

CHAPTER 2

MEASURING YOUR FINANCIAL HEALTH AND MAKING A PLAN

CHAPTER CONTEXT: THE BIG PICTURE

As the second chapter in the four-chapter section entitled “Part 1: Financial Planning,” this chapter introduces the processes and financial statements associated with financial planning and budgeting. The fundamentals of record keeping and statement analysis are discussed. Also introduced in this chapter are the financial ratios and how they are used to gauge financial health. These financial statements and formulas lay the foundation for understanding the overall picture of financial planning and Part II: Managing Your Money. An important message to students in this chapter is the importance of starting a financial plan early in the life cycle. Time is one of the biggest allies for a successful plan.

CHAPTER SUMMARY

This chapter establishes the importance of good record keeping and the use of financial statements. Balance sheets and income statements are the basis for most financial analysis, including the calculation of ratios to measure financial health. The financial ratios discussed measure liquidity, debt, and savings. Strategies for developing and using a cash budget are explained within the broader context of financial planning. The benefits of budgeting, whether for individuals in financial trouble or for those seeking more control over their money, are considered. Lastly, the role of professional financial planners, their services and their costs are presented. Financial planners can validate an existing plan or devise a financial plan.

LEARNING OBJECTIVES AND KEY TERMS

After reading this chapter, students should be able to accomplish the following objectives and define the associated key terms:

1. Calculate your level of net worth or wealth using a balance sheet.
 - a. personal balance sheet
 - b. assets
 - c. liabilities
 - d. net worth or equity
 - e. fair market value
 - f. tangible asset
 - g. blue book
 - h. insolvent
 - i. income statement

2. Analyze where your money comes from and where it goes using an income statement.
 - a. variable expenditure
 - b. fixed expenditure
 - c. budget
3. Use ratios to identify your financial strengths and weaknesses.
 - a. current ratio
 - b. month's living expenses covered ratio
 - c. debt ratio
 - d. long-term debt coverage ratio
 - e. savings ratio
4. Set up a record-keeping system to track your income and expenditures.
 - a. ledger
5. Implement a financial plan or budget that will provide for the level of savings needed to achieve your goals.
6. Decide if a professional financial planner will play a role in your financial affairs.

CHAPTER OUTLINE

- I. Using a Balance Sheet to Measure Your Wealth
 - A. Assets: What you own
 1. Monetary assets: cash, checking, and savings
 2. Investment assets: stocks, bonds, and mutual funds
 3. Retirement plans: IRAs, 401(k), and Keogh
 4. Housing: primary residence
 5. Automobiles and other vehicles
 6. Personal property: furniture, electronics, and jewelry
 7. Other: business ownership and collections
 - B. Liabilities: What you owe
 1. Current debt: credit cards, utility bills, insurance premiums, or past due bills
 2. Long-term debt: home mortgage, auto loans, and student loans, cash value life insurance loans, bank loans, or installment loans
 - C. Net worth: A measure of your wealth
 1. Insolvency: do you owe more than you own?
 2. How age affects net worth guidelines
 3. Uses of a balance sheet
 - D. Sample balance sheet for Larry and Louise Tate
- II. Using an Income Statement to Trace Your Money
 - A. Personal income statement: the financial motion picture
 1. Tracks what you take in (income) and what you spend over some period of time
 2. Cash basis: statement based entirely on actual cash flows

- B. Income: Where your money comes from
 - 1. Sources of income: wages, tips, royalties, salary, bonuses, and commissions
 - 2. Income is the amount earned, not necessarily amount received.
 - 3. Calculate take-home pay, or the money available to spend
 - C. Expenditures: Where your money goes
 - 1. Fixed expenses: mortgage, rent, and cable TV
 - 2. Variable expenses: food, entertainment, and clothing
 - 3. Major expenditure categories: taxes, food, housing, medical care and transportation
 - D. Preparing an Income Statement: Louise and Larry Tate
 - 1. Use the balance sheet and income statement together to learn more
 - 2. Use the information gained as a foundation for setting budget, or spending, goals
- III. Using Ratios: Financial Thermometers
- A. Question 1: Do I have enough liquidity to meet emergencies?
 - 1. Current ratio
 - 2. Month's living expenses covered ratio
 - 3. The rule of thumb: 3 to 6 months of expenditures
 - 4. Available credit or insurance protection may affect the rule of thumb and allow for higher yielding, less liquid investments
 - B. Question 2: Can I meet my debt obligations?
 - 1. Debt ratio
 - 2. Long-term debt coverage ratio
 - C. Question 3: Am I saving as much as I think I am?
 - 1. Savings ratio
 - 2. Savings as the top priority
- IV. Record Keeping
- A. Why is record keeping an important part of the planning process?
 - 1. Accurate record keeping is important for preparing taxes, tracking expenses, and providing information for others in case of an emergency
 - 2. Record keeping involves *tracking* your personal financial dealings and *storing* your financial records in an accessible manner
 - B. Track all expenditures, including cash, to generate a monthly income statement
 - 1. Use a ledger or computer program to record all transactions
 - 2. Keep all receipts and records dealing with taxes for 6 years
- V. Putting it All Together: Budgeting
- A. Developing a cash budget
 - 1. Examine last year's total income and make adjustments for the current year
 - 2. Estimate your tax liability
 - 3. Identify all fixed expenditures
 - 4. Identify all variable expenditures
 - 5. Look for ways to reduce your variable expenses
 - 6. Calculate the amount available for savings
 - B. Implementing the cash budget

1. Try the budget for a month
 2. Adjust the plan or your expenses as necessary to maintain the plan
 3. Try the envelope system
- VI. Hiring a Professional
- A. What planners do
 1. Make your own plan and have it checked by a professional to find the flaws
 2. Work with a professional and use him/her as a reference tool
 3. Let the professional do it all
 4. Remember Principle 1: The Best Protection Is Knowledge
 - B. Choosing a professional planner
 1. Pick a competent planner with accreditation(s) from a professional organization(s)
 2. Pick a planner that has experience, offers advice tailored to you, and readily offers referrals to other clients
 3. Understand the four ways planners are paid and consider this when choosing a planner
 4. Contact professional organizations or review their websites to get recommendations

APPLICABLE PRINCIPLES

Principle 2: Nothing Happens Without a Plan

Without a financial map and a starting point, even the wealthiest people would fail when trying to save money.

Principle 8: Risk and Return Go Hand in Hand

Emergency funds should be kept in a liquid account. Because the investor incurs less risk, liquid accounts provide a lower return. Liquidity and risk management, not return, are the key reasons for an emergency fund. But access to credit, insurance coverage, and other household characteristics (e.g., multiple earners, consistency of earnings, job stability) should be considered in the decision as to how much of the emergency funds are in lower earning accounts.

Principle 5: Stuff Happens

Budgets must be flexible because, if an unforeseen event occurs and your budget is not flexible, then the incident will have destroyed most of the plan. Adaptability is key when developing a working budget. If the plan is adaptable, then the plan can change as your situation changes.

Principle 1: The Best Protection is Knowledge

Whether you're paying a commission-based planner, a fee-only planner, or a planner using some other combination fee structure, you need some knowledge to evaluate the advice given. The planner may have a conflict of interest in that the best product for you may not

net the most commission dollars. You are at a disadvantage if you lack the knowledge to tell the difference between sound advice and a sales pitch.

CLASSROOM APPLICATIONS

1. Ask students to reflect on the assets owned by their grandparents, their parents, and themselves. How does the ownership of the seven categories of assets change throughout the financial lifecycle? How does the ownership of different assets change as a percentage of total net worth over the financial life cycle?
2. Recommendations on implementing a cash budget can be counter intuitive. On the one hand, a budget is a plan, which suggests that it should be followed. On the other hand, budgeting is described as a dynamic process that must be continually monitored. Help the class consider strategies for dealing with the dynamic nature of spending and saving, while maintaining the control aspect of a budget. For example, will unspent money allocated to one category automatically revert to monthly savings or be carried forward in the same category for future spending?
3. Throughout this chapter, the parallel between using financial tools to measure financial health and using medical tools to measure physical health is mentioned. Discuss with the class why people postpone or avoid financial check-ups. Why do most people resist paying a financial professional to measure financial well-being or to interpret the results of their assessment?
4. Discuss with the class why one financial ratio may be more informative to one household, given the unique financial situation, while another ratio may be more significant to another. For example, how might the household profile differ for a month's living expenses covered ratio of 0.75, 3.5, or 8.0? What recommendations might be made in response to this ratio, and how might household characteristics affect the interpretation of the ratio?
5. The underlying premise of the cash budget is to spend whatever is left over after subtracting the level of savings needed to achieve your goals. In other words, paying yourself first and trading the immediate satisfaction from spending for the future satisfaction of goal attainment. Ask the students to brainstorm strategies to encourage this approach to financial planning. What recommendations do they have for controlling spending today to promote future goals? For staying motivated to save for future goals?

REVIEW QUESTION ANSWERS

1. The first step is to evaluate your financial health, which would include preparing a balance sheet, income statement, and financial ratios. Step two is to define your financial goals. You will need to determine what is important to you, identify the cost of achieving the goal, and determine how much savings is needed to achieve the goal. Step three is to develop a plan of action by adjusting your spending to meet your goals. In step four of the budgeting and

planning process, you will implement your plan by taking action to achieve your plan. This could include setting up an automatic savings plan with your bank. Finally, the last step is to continually review your progress, reevaluate, and revise your plan as needed.

2. The balance sheet is often used to diagnose financial health. If the net worth is negative, then the household's financial health is considered poor. But, if the net worth is highly positive, then the household would be considered to be in excellent financial health. By using the information, the household can make sound financial decisions about adjusting savings or expenses to meet identified financial or personal goals.

A balance sheet determines financial position, or net worth. It compares assets owned and liabilities incurred to determine the current level of wealth or net worth. As the name suggests, the two sides balance—the assets minus the liabilities equals the net worth.

3. Calculation of an accurate balance sheet is based on an accurate assessment of the value of all assets and a complete listing of all current and long-term liabilities. Annual updates to the balance sheet help you track your progress toward your goals and to monitor your financial situation, or financial well-being. For example, if you have added several short- and long-term liabilities during the year, the balance sheet will help you detect the overall impact of those decisions. Reflecting on your net worth, may help you decide that regardless of how good the deal, or how pressing the need may appear, continuing to commit income to credit may delay, or derail, your savings for goals.
4. The seven categories of assets are:
 1. Monetary: This is the most liquid of all assets which are held as cash or in a form that can quickly be turned into cash with little or no loss of value. Examples include cash, checking and saving accounts, and money market funds.
 2. Investment: These assets are considered financial holdings for generating wealth and are less liquid than monetary assets. They include stocks, bonds, mutual funds, and their derivatives.
 3. Retirement plans: The individual or his/her employer accumulates these assets to meet future retirement goals. Examples include an IRA, 401(k) or 403(b) plan, Keogh plan, or other company pension plan.
 4. Housing: This is a tangible asset that is used by the owner, and is considered to be illiquid. Examples include house and land and usually represent the most valuable asset for most individuals.
 5. Automobiles and other vehicles: These are illiquid, tangible assets that depreciate.
 6. Personal property: These are tangible assets that are basically illiquid and consist of all possessions such as furniture, electronics, jewelry, and automobiles.
 7. Other assets: Any other assets or monies owed to you but not included in a previous category.

Use the fair market value, or “what a willing buyer would pay a willing seller,” to determine the current value of assets. For example, the fair market value of an auto would be entered as an asset, while the corresponding outstanding balance to pay off the auto loan, if applicable, would be a long-term liability.

5. A financial liability is the owing or borrowing of money. A current liability is an unpaid bill or debt that will be completely paid off within the next 12 months, such as a 6-month, unsecured loan, a utility bill, or your credit card paid in full each month. In contrast, a long-term liability requires payments that extend beyond the 12-month time frame, like an auto loan, student loan, or home mortgage. Because a balance sheet represents a given date, current liabilities represent all current bills due and payable at that time. Long-term liabilities are represented by the outstanding balance(s) to pay off the loan(s) or mortgage.
6. The absolute value of net worth can be compared by the same household from year to year and this comparison is recommended to track progress toward goals. Because household situations, characteristics, and financial goals vary within and across the life cycle stages, net worth is a relative measure for some comparisons. For example, a young professional in Stage 1, Wealth Accumulation may initially be insolvent until more assets are acquired and student loan debt is reduced. This situation may be unavoidable for the investment in education. However, if the parents are in Stage 2, Approaching Retirement, insolvency would represent a much direr situation, and suggest that financial goals are not being met, and that the household could experience significant difficulty in meeting future goals.
7. An income statement is used to track *income* and *expenses* over a period of time. As such the form “nets out” taxes and other spending from income available, leaving a balance available for savings or investments. The statement also reveals spending that exceeds earnings. By tracking expenditure patterns, the income statement can help a household avoid or correct financial trouble spots. The statement also shows the household exactly how much income is being saved or is available for savings. This allows the household to adjust expenditures to more successfully meet financial goals.
8. In order to accurately complete an income statement, the household must compile all financial records to account for all income and all expenses during the targeted time period. These records include all statements of income such as wages, salaries, royalties, tips, commissions, dividends, and interest. All amounts will be totaled and recorded in the income portion of the income statement. Also, all fixed and variable expenses must be recorded in the expense portion of the income statement. Checkbook registers, all receipts, and any records of cash expenditures should be reviewed. Taxes, food, housing, medical care and transportation are the biggest expenses for the average household. However, there may be variations in medical care or transportation expenses depending on the life cycle stage.
9. The practical difference between fixed and variable expenses is that a fixed expense does not change from month to month, whereas a variable expense may change. Also, with a fixed expense, the creditor usually controls the payment amount. Typically, these expenses are established by a contractual obligation such as a rental contract, auto lease agreement, or home mortgage. The consumer has greater control over variable expenses through the choice of whether to spend or how much to spend. For example recreation, utilities, or clothing expenses may be controlled, or in some cases, foregone by the consumer. Granted the consumer has a choice not to sign a contract and incur another, or larger, fixed expense. But

once signed, there may be little or no option for reducing the payment. Recall from the text—a major portion of financial planning is taking control of your situation.

10. Ratios analyze the information included in the balance sheet and income statement and make it more useable. Results of the ratio analysis can be compared to a preset target or to previous ratio trends for the household. Ratios diagnose if the household is maintaining liquidity, meeting obligations, or saving enough for future expenses.
11. The month's living expenses covered ratio would be the most beneficial for the Tates to calculate. This ratio tells them how many months they would be able to meet their current obligations with their currently available monetary assets.

$$\text{month's living expenses covered ratio} = \frac{\text{monetary assets}}{\text{monthly living expenses}}$$

Although some questions surround the recommendation of having 3 to 6 months of expenditures available for an emergency, the ratio is the best measure of cash on hand or personal liquidity. Once the appropriate amount of liquidity is determined, the ratio should be tracked to insure that it does not change unexpectedly.

12. Current ratio results can be compared to the recommended standards to diagnose the present household situation. However, some ratios are expected to trend up or down dependent on household circumstances or progression through the life cycle. Tracking the ratios over time offers additional insights about the household financial situation.
13. The long-term debt coverage ratio compares total income available for living expenses to total long-term debt payments. A ratio of less than 2.5 would be of concern as it suggests that the amount of income available would not meet the required long-term debt repayment at least 2.5 times. The inverse of the ratio intuitively offers more insight as it reflects the percentage of total income available for living expenses that is required to meet debt repayment. From another perspective, as the inverse ratio increases, say from 40 percent to 48 percent, less and less income (now only 52 percent as compared to 60 percent) is available for variable expenses.
14. The three most important reasons for keeping accurate records are:
 - Tax preparation takes less time and is more accurate if neat, up-to-date financial records are maintained.
 - Expense control is easier if the household maintains records to thoroughly track expenses.
 - Understanding the household's financial situation is dependent on accurate and complete records should someone else need information in case of an emergency.

Without an accurate record-keeping system, it is easy to feel a lack of control over financial affairs. The most obvious problem that can arise is overspending. Without accurate records,

it is very difficult to accurately assess financial well-being—both for the short- and the long-term.

15. Regarding keeping the following records:
 - Non-tax related checks or credit card receipts over a year old should be shredded, to avoid identity theft, and discarded. If less than a year old, they should be kept in a home file.
 - Listing of all bank accounts should be kept in a bank safety deposit box.
 - Investment earnings statements should be kept in a home file.
 - A copy of the will should be kept in a home file and in the safety deposit box.

16. The steps in preparing a cash budget include:
 - Locate and examine the most recent annual personal income statement.
 - Estimate tax liability.
 - Identify and calculate all sources of fixed expenses (e.g., mortgage, auto loan).
 - Identify and calculate all sources of variable expenses (e.g., food, entertainment).
 - Identify areas for possible reduction in the variable expense category.
 - Determine amount available for savings by subtracting anticipated living expenditures from anticipated take-home pay.
 - Compare anticipated monthly savings with target savings levels required to achieve financial goals.
 - Adapt the budget in accordance with the goals through efforts to earn more, spend less, or downsize the goals.

17. Despite the advanced training, planners who generate all or some of their compensation from commissions may function as a salesperson for certain products. Personal finance knowledge is one of the best protections, as noted in *Principle 1*, when choosing professional financial assistance or any of the myriad of financial products required over the life cycle. Knowledge about how to choose a planner (e.g., understanding the scope of services/products needed, recognizing accreditations, and learning about the planner's practice and experience) is also important. Look for accreditations like PFS, CFP, or ChFC that require testing and experience to earn the designation.

PROBLEM AND ACTIVITY ANSWERS

1. Net worth = assets – liabilities = (\$90,000 + \$20,000 + \$10,000) – (\$50,000 + \$4,000 - +\$150) = \$65,850

The Lees have a positive net worth of \$65,850. This means that if they sold all of their assets and paid off all their debt they would still have money left over.

2. Debt ratio = $\frac{\text{total liabilities}}{\text{total assets}} = \frac{\$54,150}{\$120,000} = 0.4513$ or 45.13%

The ratio tells Mary Jane and Mike that 45 percent of their assets are financed with borrowing. The Lees should track this ratio to make sure it goes down as they age.

3. After accounting for all expenses, Ed and Marta's income statement shows \$200 available on a monthly basis for savings.

$$\text{Savings ratio} = \frac{\text{income available for savings}}{\text{income available for living expenses}} = \frac{\$200}{\$3,250} = 0.0615 \text{ or } 6.15\%$$

The ratio tells Ed and Marta that approximately 6 percent of their income is available for savings. This amount is significant compared to average, but lower than the often-recommended level of 10 percent. The ratio should be compared with past savings ratios and target savings ratios to determine if Ed and Marta are on track to reach their goals.

- 4.

$$\text{Current ratio} = \frac{\text{monetary assets}}{\text{current liabilities}} = \frac{\$6,000}{\$1,500} = 4.00$$

The ratio tells Ojai and Kaya that their monetary assets could pay their current expenses four times. However, this ratio is not truly accurate since it does not include the monthly auto loan payment. The auto loan is not considered a current liability because it will not be satisfied within 12 months.

- 5.

$$\text{Current ratio} = \frac{\text{monetary assets}}{\text{current liabilities}} = \frac{\$3,125}{\$875} = 3.57$$

With Faith's available monetary assets, she could meet her current liabilities approximately 3.5 times, which is good. Financial advisors suggest a ratio above 2, with a trend for the ratio to be increasing.

$$\text{Savings ratio} = \frac{\text{income available for savings}}{\text{income available for living expenses}} = \frac{\$738}{\$2,400} = 0.3075 \text{ or } 30.75\%$$

Faith is to be commended for her savings rate, but it is lower than the often-recommended level of 10 percent; and Faith's records show no annual expenditures for recreation. She may have underestimated her living expenses, especially given her monthly credit card and cash expenditures. Accurate ratios depend on accurate records.

$$\text{Months living expense covered ratio} = \frac{\text{monetary assets}}{\text{annual living expenses}/12} = \frac{\$3,125}{\$2,262} = 1.38 \text{ months}$$

An emergency fund equal to 3 to 6 months of expenses is traditionally recommended. Availability of credit to offset committing such a large sum to low earning liquid accounts may reduce the emergency fund. But, Faith could meet expenses for just over one month—a precarious financial situation that can only be remedied through increased savings.

$$\text{Debt ratio} = \frac{\text{total liabilities}}{\text{total assets}} = \frac{\$55,100}{\$105,975} = 0.52 \text{ or } 52\%$$

The debt ratio suggests that 52 percent of Faith's assets are financed through borrowing. As is typical, her mortgage represents the bulk of her liabilities as well as her assets. Over time, this ratio is likely to decline; however, an increasing trend would be cause for concern.

$$\text{Long-term debt coverage ratio} = \frac{\text{income available for living expenses}}{\text{long-term debt payments}} = \frac{\$2,400}{\$795} = 3.02 \text{ times}$$

The long-term debt ratio of 3.02 exceeds the recommended minimum of 2.5, which implies that Faith could meet her mortgage and auto payments, her only long-term debt obligations, 3 times from her current income. The reverse of the ratio offers another useful insight on Faith's financial situation. Of every take-home dollar, Faith has committed 33 percent, or 33 cents, to service long-term debt obligations. Although her long-term debt ratio is high enough not to raise a caution flag, before taking on additional debt she should seriously consider the impact of having less than 67 percent of her take home pay to meet all other expenses.

On first inspection, Faith seems to be financially sound. However, based on a review of the ratios and the information provided, Faith should consider:

- Improving her recordkeeping. She has omitted budget categories that might typically occur (e.g., recreation) and has a lot of "unaccounted for" spending on her credit cards and with cash.
 - Increasing her savings for an emergency fund and financial goals (e.g., specific goals, retirement, etc.).
 - Decreasing her spending to increase savings *or* increasing her income. The latter may not be an option and the impact of the tax "bite" should not be ignored.
 - Identifying financial goals and developing a financial plan
 - Keeping her liabilities low and not adding more debt without first checking her ratios.
6. A budget is a plan for controlling cash flows, specifically income, expenses, and savings. This budget should accurately match a household's abilities with its financial goals. With a well-planned budget, money will seem to go farther and they will be able to do more with what they have. A strong budget also prepares someone for the future and the unforeseen events that the future holds. A successful budget can only be derived from accurate record keeping; if someone does not know where they are, the best map in the world will not help them get where they want to go. Once an accurate picture of a household's current financial status is developed through the use of an income statement and balance sheet, one can set goals and plan for the future. With the help of a budget and accurate record keeping, even someone who is not a financial wizard can achieve financial success.
7. According to common practice, an emergency fund should equal approximately 3 to 6 months' living expenses. However, an exact amount should also be based on job stability, life-cycle stage, credit availability, and lifestyle. For the Potinsky household, the figure

should range between \$9,750 and \$19,500. To avoid having a large sum in a liquid account earning little interest, they should have some funds available, with the remainder invested with higher earnings. In case of an emergency, they could use credit immediately and then liquidate other assets to repay the bill—assuming all accounts are not charged to the limit.

8. Student responses will vary, but an example of a \$41,000 income would yield an emergency fund ranging from \$6,662 to \$13,325.

\$41,000.00	Starting salary
-\$8,200.00	Taxes (20% x \$41,000)
-\$4,100.00	Retirement (10% x \$41,000)
<u>-\$2,050.00</u>	<u>Additional savings (5% x \$41,000) assumption for example</u>
\$26,650.00	Income to meet living expenses

Assuming another 5 percent of income is saved and the target for the emergency fund is 3 to 6 months then

$$3 \text{ Months} = \left(\frac{\$26,650}{12} \right) \times 3 = \$6,662.50$$

$$6 \text{ Months} = \left(\frac{\$26,650}{12} \right) \times 6 = \$13,325.00$$

Time frame for saving this amount could vary widely contingent on the individual financial situation and commitment to savings. But again using the 5 percent additional savings assumption then it should take 3 to 6 years to accumulate the requisite amount by simply dividing the goal by the annual savings amount.

DISCUSSION CASE 1 ANSWERS

1. In order to get an accurate financial picture, Ronald and Sami should prepare an income statement and balance sheet.

Ronald and Sami should keep records to develop an income statement and a balance sheet. They will need to document all sources of income. Expense records should include all fixed and variable living expenses, as well as records of all short- and long-term debt payments. Knowledge of their liabilities and assets will enable them to calculate net worth. Based on the income statement and the balance sheet, they can track their ratios to further diagnose their financial situation. With accurate record keeping, they will be able to prepare a budget to control their income and expenses to accomplish future goals.

2. Their net worth is calculated on a balance sheet by subtracting total liabilities from total assets.

\$55,000.00	Total Assets
<u>-\$32,000.00</u>	<u>Total Liabilities</u>
\$23,000.00	Net Worth

Their income surplus, or income available for savings, is calculated on the income statement by subtracting their total annual living expenses, long-term debt payments, and taxes from their total annual income. Since net income is given, income taxes have already been subtracted.

\$65,000.00	Net Income
<u>-\$55,000.00</u>	<u>Expenses</u>
\$10,000.00	Surplus Income

3. Assuming their income stopped, Ronald and Sami could meet their current level of living expenses for slightly over 2.5 months.

$$\text{Months living expense covered ratio} = \frac{\text{monetary assets}}{\text{annual living expenses}/12} = \frac{\$12,000}{\$4,583} = 2.62 \text{ months}$$

Depending on availability of credit, job and income stability, life cycle stage, and lifestyle, an emergency fund equal to 3 to 6 months of expenses is recommended. Their monetary savings is inadequate for their emergency needs; furthermore, the total amount is earmarked for the house purchase and is not really available for emergency needs.

$$\text{Debt ratio} = \frac{\text{total liabilities}}{\text{total assets}} = \frac{\$32,000}{\$55,000} = 0.58 \text{ or } 58\%$$

Ronald and Sami currently have 58 percent of their assets financed—a high proportion considering that they do not own their home. They should track this ratio over time to insure that it does not continue upward.

4. Student answers will vary but should include the following.

Accurate and recent financial statements are always recommended when determining financial health. Further, past records should be kept as a method for spotting and analyzing financial trends. Also, a list of personal and financial goals would aid in analyzing Ronald and Sami’s financial direction.

5. To develop their budget, Ronald and Sami need to follow the steps below.
- Locate and examine their most recent annual personal income statement. If this is not available, they should accumulate all records to track past income and expenses.
 - Estimate tax liability.

- Identify and calculate all sources of fixed expenses (e.g., mortgage, auto loan).
 - Identify and calculate all sources of variable expenses (e.g., food, entertainment).
 - Identify areas for possible reduction in the variable expense category.
 - Determine amount available for savings by subtracting anticipated living expenditures from anticipated take-home pay.
 - Compare anticipated monthly savings with target savings levels required to achieve financial goals.
 - Adapt the budget in accordance with their goals through efforts to earn more, spend less, or downsize the goals.
6. Principle 6 would be applicable in this situation because of their limited assets and knowledge. Ronald is cautious but Sami “likes” the idea, therefore they need to carefully balance *want* with *need*. Given their anticipated raises, it would be too easy to take the additional money for granted and jump into a housing situation that becomes untenable. A financial planner could help them plan for the purchase of a home and suggest ways to reduce expenses so that they could save more. They could go it alone, but professional advice at a reasonable price could prove to be money well spent, thus enhancing the “smartness” of their purchase.

DISCUSSION CASE 2 ANSWERS

1. Tim and Jill should expect to provide the planner with sufficient information to develop an income statement and balance sheet. Both will provide useful insights into the Taylors’ situation and serve as a foundation for calculating the Taylors’ financial ratios. Armed with this information, the planner and the Taylors can project a budget for meeting their short-, intermediate- and long-term goals. These assessments will be necessary to ensure a smooth transition into retirement and to help the Taylors enjoy the future without worrying about their finances or being forced back into employment.
2. Knowing the total of their investment assets can be useful in two ways. First, the information can be used to develop a balance sheet to determine their current net worth. It will be important for them to periodically track this to insure that they are not depleting their assets too quickly. Second, they can use the investment information to project future income and prepare a budget. By preparing a realistic budget to match their income, Tim and Jill will be able to live the “good life,” not overspend their assets, and leave enough money to help pay for their grandchildren’s education. They also will be able to better manage their assets by balancing their goals with their budget.
3. An income statement can help the Taylors monitor their past income and expenses. Both are likely to change as they transition into retirement. Knowledge of past expenses could be very helpful as they plan for future retirement years. Based on this information, they can develop a cash budget to ensure that they meet expenses and leave the desired amount to their grandchildren without outliving their assets.

4. Develop a budget in accordance with their goals. Track expenses to control spending. When a lifestyle change occurs, it is very easy to change past spending habits that fostered a strong financial position. By identifying and pricing their goals, tracking their net worth, and budgeting to control spending, Tim and Jill will know exactly how much of the “good life” they can realistically afford. It is always wise to provide for the future by preparing in the present.
5. Whether or not Tim and Jill continue to work with a financial planner depends on their financial knowledge, time and commitment. Given their successful, independent, management of their financial situation to date, they may want to develop their own plan and have it reviewed by a planner as confirmation that they are on the right track. But successfully managing a large investment portfolio takes a great deal of time and knowledge. They may prefer to find a reputable planner with appropriate credentials and experience. It will be important for them to shop around to find someone with whom they feel comfortable. A fee-only planner might be the best choice, especially if their current investments are doing well and the Taylors are not interested in making big changes that would generate sales, and commissions, for the planner.
6. The Taylors should track their expenses more closely because overspending without replacement income can be disastrous. In the event of an unexpected bad financial situation or a long downturn in the economy, they would not have the time or resources to rectify their misfortune and achieve their goals. Their big five expenses are likely to be the same as the average U.S. household – taxes, food, housing, medical care and transportation. Most retirement benefits will be taxable, as will other investment earnings. Depending on the age of the house or appliances, repairs or replacements may be necessary.