Unit 3: Financial Statements

Topics:
- Using financial statements
- A personal balance sheet
- Personal income and expense statement
- Cash budget

Using Financial Statements

Financial statements are important in the financial planning process. From the daily spending log to the budget, all of the financial statements serve a purpose in building your personal financial plan. The information that you provide must be accurate to show your actual financial position. Figure 3.1 provides an overview of what is needed to support your financial statements for this part of your financial plan.

Figure 3.1

As you work on your plan the benefits of being precise when completing your financial statements will be obvious as you look at your finances. The more exact you are in your reporting your finances, the clearer it will be to see where you might need to adjust your income and expenses.

Financial statements and a budget can help you achieve your financial goals. The balance sheet tells you where you are now, the cash flow or cash budget shows your income and expenses for the month, and the budget is the plan to reach financial goals.
**Personal Balance Sheet**

The balance sheet is a financial statement that describes your financial position at a given point in time. The personal balance sheet is a summary of your **assets** (what you own), your **liabilities** (what you owe), and your **net worth** (assets minus liabilities).

**Assets**

Assets are items that you own. Assets can be categorized on the balance sheet as liquid, household, or investments.

- **Liquid assets** can be turned into cash and will not lose value. Cash, checking accounts, and savings are examples of liquid assets which are readily available to cover unexpected expenses.
- **Household assets** are the items owned by those in the household. Examples of household assets include a home, furniture, and an automobile. The current market value should be placed on the balance sheet.
- **Investments** include stocks, bonds, mutual funds, and real estate. Real estate includes any commercial or residential properties that create income.

**Liabilities**

Liabilities are debts. Debts are financial obligations that you owe to others. There are two categories of liabilities: current and long-term.

- **A current liability** is debt that will be paid within a year. Examples include tax payments, insurance premiums, medical bills, credit card balances and charge accounts.
- **Long-term liabilities** are debts that will be paid back over a longer period. Examples include student loans, auto loans, and mortgages.
Net Worth

Net worth is what you own once you pay off all debts. Once assets are used to pay off all liabilities, what you have left is your net worth.

In reviewing the balance sheet you will find that assets equal the combined total of your liability plus net worth. Another way to say this is:

\[
\text{Net worth} = \text{Assets} - \text{Liabilities}
\]

Personal Income and Expense Statement

A personal income and expense statement shows income and expenditures. It is a cash-basis statement that shows the actual cash coming in and the actual cash going out for a certain period. At the end of the period, you should have money left over. This is a cash surplus. If you do not have money left over, you have spent more than you made and the result will be a cash deficit. For example:

Income of $50,000.00 minus expenses of $30,000.00 = $20,000.00 (surplus)

Income of $30,000.00 minus expenses of $40,000.00 = - $10,000.00 (deficit)

**Income** includes all earnings such as salaries, wages, self-employment income, company bonuses, and commissions. It also includes interest received from savings and checking accounts as well as from investments. If you sell any assets such as an automobile, stocks, and bonds, this is also considered to be income. Income includes pensions, annuities, social security income, and any monies received from a rental property. Income also would include alimony, child support, scholarships, and grants.

**Expenses** refer to monies paid out. Categories for expenses include: housing, utilities, food, transportation, medical, clothing, insurance, taxes, personal care, and entertainment. When preparing your statement, you can include additional categories that fit your personal situation such as pet care or gym expenses.

Some expenses are **fixed** and are the same amount each month. Examples include a car payment or loan payment. **Variable** expense amounts change each month; examples include utilities, groceries or credit card payments.
How to prepare a personal income and expense statement:

Step 1: Record all income

Step 2: Determine expense categories

Step 3: Subtract all expenses from income

Step 4: Analyze the results. A positive figure indicates a cash surplus. This means that you have excess funds that can be reallocated. A negative figure shows that you have a cash deficit which means you have spent more than you made. You will have to make adjustments to your expenditures, such as going without that daily latte!

Cash Budget

A cash budget takes into account estimated monthly cash receipts (income) and cash expenses for the coming year. A cash budget must be as detailed as possible so you can accurately see where you are receiving money as well as where you are spending money.

Steps to preparing a cash budget:

1. Gather all information you can from your statements. Include pay stubs, investment statement(s), utilities, debt, and bank statements.
2. Record all sources of income.
3. List all monthly expenses. It is important to make sure you include everything, being careful not to omit any expense(s), no matter how small. Put your expenses into two categories:
   a) Fixed expenses are those that stay the same each month (e.g., mortgage payments, loan payments, cable TV fees, and insurance premiums).
   b) Variable expenses are those that may fluctuate each month, such as utilities, medical expenses, and entertainment.
4. Total each column (income and expenses).
5. Review your budget frequently to keep control of your finances.

The purpose of the cash budget is to help you to concisely register your finances. Every dollar earned, spent, or saved needs to be accounted for. If you find you have money left over, you can determine where to use this money. You might pay off a debt, for instance, by adding more to your monthly credit card payments, or you could put this money into your savings account. If you find that you have run out of money, you must reduce some of your expenses to cover the shortfall.

Although cash budgets are a common tool for businesses, they are also very beneficial to individuals. Creating a cash budget can help determine where cash is regularly being spent. Knowing how much you are spending in one category or another will help to identify areas where additional
savings can be found. Moving unnecessary incidental expenditures into a savings account will yield big rewards.

It is often hard to identify how much money is spent for small purchases. This is why creating a cash budget for your personal spending is a valuable activity. It may not seem like much to spend a dollar or two on a cup of coffee or a soda, but when you track this expense, a significant amount of money can be found. Eliminating small daily expenditures, like buying a drink from a convenience store, can realize savings of $300-$700 (or more) per year. You may well decide that this money can be better spent on other things.

The cash budget is a good indicator of how you might want to control your cash. The cash budget shows you where your money is coming in and going out. It accounts for every dollar made and spent.

**Financial Ratios**

Financial ratios are used to help you to understand your financial position and aid in making improvements to achieve financial goals. Knowing where your strengths and weaknesses are will allow you to see when there is a need to make improvements. Using the **debt ratio**, as an example, you can see if your cash on hand will be sufficient to cover liabilities as they come due. You want to aim for a low debt ratio. A low number indicates that you have plenty of assets to cover your liabilities. A high number shows that you need to focus on improving spending decisions to improve your financial health. Table 3.2 provides examples of several ratios that can be used to help you to get a clear picture of your financial position.

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Calculation</th>
<th>Example</th>
<th>Interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Ratio</td>
<td>Liabilities divided by Net worth</td>
<td>$50,000/$100,000 = .5  or 50%</td>
<td>Shows relationship between debt and net worth; a low debt ratio is best.</td>
</tr>
<tr>
<td>Current ratio</td>
<td>Liquid assets divided by current liabilities</td>
<td>$6,000/$3,000 = 2</td>
<td>Indicates $2 in cash for every $1 of expense; if liquid assets are more than twice your liabilities, you are in good shape.</td>
</tr>
<tr>
<td>Liquidity Ratio</td>
<td>Liquid assets divided by monthly expenses</td>
<td>$20,000/$8,000 = 2.5</td>
<td>Indicates the number of months in which living expenses can be paid if an emergency arises; the more months you can survive with liquid</td>
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<tr>
<td>Debt/payments ratio</td>
<td>Monthly credit payments divided by take-home pay</td>
<td>$640/$4,600 = 0.14</td>
<td>Indicates how much of a person’s earnings is needed for debt payments (excluding a home mortgage); most financial advisers recommend a debt/payments ratio of less than 20 percent.</td>
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<tr>
<td>Savings ratio</td>
<td>Amount saved each month divided by gross income</td>
<td>$648/$5,400 = 0.12</td>
<td>Financial experts recommend monthly savings of 5-10 percent.</td>
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<tr>
<td>Net Cash Flow</td>
<td>The difference between income and outflows.</td>
<td>$4,400 – $3,100 = $1,300</td>
<td>Positive is a surplus; Negative is a deficit.</td>
</tr>
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**Summary**

Once you have completed all the financial statements you will have a clearer picture of where you stand financially. The statements will help you determine where you are strong financially and where you are weak and need improvement. The ratios will help you understand how you are using your money. You now have many tools to assist you to determine where your personal finances stand today.

**Resources**

For assistance in tracking your income and expenses electronically, Kiplinger has provided a review of computer programs and other helpful information available. Visit:

Glossary

Assets
Items that one owns.

Balance Sheet
A financial statement that describes a person’s financial position at a given point in time.

Cash Budget
A budget that takes into account estimated monthly cash receipts and cash expenses for the coming year.

Current (short-term) liability
Any debt due within one year of the date of the balance sheet.

Equity
The actual ownership interest in a specific asset or group of assets.

Expenses
Money spent for living expenses, taxes, to purchase assets, or to repay debt.

Financial ratios
Ratios used to help you to understand your financial position.