***Net worth***, also called ***shareholder’s equity*** or ***net assets*** in a business, is simply the total assets minus total liabilities. It is defined as the amount of equity the client has in owned assets.  Net worth will generally increase as a result of the following:   * Additional cash account balances, savings account balances, or investments from discretionary income, gifts or inheritances. * Appreciation in the value of assets * Reduction of liabilities (note that if loan principal is paid from cash, net worth will remain unchanged UNLESS the principal is reduced with Discretionary Cash Flow). Also, forgiveness of a loan would increase net worth. * Employer contributions to employee benefit and/or retirement plans. |

## The Uses and Benefits of the Statement of Financial Position

Why is the ***statement of financial position*** (a.k.a. ***balance sheet***) one of the two fundamental documents that a financial professional uses? A review of the client's Balance Sheet can tell us a great deal about the client and their financial position that is both obvious and maybe not so obvious.

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| **Insights**  We have listed some of these insights below. Can you think of any others?   * What is the size of their assets, liabilities and estate? * What is the amount of their net worth? * What is the size of their estate(s) in the event of death? * How close are they to financial independence, or ability to retire? * How diversified are the client’s assets? * What is the nature of assets? * What is their investment personality (saver, speculator, etc.?) If married, do the spouses demonstrate different risk tolerances? Are they the same risk tolerances that they said they had when interviewed? * Are they realistic about their financial goals? * What level of sophistication do they demonstrate? * How dependent are they on employer benefits for retirement resources? * Client’s liquidity position. Do they need to build a more substantial emergency fund? * How have they used debt? Prudently or not? * What possible areas or issues need immediate attention? (Possibly too much short-term debt or too many assets in taxable cash reserves, etc.) * Are the initial stated client objectives attainable? * Periodic updating keeps the client(s) and advisor aware of changes or reminds them of issues that require continued attention. * At least annual updating illustrates the progress (or lack of progress) being made by the client. |

Other more detailed analyses will typically be done by a financial professional using pieces of the data from this Balance Sheet, such as a risk management analysis, a retirement income projection, need for college savings, a budget analysis, an estate planning review, etc. In these cases, more details regarding the assets and liabilities may be obtained by the financial professional, but they are not necessarily shown on the Balance Sheet.

Clients typically have two major financial resources; their assets and their ability to earn an income. They also have liability payment obligations and expenses. Hopefully, they are investing discretionary cash flow and reducing liabilities in order to attain greater security and financial independence. The addition of a Statement of Cash Flows gives us a much more comprehensive snapshot of a client's current financial position, which we review on the next page.

## The Statement of Cash Flows

A ***Statement of Cash Flows*** is sometimes referred to as a "***statement of income and expenses."*** Most, but not all, practitioners believe that there is a clarifying distinction between the two. Most advisors use a Statement of Cash Flows to list ***all*** cash receipts and disbursements of the client during a specified period of time regardless of their nature. Cash Receipts may include more than "income," such as gifts received, inheritances, liquidation of investment capital that does not include or even have a gain, etc. Cash Disbursements include living, household, personal, fixed, or variable "expenses," but also include investment purchases, cash gifts to family members or trusts, etc. These "non-expense" cash disbursements usually have a corresponding effect on the Balance Sheet by increasing assets or reducing liabilities. Cash gifts could be deemed "expenses" because they reduce cash without a corresponding increase in an asset or decrease in a liability, but they would not be considered part of the routine living expenses of the client.

Keep in mind that these rules are not subject to strict guidelines, let alone agreement among practitioners. It is important to be consistent so that the statements are clear and meaningful to the financial advisor as well as to the client. It is important for the financial professional to gain an accurate understanding of ***all*** resources of cash receipts and allocations of cash disbursements. Review the Statement of Cash Flows below.Notice how the footnotes add additional insight to the assets and liabilities. (Some of the footnotes in these examples are obviously directed to the student vs. an actual part of the financial statements.)

|  |  |  |  |
| --- | --- | --- | --- |
| **Statement of Cash Flow Projection**  **Jack and Jill Client**  **Calendar and Tax Years 2015, 2016 and 2017** (1) | | | |
|  | **2015** | **2016** | **2017** |
| **RECEIPTS:** |  |  |  |
| **Earned Income:** |  |  |  |
| Jack's Partnership Income **(2)** | $85,000 | $95,000 | $115,000 |
| Jill's Salary **(2)** | 45,000 | 48,000 | 52,000 |
| **Subtotals:** | **$130,000** | **$143,000** | **$167,000** |
| **Receipts from Investments:** |  |  |  |
| Cash Equivalent Interest | $1,500 | $1,500 | $4,000 |
| Growth Fund Income Distributions | 400 | 450 | 500 |
| Growth Fund Capital Gain Distribs | 300 | 0 | 0 |
| Gross Rents from Rental Property | 15,000 | 15,000 | 15,500 |
| Maturity of CD & T-Bill **(3)** | 0 | 35,500 |  |
| **Subtotals:** | **$17,200** | **$52,450** | **$20,000** |
| **Other Receipts:** |  |  |  |
| Gift from Jack's Parents | $10,000 | $10,000 | $10,000 |
| Probable Inheritance from Jill's father | 0 | 150,000 | 0 |
| Income Tax Refunds | 6,500 | 200 | 200 |
| **Subtotals:** | **$16,500** | **$160,200** | **$10,200** |
| **TOTAL RECEIPTS:** | **$163,700** | **$355,650** | **$197,200** |
|  |  |  |  |
| **DISBURSEMENTS:** |  |  |  |
| **Family Living Expenses:** |  |  |  |
| Residential Expenses **(4)** | $50,000 | $52,250 | $55,000 |
| Personal Living Expenses **(4)** | 40,000 | 42,000 | 45,000 |
| Discretionary Living Expenses **(4)** | 20,000 | 23,000 | 25,000 |
| FICA Taxes | 9,945 | 10,940 | 12,500 |
| Federal/State Income Taxes **(8)** | 20,000 | 18,000 | 24,000 |
| Credit Card Principal Balance **(5)** | 1,000 | 1,800 | 0 |
| Auto Loan Principal Balance **(5)** | 1,800 | 4.500 | 0 |
| **Subtotals:** | **$142,745** | **$152,490** | **$161,500** |
| **Fixed Investment Disbursements: (9)** |  |  |  |
| Rental Property Expenses (6) | $6,000 | $16,000 | $6,000 |
| Retirement Plan Contributions (8) | 2,250 | 18,900 | 19,600 |
| 529 Plan Contributions | 6,000 | 6,000 | 6,000 |
| **Subtotals:** | **$14,250** | **$40,900** | **$31,600** |
| **Discretionary Investment Disbursements: (9)** |  |  |  |
| Residence Capital Improvements **(7)** | $0 | $20,000 | $60,000 |
| Reinvestment of Int/Divs/CapGain Distrb | 2,200 | 1,950 | 2,500 |
| Reinvestment of CD/T-Bill | 9,500 | 35,500 | 0 |
| Growth Fund Contributions | 6,000 | 6,000 | 6,000 |
| **Subtotals:** | **$17,700** | **$63,450** | **$68,500** |
| **TOTAL DISBURSEMENTS:** | **$174,695** | **$256,840** | **$261,600** |
| **Total Receipts Less Total Disbursements = Discretionary Cash Flow:** (10) | **$(10,995)** | **$98,810** | **$(64,400)** |

|  |
| --- |
| **Remember:**  **Receipts - Disbursements = Discretionary Cash Flow** |
| **Footnote (1):**  This is a moderately complex projection that is also referred to as a "Pro Forma Statement”, since it projects receipts and disbursements in the future. Three years gives a snapshot of last year, the current year, and the following year, thus this Statement of Cash Flows includes "projection" in the title. As stated above, a Statement of Cash Flows will vary by practitioner preferences and the client's situation. In addition, many practitioners will concurrently prepare an income tax projection (last year actual, this year and next year estimated). Income tax projections present a platform for tax planning and can illustrate the impact of financial planning proposals or decisions on income taxes. The Statement of Cash Flows will show the result of the tax projections since income tax payments are a cash disbursement. Most practitioners use sophisticated software to build and maintain these "pro forma" projections. |

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| **Footnote (2):**  Based on statements by Jack and Jill, we have projected increases in their compensation. |

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| **Footnote (3):**  The CD was purchased prior to 2015. The T-Bill was purchased in 2015. Both mature in 2016 and will represent cash receipts. A decision will be made what to do with this cash as these assets mature. |

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| **Footnote (4):**  Many practitioners will break these categories into more detail if it is deemed beneficial to examine the client's budget. Note that we have distinguished between "Personal Living Expenses and "Discretionary Living Expenses." Most advisors and clients will want to distinguish between actual "necessary" living expenses (such as housing, food, clothing, transportation, etc.) and discretionary living expenses (such as vacations, club dues, etc.) Note the distinction between "necessary" and "discretionary" will vary by client and may require a more detailed or supplemental statement to clearly distinguish the two. We will discuss this issue in the next course when we analyze personal financial statements. |

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| **Footnote (5):**  The financial statements point out that these relatively small debts should be paid off with sufficient cash reserves, which is a substantial, guaranteed, tax-free rate of return. |

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| **Footnote (6):**  Note that like many numbers in this statement, the projected numbers are estimates only that will likely fluctuate somewhat in the future. However, a statement based on good estimates is a very valuable planning tool. |

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| **Footnote (7):**  The Clients want to make improvements and an addition to their home. They believe they will receive an inheritance this year and will probably pay cash for the improvements. The two primary financial statements provide a platform for discussing this issue. If interest rates were favorable, some advisors would encourage the Clients to refinance their home and invest their cash for retirement. |

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| **Footnote (8):**  Note that the income tax liability decreases in 2016 and 2017 even though the Client's income increases. We assume that Jack participates in a new 401(k) Plan beginning in 2016. His contributions are assumed to be tax deductible. We will discuss these plans and deductions in later courses. |

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| **Footnote (9):**  Like the Household and Personal Living Expenses, we have distinguished between "Fixed Investment Disbursements" and Discretionary Investment Disbursements." Most advisors and clients will want to distinguish between actual "necessary" investments (such as retirement plan contributions, 529 Plan contributions, etc.) and discretionary investments. Note the distinction between "necessary" and "discretionary" will vary by client and may require a more detailed or supplemental statement to clearly distinguish the two. We will discuss this issue in the next lesson when we analyze personal financial statements. |

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| **Footnote (10):**  "Net Discretionary Cash Flow" can be either positive or negative as illustrated in this three-year projection. If the client has negative cash flow, it DOES NOT necessarily mean that their family budget is flawed. Notice that the Clients have a surplus of cash in 2016 of about $99,000 and a deficit the next year of about $64,400. This is primarily due to two transactions. The first is the projected inheritance of $150,000 in 2016. The second is the expenses of $80,000 for home improvements that are paid in 2016 and 2017. If the family budget is an issue, a supplemental statement can be created to specifically analyze the family budget. |

## A Few Notes about Cash Receipts and Disbursements

Remember, cash receipts are not necessarily taxable or the same thing as income. A cash receipt included in the Statement of Cash Flows must fall within the designated period (usually a calendar year). We have allocated cash receipts into three categories in the table below that would usually include the items shown.

|  |  |  |
| --- | --- | --- |
| **Earned Income** | **Investment Income** | **Other Receipts** |
| * Salary/wages/bonuses * Deferred compensation * Self-employment income distributed in cash | * Interest and dividends * Mutual fund capital gain distributions * Cash proceeds from sale of investment asset * Annuity income * Retirement plan withdrawals/income * Royalty cash payments * Gross rental payments | * Cash gifts * Cash portion of inheritances * Income tax refunds * Loan proceeds * Social Security income * Life insurance proceeds * An insurance payment |

Cash Disbursements

Cash disbursements are not necessarily just "expenses." Remember that the cash disbursement included in the Statement of Cash Flows must fall within the designated period (usually a calendar year). Disbursements may include capital investments, purchase of investment assets, debt principal repayments, cash gifts, etc. We have also allocated cash disbursements into three categories in the table below that would usually include the items shown.

|  |  |  |
| --- | --- | --- |
| **Personal/Family Living Expenses** | **Financial/Investments** | **Other Distributions** |
| * Income taxes (paid, not accrued * Payroll taxes * Consumer debt/mortgage loan payments * Capital improvements to residence * Purchase of substantial personal use assets for cash (a car or boat) | * Investment purchases * Reinvestment of interest, dividends, or capital gain distributions * Retirement plan contributions * Investment asset expenses/capital expenditures | * Repayment of debt principal * Cash gifts |

Click the icon to view an important note.

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| **Important Note**  Note also a few items that are taxable income but not cash receipts:   * Phantom income is taxable income but occurs when no cash is distributed (for example, from a partnership or Subchapter S corporation that reports taxable income to partners or shareholders, but does not distribute the same amount or possibly any cash - we will discuss these entities later in this course and in the Income Tax course) * Taxable employee benefits not distributed as cash (such as group life insurance that exceeds $50,000 paid for by an employer) |

## The Uses and Benefits of the Statement of Cash Flows

The Statement of Cash Flows is extremely useful to financial professionals because instead of taking a snapshot of the client’s financial picture, like the balance sheet, it presents the client’s financial activities over a time interval. This can give the financial professionals a better understanding of exactly how the client earns, spends, and maintains wealth.

The Statement of Cash Flows can be prepared with two simultaneous perspectives:

1. First, it can be prepared after all receipts and disbursements have been realized, making it useful for comparison to budgeted goals.
2. Or it can be prepared in advance, making it useful for budgeting and/or planning for the future.

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| **Information Revealed by the Statement of Cash Flows**  Specifically, among other things, the Statement of Cash Flows can reveal some or all of the following:   * The size of the client’s net discretionary cash flow; surplus or deficit. * The primary reasons for surplus or deficit. * Can tell the advisor a great deal about the client's financial personality. * Typically reveals numerous opportunities for improvements in the management of income tax and cash flow planning. * In most cases, it will be the first time a client has seen a snapshot of where their money is coming from and particularly where it is going. For many clients, this statement will be a very significant "revelation" and a motivator to alter spending and saving habits. * Serves as a foundation for more specialized statements such as Income Tax Projections (for Income Tax Planning) or a more detailed analysis of household expenditures for development of a household budget. * Once the Statement of Cash Flows has been established for a client, future updates are relatively easy to implement plus the initial format can be expanded for alternative pro-forma or "what if" projections based on a wide range of hypothetical scenarios or recommendations. |

## Integrating the Value of the Two Primary Financial Statements

When looking at two balance sheets dated one year apart, it is easy to identify ***where*** changes have occurred, but it is not so easy to identify ***why*** changes have occurred. These changes between balance sheets are caused by the following factors:

* **The Discretionary Cash Flow (surplus or deficit) for the same time period.** In the case of a deficit, liabilities have probably been increased and/or assets have been decreased. In the case of a surplus, liabilities have probably been decreased and/or assets have been increased.
* **Changes in the market value of assets.** This dynamic obviously occurs regardless of whether or not net discretionary cash flow is positive (surplus) or negative (deficit).
* **An asset other than cash being exchanged for assets; e.g., when buying a new car, the credit given for the old car.**
* **Assets other than cash received as a gift or inheritance.**
* **Liabilities are forgiven or paid by another party (a gift).**

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| **Example**  An investment account may show up as worth $50,000 in the latest balance sheet, but the prior balance sheet might show it as worth $40,000. The $10,000 increase in its value may have been caused by a contribution of additional cash into the account or an increase in the market value of the securities in the account, or a combination of both.  A new vacation home may appear on the current end-of-year balance sheet that was not on the previous year's balance sheet. This asset could have been totally or partially gifted or inherited, purchased for cash, purchased with borrowed funds or any combination of the above.  A grandparent pays off a grandchild's student loan. This will reduce the student's liabilities but would not show up on a Statement of Cash Flows. |

A review of changes in net worth is an issue that will be of value to the client. This can often be handled in footnotes to statements. In other cases, it may be addressed in specialized reports, such as a review of investment or retirement portfolio performance.

Keep in mind that a client's net worth will actually change on a daily basis. Income is received (net worth increases), bills are paid (net worth decreases), assets, particularly marketable securities, may fluctuate in value every day (net worth may go up or down), etc. A Statement of Cash Flows typically only provides useful information over longer periods of time, such as year to year. For a wealthier client with an uneven income, projections that break down periods into smaller time periods (such as monthly or quarterly) may provide assistance to the client when making decisions regarding sizable cash expenditures.

## Review Exercise

Select the correct answer to each question.

1. **A client provides a current personal balance sheet to the financial professional during the initial data-gathering phase of a financial evaluation process. This financial statement will enable the financial professional to gain an understanding of all of the following except the:**

* Diversification of the client’s assets
* Size of the client’s net cash flow
* Client's liquidity position
* Client's use of debt

1. **Where would a financial professional look to find a client’s net worth at year’s end?**

* Statement of Financial Position
* Statement of Cash Flows
* None of the above

1. **The government has just created a new financial instrument called a wiggle. Individuals may purchase wiggles from the government and may only redeem them in 5 years for twice the face value, or in ten years for three times the face value. Would this instrument be placed on a Statement of Cash Flows in the year it was purchased or on The Statement of Financial Position?**

* The Statement of Financial Position
* The Statement of Cash Flows
* It would appear on both statements.

1. **The Statement of Financial Position is a summary of a person’s cash flow activity over a period of time.**

* True
* False

1. **Which of the following factors can cause a change in the Net Worth of a client?**
2. **The client purchases a Treasury Bill with cash from his checking account.**
3. **The client receives an inheritance of a 300-acre farm.**
4. **A decrease in the value of a common stock**
5. **The forgiveness of a debt.**
6. **The purchase of a residence for $80,000 down and assumption of a mortgage for $320,000. Assume the house is appraised for the purchase price.**

* a, c and e
* b, c and d
* b, c and e
* c and d

1. **All of the following would be considered Cash Receipts on the Statement of Cash Flows EXCEPT?**

* Salary
* A cash loan to purchase a car
* Social Security income
* Life insurance proceeds
* None of the above - all are cash receipts

1. **All of the following would be considered Cash Disbursements on the Statement of Cash Flows EXCEPT?**

* Cash gifts to children
* Tuition payments
* Income tax refunds
* Investment purchases that appreciate in value
* Capital improvements to a residence

1. **The Statement of Cash Flows can reveal all of the following EXCEPT?**

* The size of the client's net discretionary cash flow - a surplus or deficit.
* Typically reveals numerous opportunities for improvements in management of income tax and cash flow planning.
* Tells the advisor a great deal about the client's financial personality.
* Calculates the client's Net Worth

The answers to these questions are found on the following page.

## Review Exercise – Answer Key

Select the correct answer to each question.

1. **A client provides a current personal balance sheet to the financial professional during the initial data-gathering phase of a financial evaluation process. This financial statement will enable the financial professional to gain an understanding of all of the following except the:**

* Diversification of the client’s assets

**Incorrect**. The correct answer is “size of the client’s net cash flow”. The balance sheet (Statement of Financial Position) lists assets, liabilities, and net worth on a specific date. It does not provide any information about cash flows. Diversification of assets, liquidity, and use of debt can all be determined from the information listed on the balance sheet.

* **Size of the client’s net cash flow**

**Correct**! The balance sheet (Statement of Financial Position) lists assets, liabilities, and net worth on a specific date. It does not provide any information about cash flows. Diversification of assets, liquidity, and use of debt can all be determined from the information listed on the balance sheet.

* Client's liquidity position

**Incorrect**. The correct answer is “size of the client’s net cash flow”. The balance sheet (Statement of Financial Position) lists assets, liabilities, and net worth on a specific date. It does not provide any information about cash flows. Diversification of assets, liquidity, and use of debt can all be determined from the information listed on the balance sheet.

* Client's use of debt

**Incorrect**. The correct answer is “size of the client’s net cash flow”. The balance sheet (Statement of Financial Position) lists assets, liabilities, and net worth on a specific date. It does not provide any information about cash flows. Diversification of assets, liquidity, and use of debt can all be determined from the information listed on the balance sheet.

1. **Where would a financial professional look to find a client’s net worth at year’s end?**

* **Statement of Financial Position**

**Correct**!

* Statement of Cash Flows

**Incorrect**. The statement of cash flows does not list net worth.

* None of the above

**Incorrect**. One of the responses will list the net worth.

1. **The government has just created a new financial instrument called a wiggle. Individuals may purchase wiggles from the government and may only redeem them in 5 years for twice the face value, or in ten years for three times the face value. Would this instrument be placed on a Statement of Cash Flows in the year it was purchased or on The Statement of Financial Position?**

* The Statement of Financial Position

**Incorrect**. It would be included on both Statements.

* The Statement of Cash Flows

**Incorrect**. It would be included on both Statements.

* **It would appear on both statements**.

**Correct**! It may be lumped together with other similar assets/investments, but the asset value would show up on the Balance Sheet and the purchase would be accounted for on the Statement of Cash Flows.

1. **The Statement of Financial Position is a summary of a person’s cash flow activity over a period of time.**

* True

**Incorrect**. The balance sheet is a snapshot of a person’s financial standing, not a summary.

* **False**

**Correct**! The balance sheet is a snapshot.

1. **Which of the following factors can cause a change in the Net Worth of a client?**
2. **The client purchases a Treasury Bill with cash from his checking account.**
3. **The client receives an inheritance of a 300-acre farm.**
4. **A decrease in the value of a common stock**
5. **The forgiveness of a debt.**
6. **The purchase of a residence for $80,000 down and assumption of a mortgage for $320,000. Assume the house is appraised for the purchase price.**

* a, c and e

**Incorrect**. Try again.

* **b, c and d**

**Correct**! These would all change net worth.

* b, c and e

**Incorrect**. Try again.

* c and d

**Incorrect**. Try again.

1. **All of the following would be considered Cash Receipts on the Statement of Cash Flows EXCEPT?**

* Salary

**Incorrect**. This is a cash receipt.

* A cash loan to purchase a car

**Incorrect**. This is a cash receipt.

* Social Security income

**Incorrect**. This is a cash receipt.

* Life insurance proceeds

**Incorrect**. This is a cash receipt.

* **None of the above - all are cash receipts**

**Correct**!

1. **All of the following would be considered Cash Disbursements on the Statement of Cash Flows EXCEPT?**

* Cash gifts to children

**Incorrect**! This is a cash disbursement.

* Tuition payments

**Incorrect**. This is a cash disbursement.

* **Income tax refunds**

**Correct**! This is a cash receipt.

* Investment purchases that appreciate in value

**Incorrect**! This is a cash disbursement.

* Capital improvements to a residence

**Incorrect**. This is a cash disbursement.

1. **The Statement of Cash Flows can reveal all of the following EXCEPT?**

* The size of the client's net discretionary cash flow - a surplus or deficit.

**Incorrect**. This is a characteristic of a Statement of Cash Flows

* Typically reveals numerous opportunities for improvements in management of income tax and cash flow planning.

**Incorrect**. This is a characteristic of a Statement of Cash Flows

* Tells the advisor a great deal about the client's financial personality.

**Incorrect**. This is a characteristic of a Statement of Cash Flows

* **Calculates the client's Net Worth**

**Correct**! Net Worth is calculated on the Balance Sheet.

## Analyzing Personal Financial Statements and Liquidity Ratios

Technical calculations can be helpful as snapshots of the client's financial health relative to consensus norms, such as measuring liquidity, amount of debt relative to assets, or cash receipts. In this course, we will discuss the two most commonly used ratios that financial professionals use to evaluate client liquidity. In addition, we will examine the most commonly used ratio to determine a person’s ability to support debt from current income.

The two most common liquidity ratios are the emergency funds ratio and the current ratio. These ratios measure the ability of the client to meet short-term cash demands by comparing required monthly living expenses and short-term liabilities to liquid term assets. Examples of each can be seen on the next two pages.

## The All Important Emergency Fund

A fundamental tenet of sound financial planning is for every client to establish and maintain an "emergency fund" of highly liquid assets that can serve as a reliable resource in the event of a lost job, disability, or any unexpected event that strains cash resources. Substantial cash resources can also allow the client to take advantage of unexpected investment opportunities, assist others in need, and/or allow the client to take advantage of discounted cash purchases and utilize higher deductibles when insuring a variety of risks. A cash reserve, supplemented by established lines of credit may also prove to be an appropriate strategy, but if the client has a serious financial reversal, additional debt is not likely to be a good option. The vast majority of our clients are trying to move toward financial independence where earned income is an optional activity. This usually involves minimizing debt, or at least using debt as a strategic, versus necessary financial tool.

In order to determine the adequacy of a client's Emergency Fund, we need to determine three things:

1. What is an adequate Emergency Fund amount?
2. What assets are included in an Emergency Fund and what is their current value?
3. What categories of monthly expenses should be included for payment by the Emergency Fund and what is the estimated monthly total?

We will address the answers to these three questions one by one and then calculate the adequacy of Jack and Jill Clients' Emergency Fund using data from their Financial Statements that we reviewed earlier in this course.

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| **What is an adequate Emergency Fund amount?** |
| **Answer:** There is a consensus among financial professionals regarding an adequate size of an Emergency Fund (EF) that many financial professionals consider appropriate:   1. The EF should be able to ***cover three months*** of "fixed and variable" expenses if : 2. The client is single and has an additional and reliable source of income other than earned compensation. 3. The client(s) is/are married and both spouses have substantive and reliable earned income. 4. The client(s) is/are married and one spouse has an additional and reliable source of income other than the earned compensation of one spouse. 5. The EF should be able to cover six months of "fixed and variable" expenses if: 6. The client is single and does not have an additional and reliable source of income other than earned compensation. 7. The client(s) is/are married and they do not have an additional and reliable source of income other than the earned compensation of one spouse. |

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| **What are additional and reliable sources of income other than earned compensation?** |
| **Answer:** Alimony, child support, a trust fund providing substantive income and/or rights of withdrawal, or an investment portfolio that can provide substantive income are examples of good secondary sources of income. For the vast majority of clients, these secondary sources will be either nonexistent or only partially adequate to replace lost earned income. |

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| **What assets are included in an Emergency Fund and what is their current value?** |
| **Answer:** In a word (or two) - cash equivalents. Cash equivalents are assets that can be liquidated quickly and easily without loss of value. (We define Marketability as the availability of a market to purchase a seller's assets at any price).  In the Balance Sheet for Jack and Jill Client from earlier in this course, we subtotaled this category of assets as follows:   |  |  |  |  |  | | --- | --- | --- | --- | --- | | **Jack and Jill Client**  **BALANCE SHEET**  **As of December 31, 2015** | | | | | |  | **Owner** | **Value** | **Subtotals** | **TOTALS** | | **ASSETS:** |  |  |  |  | | ***Cash & Cash Equivalents:*** |  |  |  |  | | First Bank Checking | JWROS | $11,000 |  |  | | Elm S&L CD | Jack | 26,000 |  |  | | SWB MMF | JWROS | 32,500 |  |  | | U.S. Treasury Bill | Jill | 9,500 |  |  | | **Subtotal:** |  |  | **$79,000** |  |   Thus, the current value of the Clients' Emergency Fund is $79,000. |

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| **What categories of monthly expenses should be included for payment by the Emergency Fund and what is the estimated monthly total?** |
| **Answer:** In the Statement of Cash Flows prepared for Jack and Jill Client, we projected the following disbursements:   |  |  |  |  | | --- | --- | --- | --- | | **DISBURSEMENTS:** | **2015** | **2016** | **2017** | | ***Family Living Expenses:*** |  |  |  | | Residential Expenses | $50,000 | $52,250 | $55,000 | | Personal Living Expenses | 40,000 | 42,000 | 45,000 | | Discretionary Living Expenses | 20,000 | 23,000 | 25,000 | | FICA Taxes | 9,945 | 10,940 | 12,500 | | Federal/State Income Taxes | 20,000 | 18,000 | 24,000 | | Credit Card Principal Balance | 1,000 | 1,800 | 0 | | Auto Loan Principal Balance | 1,800 | 4.500 | 0 | | **Subtotals:** | **$142,745** | **$152,490** | **$161,500** | | ***Fixed Investment Disbursements:*** |  |  |  | | Rental Property Expenses | $6,000 | $16,000 | $6,000 | | Retirement Plan Contributions | 2,250 | 18,900 | 19,600 | | 529 Plan Contributions | 6,000 | 6,000 | 6,000 | | **Subtotals:** | **$14,250** | **$40,900** | **$31,600** | | **Discretionary Investment Disbursements:** |  |  |  | | Residence Capital Improvements | $0 | $20,000 | $60,000 | | Reinvestment of Int/Divs/CapGain Distrb | 2,200 | 1,950 | 2,500 | | Reinvestment of CD/T-Bill | 9,500 | 35,500 | 0 | | Growth Fund Contributions | 6,000 | 6,000 | 6,000 | | **Subtotals:** | **$17,700** | **$63,450** | **$68,500** | | **TOTAL DISBURSEMENTS:** | **$174,695** | **$256.840** | **$261,600** |   Determining the amount of expenses to be included in the EF calculation is somewhat subjective and one where feedback from the client is important. However, we are not addressing an issue of precision here - we are merely trying to get a snapshot view of how well the client can weather a financial storm. Let's assume that we have reviewed the above disbursements regarding their ongoing necessity in the event Jack or Jill loses their job, and we have concluded the following disbursements are not "flexible" in 2016:   |  |  | | --- | --- | | Residential expenses: | $45,000 | | Personal living expenses: | 35,000 | | Discretionary living expenses: | 0 | | FICA & income taxes: | 10,000 | | Rental property expenses: | 6,000 | | Retirement plan contributions: | 2,400 | | Total annual required payments: | $98,400 | | Divided by 12 for monthly amount: | $8,200 | | **Required EF amount** | **=$8,200** |   The EF Ratio is thus calculated as follows:   |  |  | | --- | --- | | Current Cash Equivalent Assets ($79,000) | =9.63 | | Required Monthly Cash Expenditures (8,200) |   The Emergency Fund Ratio in this case indicates that the Clients have an Emergency Fund that will last 9.63 months, which is far more than the guideline of three months. Keep in mind that, in reality, this is a somewhat subjective calculation and "necessary expenses" will vary with every client. | |

## Current Ratio

Another ratio can be quickly calculated to provide a snapshot of a client's liquidity risk by calculating the ratio of current assets to current liabilities. Both of these classifications are defined somewhat differently by the Financial Accounting Standards Board (FASB) and various financial advisors. In this case, financial professionals are not subject to FASB guidelines and financial professionals can even create their own ratios if they like. We define these terms as follows:

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| **Current Assets:** Cash equivalents, marketable securities, accounts receivable, and inventory and accounts receivable (inventory or receivables may be owned by a sole proprietor)  **Current Liabilities:** Credit card debt, taxes payable, accounts payable (accounts payable may be owed by a sole proprietor), and any debts that are due within one year. |

In the case of Jack and Jill Client, we will need to pick assets out of their Balance Sheet to determine the two totals. In the abbreviated portions of the Balance Sheet below, we have highlighted the Current Assets in yellow and the Current Liabilities in blue. The auto loan is included in the definition because we know that the loan only has six payments left and is totally due and payable within one year. We will presume that Jack and Jill have no tax liabilities since they are not listed on the Balance Sheet and we also assume they are both subject to withholding.

|  |  |  |  |
| --- | --- | --- | --- |
| **ASSETS:** | **Owner** | **Value** | **Subtotals** |
| ***Cash & Cash Equivalents:*** |  |  |  |
| First Bank Checking | JWROS | $11,000 |  |
| Elm S&L 3 mo. CD | Jack | 26,000 |  |
| SWB MMF | JWROS | 32,500 |  |
| U.S. Treasury Bill | Jill | 9,500 |  |
| **Subtotal:** |  |  | **$79,000** |
| ***Investments:*** |  |  |  |
| Growth Fund | JWROS | $16,500 |  |
| Amer Funds IRA (Jill) | Jill | 12,000 |  |
| Elm S&L IRA (Jack) | Jack | 8,000 |  |
| TRS 403(b) Plan (Jill) | Jill | 128,000 |  |
| Rental Property | JWROS | 250,000 |  |
| Partnership Interest | Jack | 87,000 |  |
| 529 Plan (10) | Jack | 6,500 |  |
| **Subtotal:** |  |  | **$508,000** |

|  |  |  |  |
| --- | --- | --- | --- |
| ***Short-Term: or "Current Liabilities"*** | **Owner** | **Value** | **Subtotals** |
| Master Card | Jill | $1,500 |  |
| Visa Card | Jack | 300 |  |
| Auto Loan | Jill | 4,500 |  |
| **Subtotal:** |  |  | **$6,300** |

The Current Assets thus total $95,500 and the Current Liabilities total $1,800.

|  |  |
| --- | --- |
| Current Ratio = | Current Assets  Current Liabilities |

Using the Current Ratio formula, we calculate the Clients' Current Ratio as follows:

|  |  |
| --- | --- |
| Current Assets ($95,500)  Current Liabilities ($6,300) | **=15.16** |

A Current Ratio of at least 1.00 is considered adequate. A ratio of 2.00 is considered good. As you can see, the Clients' Current Ratio is excellent. Note, however, that a Current Ratio can change rapidly. If the financial professional has historical data, it would be informative to evaluate how stable the Current Ratio has been in the past, and it should be monitored in the future.

## Debt-to-Income Ratio and Mortgage Qualification

The Debt-to-Income Ratio is useful in determining a person’s ability to carry debt payments out of current income. This ratio is calculated as follows:

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| --- |
| **Debt-To-Income Ratio = Monthly Debt Payments ÷** **Monthly Gross Income** |

To make the calculation, you simply total your monthly debt payments and divide them by the monthly gross income. For example, if total debt payments are $2,000 per month and monthly gross income (before taxes and other deductions) is $10,000 per month, then the debt-to-income ratio is $2,000 ÷ $10,000 = .20, or 20%. People with high debt-to-income ratios are generally at greater risk of default; for this reason, they are less likely to qualify for loans or mortgages.

For example, when applying for a home mortgage, the lender will look at two ratios. One ratio will look at your monthly housing payment (principal and interest, escrow deposits for taxes, hazard insurance, mortgage insurance premium, homeowners’ dues, etc.) as a percentage of monthly gross income. The other ratio is the debt-to-income ratio, including the monthly housing payment as part of the monthly debt.

## Review Exercise

Select the correct answer to each question.

1. **George is single and earns $6,000 per month. In the event he lost his job or was unable to work, he figures he would need $4,000 per month to pay his bills. He has no other source of income other than his salary. He has $8,000 in his checking account and $4,000 in a Money Market fund. His assets are relatively nominal. How large should George's emergency fund be?**

* $12,000
* $18,000
* $24,000
* $48,000

1. **From the question above, what is George's current Emergency Fund Ratio?**

* .50
* 3.00
* 6.00
* 4.00

1. **Mary and Manny are married. They both earn about $60,000 per year. Their "required" monthly living expenses are $7,500 per month. Neither spouse has an additional source of income other than their earnings. Mary averages a $2,400 balance in her checking account. Manny's checking account usually runs close to zero, but he has a $3,000 balance in a savings account. How large should Mary and Manny's Emergency Fund be?**

* $22,500
* $45,000
* $15,000
* $30,000

1. **From the question above, what is Mary and George's current Emergency Fund Ratio?**

* .24
* .09
* .72
* 1.39

1. **Boris has current assets totaling $125,000. His current liabilities total $250,000. What is his Current Ratio?**

* .50
* 2.00
* 1.00

1. **Samantha is wanting to purchase a house and is applying for a mortgage. Her monthly housing expenses on the new house would be $2,400 (principal and interest, escrow deposits for taxes, hazard insurance, mortgage insurance premium, homeowners’ dues, etc.). In addition, she has monthly charge card and car loan payments totaling $1,200. Her lender requires her to meet debt ratios of 31/43, where 31% is the debt ratio for her housing expense and 43% is her total debt ratio including her housing expense. If Samantha has monthly gross income of $8,000, can she qualify for the loan based upon the ratio limits?**

* Yes
* No

The answers to these questions are found on the following page.

## Review Exercise – Answer Key

Select the correct answer to each question.

1. **George is single and earns $6,000 per month. In the event he lost his job or was unable to work, he figures he would need $4,000 per month to pay his bills. He has no other source of income other than his salary. He has $8,000 in his checking account and $4,000 in a Money Market fund. His assets are relatively nominal. How large should George's emergency fund be?**

* $12,000

**Incorrect**. Try again.

* $18,000

**Incorrect**. Try again.

* **$24,000**

**Correct**! The calculation is six months times $4,000 per month totals $24,000.

* $48,000

**Incorrect**. Try again.

1. **From the question above, what is George's current Emergency Fund Ratio?**

* .50

**Incorrect**. Try again.

* **3.00**

**Correct**! The calculation is $12,000 divided by $4,000.

* 6.00

**Incorrect**. Try again.

* 4.00

**Incorrect**. Try again.

1. **Mary and Manny are married. They both earn about $60,000 per year. Their "required" monthly living expenses are $7,500 per month. Neither spouse has an additional source of income other than their earnings. Mary averages a $2,400 balance in her checking account. Manny's checking account usually runs close to zero, but he has a $3,000 balance in a savings account. How large should Mary and Manny's Emergency Fund be?**

* **$22,500**

**Correct**! The calculation is three months times $7,500 totals $22,500.

* $45,000

**Incorrect**. Try again.

* $15,000

**Incorrect**. Try again.

* $30,000

**Incorrect**. Try again.

1. **From the question above, what is Mary and George's current Emergency Fund Ratio?**

* .24

**Incorrect**. Try again.

* .09

**Incorrect**. Try again.

* **.72**

**Correct**! The calculation is $5,400 divided by $7,500.

* 1.39

**Incorrect**. Try again.

1. **Boris has current assets totaling $125,000. His current liabilities total $250,000. What is his Current Ratio?**

* **.50**

**Correct**! The calculation is $125,000 divided by $250,000.

* 2.00

**Incorrect**. Try again.

* 1.00

**Incorrect**. Try again.

1. **Samantha is wanting to purchase a house and is applying for a mortgage. Her monthly housing expenses on the new house would be $2,400 (principal and interest, escrow deposits for taxes, hazard insurance, mortgage insurance premium, homeowners’ dues, etc.). In addition, she has monthly charge card and car loan payments totaling $1,200. Her lender requires her to meet debt ratios of 31/43, where 31% is the debt ratio for her housing expense and 43% is her total debt ratio including her housing expense. If Samantha has monthly gross income of $8,000, can she qualify for the loan based upon the ratio limits?**

* Yes

**Incorrect**. Samantha meets the first limit regarding her housing expense with a 30% ratio ($2,400 ÷ $8,000), but her total debt-to-income ratio is 45% ($3,600 ÷ $8,000), which exceeds the lender’s 43% limit.

* **No**

**Correct**! Samantha meets the first limit regarding her housing expense with a 30% ratio ($2,400 ÷ $8,000), but her total debt-to-income ratio is 45% ($3,600 ÷ $8,000), which exceeds the lender’s 43% limit.

## Conclusion

This concludes the material for this subject. At this time, you may return to any sections in which you feel the need for further study.