

Gathering Data and Preparing Financial Statements

Learning Objectives

An understanding of the material in this chapter should enable the student to

- 5-1. Describe the initial financial planning session, and explain the importance of fact finders.
- 5-2. Describe the types of information contained in comprehensive fact finders, and explain why it is important to review this information periodically and keep it up to date.
- 5-3. Explain the importance of personal financial statements in financial planning.
- 5-4. Explain what a financial position statement indicates to a financial advisor, and describe its key components.
- 5-5. Explain the steps involved in the preparation of a financial position statement.
- 5-6. Explain how financial position statements are used in the financial planning process.
- 5-7. Explain what a cash flow statement indicates to a financial advisor, and describe its key components.
- 5-8. Explain the purpose of cash flow management, and describe its key components.
- 5-9. Explain the steps involved in the preparation of a cash flow statement.
- 5-10. Explain how cash flow statements are used in the financial planning process.
- 5-11. Define, be able to calculate, and explain the importance of consumer financial ratios such as a solvency ratio, a debt service ratio, and a liquidity ratio in financial planning.
- 5-12. Discuss the importance of monitoring the client's financial position and the use of pro forma forecasts as evaluation tools in the monitoring process.

The development of a comprehensive financial plan covering all the major planning areas is neither a quick nor an easy task. The diversity and complexity of needed information require a systematic method for gathering, organizing, and processing that information. Although there are many possible ways to systematize the gathering of information, almost all financial advisors prefer to use a structured fact-finder form.

With the financial information gathered by a fact finder, an advisor is able to determine a client's current financial position and cash flow status. Without this type of financial information about the client, it would be difficult, if not

impossible, for the advisor to develop a financial plan and/or formulate strategies for achieving the client's financial goals.

THE INITIAL SESSION

To ensure that fact-finding and planning sessions with the client will be both productive and efficient, the financial planning process usually begins with an initial session to determine whether the client and advisor are a good fit for one another. While this session will generally involve a single prospective client, the advisor may wish to conduct a seminar for a group of prospective clients, such as the executives of a business firm or the members of the local community. In either case, the advisor will describe the nature and scope of the services to be provided (including referral to other specialists), the modes of operation, the structure of compensation for services, and the form of the financial plan to be developed for the client. In addition, the advisor will give the client a disclosure form that describes his or her philosophy in working with clients; his or her educational background and employment history; professional certifications and licenses; and sources of compensation. (A sample disclosure form is located in appendix B at the end of this textbook.)

If the advisor and the prospective client hope to establish an advisor-client relationship (step 1 of the financial planning process), ground rules must be clarified. Foremost among them should be the understanding that comprehensive financial planning for the client will only be as accurate as the personal information provided. The client should understand the need to furnish financial records and documents and to participate in fact-finding and planning sessions with the advisor, during which time his or her financial situation, problems, and goals will be thoroughly discussed.

THE IMPORTANCE OF FACT FINDERS

If an advisor-client relationship begins to evolve at the initial session, the advisor may want to follow up by sending the client a letter summarizing the session and offering his or her financial planning services. In addition, the advisor may also want to send a fact-finder form along with the letter so the client can begin to gather and organize his or her personal and financial information. Assembling complete, accurate, and up-to-date information about the client is the single most important task in financial planning. Some fact-finder forms, however, are only thin pamphlets that ask for basic information; the forms most useful for financial planning purposes generally are thick booklets that seek very detailed information. It is therefore imperative that the fact finder used to gather information for financial planning purposes be sufficiently comprehensive to enable the advisor to:

1. evaluate the client's total financial condition
2. identify what type of person the client really is

3. determine where the client wants to be
4. formulate the most appropriate strategies for getting there

If the client is married, his or her spouse should be fully involved in providing information and both the client and spouse should be present during fact-finding and planning sessions with the advisor, unless there are compelling personal reasons to the contrary (such as an impending divorce). Indeed, in households in which both spouses have income and assets, the financial advisor should counsel both spouses and develop a plan that reflects their mutual as well as their individual concerns and goals. In such cases, appropriate sections of the fact finder should be duplicated and filled out by both the client and spouse.

Because every financial advisor operates in a complex marketplace of varying services, products, and clients, no single fact-finder form can serve the needs of everyone. If the advisor is not required to use his or her company's designated fact finder, the experienced advisor typically will modify an existing fact finder or develop a new one that can be used to meet the needs of his or her practice. The type of information requested by comprehensive financial planning fact finders includes not only quantitative data about the client's current financial position but qualitative information about the client's personal circumstances. Armed with complete information about the client, the advisor is then able to analyze and evaluate the client's financial condition and make appropriate recommendations in the form of a multiple-purpose or comprehensive plan tailored exclusively for the client.

In cases where the financial advisor is hired to provide solutions for a single planning objective and does not need all the information elicited by a comprehensive fact finder, the client only needs to fill out those sections of the fact finder that are relevant to analyzing and evaluating the single objective. To help determine exactly what information is needed in each case, the advisor must ask himself or herself the following questions:

- What information do I need from the client for a particular area (or areas) of planning?
- How do I evaluate this information and discuss it with the client?
- What information on products, services, and taxes do I need in order to address this area (or areas) of planning? (That is, what information do I need from the marketplace?)
- How do I apply this information to my client's planning objective(s) in order to develop recommendations that the client will adopt and implement?

Because many clients do not understand how comprehensive financial planning can benefit them, they seek help only in a planning area (or areas) in which they have a financial problem or goal that needs immediate attention. In order for these clients to understand and embrace comprehensive financial planning, they must be exposed to its principles and procedures through the financial planning process. This is done when the advisor presents his or her recommendations for the planning area (or areas) in which the clients are

seeking help. At this time, the advisor must show these clients how his or her recommendations affect other planning areas and explain to them how a comprehensive financial plan could thoroughly integrate and coordinate all the planning areas. One of the tools that makes the integration and coordination of all the planning areas possible is a comprehensive fact finder.

COMPREHENSIVE FINANCIAL PLANNING FACT FINDER

The variety of clients and potential planning areas requires a fact finder that is both flexible and adaptable. It should be divided into several sections and subsections that can be used individually or in various combinations. The American College's Comprehensive Financial Planning Fact Finder (hereinafter referred to simply as Fact Finder) was designed with these requirements in mind.

Together all sections of The College's Fact Finder elicit the information necessary to design and implement a comprehensive financial plan tailored exclusively for the client. In cases where the whole Fact Finder elicits more information than is needed, the advisor can select the relevant sections for the client to fill out. In those rare cases where the advisor needs more extensive and detailed information than the whole Fact Finder can provide, the advisor can supplement the Fact Finder with special analysis forms and computer software programs specifically designed for more complex planning situations.

Although The College's Fact Finder can be used by financial advisors, its purpose in being included in this book is to demonstrate how important a comprehensive fact finder is to financial planning. Most advisors choose fact finders that are designed to be used with specific financial planning software to simplify data entry. Moreover, many large financial services companies have developed their own fact-finder forms to satisfy their compliance departments, and they fully expect their advisor-representatives to use them. Therefore, even though The College's Fact Finder will probably not be adopted for use by many advisors, its real value lies in providing an example of the types of client information needed by financial advisors who engage in comprehensive financial planning. To this end, a fairly brief section-by-section discussion follows that describes the Fact Finder and how the information it gathers relates to comprehensive financial planning.

Personal Data

In order to involve clients in the planning process and diminish the time spent in fact-finding sessions, many advisors send their clients the whole Fact Finder form prior to or immediately after the initial session. The client is instructed to fill out as much of the Fact Finder as possible. The Fact Finder begins the accumulation of client information with the Personal Data section. The information requested by this section is of the type that clients typically can provide without the assistance of the advisor.

The content of the Personal Data section includes information about the client and his or her family. It begins on page 2 by requesting the street addresses, phone numbers, and e-mail addresses of the client (and spouse if the client is married). The unmarried client should ignore Fact Finder spaces requesting information about a spouse unless he or she has a domestic partner, in which case these spaces could be adopted to accommodate this type of arrangement.

Also on page 2, this section asks for the names, addresses, and phone numbers of the client's other advisors. One of them may be a resource for clarifying the client's financial history and may even provide important expertise that could help in implementing a financial plan. Moreover, it is important for the advisor to know who holds the client's confidence and trust and who (if anyone) is already considered the client's primary financial advisor. Knowing who the client's other advisors are helps to avoid alienating them, infringing on their territory, or giving them cause to thwart the planning process.

On page 3 of the Fact Finder, the Personal Data section requests information about the client's whole family including their dates of birth, Social Security numbers, occupations (if applicable), and whether the client (and/or spouse) provides any support for them. Support obligations are vital in determining the client's income needs while working, in retirement, and in the event of disability; they also help determine the income needs of survivors in the event of the client's (or spouse's) death. In addition, the section requests information about any health problems and/or special needs of family members including the client (and spouse).

The information sought on page 4 of the Fact Finder is designed to uncover potential complications in the client's (or spouse's) situation, such as previous marriages and alimony or child-support obligations; the existence (or lack) of current wills and prenuptial or postnuptial agreements; the existence of trusts or custodial accounts for children or others; guardian nominations for the children; trusts in which the client (or spouse) is the beneficiary; gifts or inheritances pending or anticipated; education background; and any benefits resulting from military or government service. Not only are these items important for subsequent financial planning, but they also provide insight into what kind of person the client is and the level of sophistication and complexity of the client's current financial program. In spite of their importance, however, the Fact Finder does not attempt to gather detailed information about existing wills, trusts, nuptial agreements, or guardianships. What the financial advisor needs to know at this point in time is whether these items exist and if they do, will he or she be able to examine them at a future time to determine if they are in line with the client's expressed wishes and overall financial plan. The client's perception of problems in these personal affairs should also be explored at this time so the advisor will have the benefit of the client's current thoughts and feelings about these sensitive matters.

Financial Objectives

The Financial Objectives section on page 5 of the Fact Finder asks the client to rank and prioritize her financial objectives. However, both the rankings and the objectives are subject to change. Subsequent analysis of the client's actual financial position may compel radical revisions of both the priorities and objectives or, at least, deferment of the target dates for achieving some of the objectives. Often the client will establish different priorities and objectives as a result of going through the planning process. Nevertheless, these preliminary rankings of objectives will give the advisor a perception of the client's concerns, which can be explored in planning sessions and evaluated in light of the client's current financial position, risk tolerance level, and projections for the future. Knowing what the client believes his or her priorities and objectives are will help the advisor establish a track for the client to run on.

The exercise of filling out a fact finder may be the first time a client has quantified their financial goals. The fact finder also serves as an introduction to the financial advisor. A neat, organized and well formatted fact finder can be as powerful as marketing literature in making first impressions to the client.

This section of the Fact Finder also contains questions about the client's current monthly budget and annual savings/investments. Information provided here will be important for the projections into future years that will be made in the Cash Flow Statement and the Financial Position Statement (pages 8 and 30–31 of the Fact Finder).

Factors Affecting Your Financial Plan

In this section, which is on page 5 of the Fact Finder, there are several questions that are of particular importance to the financial advisor's perception of the client's personality and willingness to implement subsequent recommendations. The first two questions ask whether the client or spouse has made gifts or is willing to consider making gifts. Although positive responses to these two questions exhibit an openness to gift giving as a strategy, negative responses do not necessarily indicate the opposite.

The next two questions ask whether the client is dissatisfied with the results of previous savings/investments or feels committed to them. If the answers are yes, the client's thoughts should be explored. The Risk/Return Profile on page 22 of the Fact Finder may provide some insight into the source of the client's dissatisfaction or commitment.

The next four questions in this section probe the nature of the client's family relationships. These questions about the client's spouse (if married), desired age of retirement, and how the estate is to be distributed are helpful in discovering the client's (and the spouse's) underlying attitudes and motives for a whole range of financial objectives.

The final question in this section—"What do you think financial planning should do for you?"—may bring to a head a whole range of client concerns. Certainly the client's response to this question will have an impact on what direction the financial planning process should take.

One final comment is necessary. It concerns the relevance of the types of personal information sought on pages 2 through 5 of the Fact Finder. It is in these areas that the client's most sensitive feelings and thoughts are likely to emerge and that profound human and relational concerns are likely to be discovered. Therefore, these areas demand the most sensitive employment of the advisor's communications skills and techniques. Even though the client may provide extensive and accurate data and facts before and during the planning sessions, responses should be thoroughly evaluated for clues to personal, family, and economic problem areas. The advisor should ask appropriate clarifying questions in a nonjudgmental way. The client's responses should be compared with information and facts provided in other sections of the Fact Finder to ascertain consistency.

Financial professionals should consider adding two powerful questions on a fact finder. The first question is, "What has been your best financial planning experience?" The answer to this question can help the advisor evaluate client attitude, values, and expectations. Some clients might answer this question with broad strokes, while other clients may provide specific investment returns or customer service experience. Advisors should also ask the follow up question, "What has been your worst financial planning experience?" This question provides advisors with additional discovery of client goals and expectations.

Objectives Requiring Additional Income/Capital

The section titled Objectives Requiring Additional Income/Capital is on page 6 of the Fact Finder; it gathers details about specific client financial objectives that may require income and/or capital beyond what is needed for retirement and estate planning purposes. The most common objective typically is the client's desire to send his or her children to college.

Besides education funding, the client may have other objectives that require either long- or short-term planning, and allocation. These objectives could include a desire to take care of a handicapped child, to provide support for a parent or other relative, or to accumulate funds for a future charitable bequest. The advisor should thoroughly explore the client's situation and uncover all funding objectives beyond the need to provide for personal economic well-being. The advisor can then lead the client to a full determination of all other resources (including the resources of the proposed beneficiary) that may be available to help fund these needs, such as Social Security benefits, private pensions, part-time work, life insurance proceeds, and income from the proposed beneficiary's own earlier investments.

A major consideration in financial planning is the comprehensive and efficient use of both financial resources and tax advantages to achieve the client's objectives. Therefore, all of the client's specific objectives requiring additional income and/or capital should be considered in relation to the client's total financial condition and funded with the most appropriate tax-advantaged investment media available.

Sources of Income

Page 7 of the Fact Finder is a survey of the client's income from all sources including the income of spouse and dependents, if any; income tax obligations; estimated income 1, 3, and 5 years in the future; and anticipated salary increases and bonuses.

After the client has provided all of the income information, the financial advisor should check tax returns to verify the amounts reported. It is crucial that all of this information be correct and complete, as many recommendations the advisor may make for family budgeting, savings, investment, funding for specific objectives, additional insurance coverage, tax planning, retirement planning, and estate planning will be related to the current and continuing income sources inventoried on page 7. Using this information, the advisor may project the probable growth rate of the client's financial position for years into the future. But planning is only as good as the information on which it is based.

The sources and amounts of the client's income will be transferred to the Cash Flow Statement on page 8 of the Fact Finder where it will be evaluated in relation to the client's annual expenses.

Cash Flow Statement

The most important point to be made about the Cash Flow Statement on page 8 is that the figures for all items should be complete and correct. Most individuals and families do not follow a realistic and exacting budget; indeed, many are averse to doing so. For these individuals and families the completion of the Cash Flow Statement, detailing all items of income and expense, will be an uncomfortable task for which most will not have kept adequate records. Nevertheless, completing this statement, analyzing and evaluating total income and expenses, and seeing their relationship to both short- and long-term financial objectives are extremely important in the financial planning process. Clients must have a positive net cash flow in the long run if they want the flexibility to fund additional financial objectives that may arise. Clients who experience a negative net cash flow will either have to borrow or liquidate assets in order to balance income and expenses. No financial plan can work, let alone be formulated, if net cash flow is consistently negative.

Because of their importance to financial planning, cash flow statements (along with financial position statements) are discussed and analyzed in greater depth later in this chapter.

Inventory of Assets and Liabilities

Three Fact Finder sections, Inventory of Assets, Business Interest, and Inventory of Liabilities, are pivotal in financial planning. When information about a client's assets and liabilities is transferred to the first column of the Financial Position Statement (pages 30–31 of the Fact Finder), the client's total financial position and net worth will be reflected. Moreover, this inventory

of assets and liabilities will enable the financial advisor to understand how the client uses financial resources and debt, what the client's preferences and aversions are, what the client's liquidity position is, what problems exist, whether all assets (including any business interest) are being used efficiently to meet financial objectives, how diversified the assets are, whether the client is aware of his or her total financial condition (or even wants to be), and how the client thinks and feels about his or her present assets and financial resources.

Many clients have an inexact and often sketchy idea of what their total assets are. Even more have a poor grasp of whether their assets are working efficiently toward their objectives or whether their investment risk exposures are really consistent with their temperaments. No other area of the client's financial posture is more crucial for achieving realistic financial objectives than his or her total asset and liability positions and their tax implications, particularly if the client's business interest represents a substantial portion of his or her total assets.

Financial Position Statement

Pages 30 and 31 of the Fact Finder should be used to bring together information on the client's assets and liabilities in a Financial Position Statement, both current and projected for one or more years into the future. This statement is in effect a balance sheet that uses fair market value for asset items instead of historical cost.

All items in the statement have been transferred from the Inventory of Assets, the Business Interest, and the Inventory of Liabilities sections of the Fact Finder but have been somewhat rearranged here. Client assets are classified in three broad groups: (1) cash and near-cash equivalents, (2) other financial assets, and (3) personal assets. These broad groups contain the subsections from the Inventory of Assets on pages 9–12 of the Fact Finder in addition to a value of business interest item derived from the valuation of business interest subsection on page 14.

The client's total liabilities are subtracted from his or her total assets to determine net worth. To increase this bottom-line figure is, of course, one of the primary objectives of financial planning.

The Financial Position Statement, in conjunction with the Cash Flow Statement on page 8, provides a profile of the client's total financial position as of a particular date. It also provides projections of the client's asset, liability, and net worth positions for one or more years into the future, which makes it possible to establish some working objectives. It goes without saying that these working objectives should be consistent with the client's wishes, what his or her resources can realistically support, and the various methods and vehicles used to implement his or her comprehensive financial plan.

The projections are based on certain assumptions about the future (such as the inflation rate and the rates of anticipated return on investment). The fact, however, that the projections are based on assumptions needs to be clarified for the client; otherwise they might be misleading, especially since they are likely

to give the illusory impression of certainty. Only by periodically reviewing and adjusting a client's plan can there be any assurance that it will achieve the client's objectives.

Because of their importance to financial planning, financial position statements (along with cash flow statements) are discussed and analyzed in greater depth later in this chapter.

Individually Owned Insurance

Pages 17–19 of the Fact Finder ask for information on the life, long-term care, medical/dental, disability income, and property/liability insurance policies currently held by the client. Complete information about these coverages is crucial for developing a comprehensive financial plan. For example, the coverage amounts provided by the client's personal life and disability income policies should also be listed on page 32 of the Fact Finder, where they will constitute one element of the client's current resources available for death, disability, and retirement needs. Personal life insurance coverage amounts will also be a factor in the value of the client's estate and its liquidity position. Moreover, personal property and liability insurance coverages should be analyzed to see if they give adequate protection against potential property and liability losses.

People typically do not know how to read and interpret the provisions of their insurance policies, so this type of information probably cannot be provided by the client. It most likely will have to be recorded directly from the client's insurance policies.

Once the advisor has reviewed the policies and filled out the appropriate spaces of the Fact Finder, the amounts, types of coverages, and other relevant policy provisions should be reviewed with the client and analyzed in light of areas of risk in the client's personal and financial situation. By the end of the data-gathering phase (step 2, determine goals and gather data) of the financial planning process, the advisor should have enough information about the client and his or her family to determine whether the client's current insurance coverages provide adequate protection relative to his or her overall financial position and degree of exposure to risk.

Pages 13–14 of the Fact Finder, pertaining to the client's business interest, should also be reviewed with the client during the discussions about insurance protection. This information relates directly to the possible need or desire to fund buy-sell or other business-continuation agreements through disability income and life insurance and to cover various liability risks in the client's particular business or professional practice.

The financial advisor who is not an insurance specialist should include appropriate specialists on the financial planning team who can thoroughly analyze all of the client's business and personal risk exposures and recommend appropriate coverages if needed.

Employment-Related Benefits

The Employment-Related Benefits Checklist on page 20 and the Employment-Related Retirement Benefits/Deferred Compensation section on page 21 of the Fact Finder have several important uses in financial planning. If a client or spouse owns a controlling interest in a business, these sections provide a convenient place for not only recording existing employee benefits but also identifying additional benefits that might be implemented in order to put the business ownership to more effective use (and to greater tax advantage) in planning for personal financial objectives. The financial advisor should analyze the advantages of possible additional benefits in relation to the client's or spouse's particular form and degree of business ownership. This type of planning will almost always involve bringing other specialists (an attorney for drafting legal instruments, a CPA, an employee benefits specialist, and so on) onto the financial planning team at both the development (step 4, develop and present a plan) and the implementation (step 5, implement the plan) stages of the financial planning process.

If a client and spouse have no business ownership interest, or have no control over the kinds of benefits their business interest can provide, then pages 20–21 should be used as a checklist for the benefits they actually derive from their employment. The client and spouse should each furnish the name and title of the person in their company who can provide detailed information and documents they may not have in their own possession. The documents relating to these benefits are listed on Fact Finder page 26, Receipt for Documents, which is also a checklist of information and documents that the client and spouse, or their companies, will need to make available for the financial advisor's use.

The column titled information/comments on the Employment-Related Benefits Checklist on page 20 can be used either to describe a benefit or to indicate the advisor's or the client's feelings about the benefit. Besides being listed on page 20, the amounts of benefits should also be listed on page 32 of the Fact Finder, Income and Lump-Sum Resources for Disability, Retirement and Death.

Risk/Return Profile

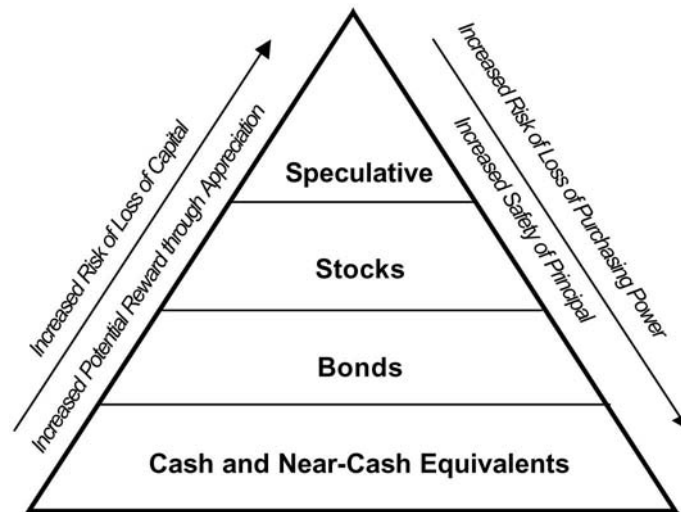
The Risk/Return Profile on page 22 of the Fact Finder is designed to provide a quick assessment of the client's psychological propensity for risk taking, that is, his or her financial risk tolerance. Risk tolerance, however, is difficult to measure in clients. No matter what method of measurement is used, the result will be misleading unless it is related to the rate of return the client expects on invested money. It is equally difficult, however, to measure the risk characteristics of investment media themselves especially in an environment of fluctuating interest rates, an uncertain economy, an unpredictable stock market, and a financial marketplace of evolving concepts and many new and unseasoned investment media. Because nothing in the financial markets stays the same for very long, even the most sophisticated portfolio-management strategies are little more than rules of thumb that require periodic adjustment for

changing circumstances. Therefore, the investment strategies developed for an individual client should reflect the client's current risk-taking propensities, the rate of return required to achieve agreed-on financial objectives, and the client's understanding that both personal circumstances and the financial environment will change over time, thus altering his or her Risk/Return Profile and requiring modification of the financial plan.

Risk/Return Investment Pyramid

What the Risk/Return Profile intends to measure is dramatically illustrated by the *Risk/Return Investment Pyramid* shown in *Figure 5-1, Risk/Return Investment Pyramid*. Typical investment media are arranged in a pyramid with the most conservative, least risky, and (generally) lowest-yielding media at the broad base of the pyramid. The investment media become progressively riskier as they approach the apex where speculative investments are located. Toward the apex there is typically a corresponding and commensurate potential for higher return.

Figure 5-1 Risk/Return Investment Pyramid



The arrows along the sides of the pyramid demonstrate the relationship between risk and return as one ascends or descends through this pyramid of investment possibilities. *Figure 5-1, Risk/Return Investment Pyramid* illustrates that all investments bear an element of risk and that the rate of return is inextricably related to a corresponding degree of risk of loss. There is no way out of this risk/return trade-off; even investment in the most conservative media risks erosion of capital if the rate of return is less than the rate of inflation. In other words, all efforts to manage money involve a trade-off of risk against return. Clients must choose the investment media most closely suited to both their financial objectives and their range of psychological comfort as represented by their risk tolerance levels.

A note about how the Risk-Return Profile on page 22 is used. On the top part of the page the client is asked to evaluate, on a scale of 0 to 5, his or

her preference for a range of savings and investment media, from a savings account (conservative, virtually no risk) to commodities (speculative, extremely high risk). In the middle part of the page the client is asked to rate personal financial priorities, also on a scale of 0 to 5. The results of the two rankings should correlate with each other, giving an indication of the client's financial risk tolerance.

However, if the rankings are inconsistent and do not correlate well with each other, the advisor should question the client about the inconsistencies and, if necessary, make the required changes. When both the advisor and client are satisfied with the rankings, the advisor should note the results on the bottom part of the page and indicate the types of investment media most likely to achieve the client's expectations and objectives.

Income and Lump-Sum Needs for Disability, Retirement, and Death

On page 23 of the Fact Finder the client should record the monthly amounts of income needed if the client or his or her spouse becomes disabled, retires, or dies. These estimates of monthly income needs are expressed in current dollars, that is, in amounts needed now. However, in formulating a retirement plan for the client, the advisor will have to adjust the client's estimate of these monthly needs by an agreed-on inflation factor.

Survivors' monthly income needs in the event of the client's or spouse's death are assessed for three periods: (1) an adjustment period when a continuing and unreduced income flow is needed; (2) a period of reduced income after the adjustment period until the youngest child is self-supporting; and (3) the period after the youngest child is self-supporting.

In addition, the survivors may need certain lump sums—to establish an emergency fund, to pay postmortem expenses, to pay off any outstanding mortgage balance on a personal residence, to pay off the deceased's notes and loans, to pay accrued taxes, and to fund college educations for surviving children. These lump-sum needs can be substantial and very real, but often there is not enough ready cash or other assets to meet them.

Close consultation with the client in establishing both income and lump-sum needs upon disability, retirement, and death is always called for. But there is little purpose in establishing precisely the amounts needed unless there is also a concerted planning effort to assure that the resources are available when needed.

Tax-Planning Checklist

Pages 27–29 of the Fact Finder inquire in some detail into the client's present and possibly advisable tax planning strategies. Since the impact of taxation on nearly all types of income and assets is one of the primary concerns of comprehensive financial planning, this section of the Fact Finder should prove to be especially helpful in evaluating the client's current financial position and for exploring a range of possible strategies for reducing the client's tax burden.

Tax planning involves the analysis, evaluation, and client acceptance of the tax consequences of every capital and financial transaction—before the transaction is made. It is one thing to look up the tax law and determine the consequences of one's economic activity during the past year (or to pay a tax return preparer a fee for doing that onerous task). It is quite another thing to determine in advance what short - and long-term tax liability will result from every transaction and then to conduct one's transactions so as to achieve financial objectives by the most tax-advantaged means. Tax planning, in other words, is a delineation and analysis of primary tax considerations in determining when, whether, and how to conduct various personal and business transactions to affect both the desired economic end and to minimize the tax impact of achieving that end.

In the complicated financial situations of most clients there is almost always at least one alternative (and in most cases several) to the one that may seem most obvious. Financial strategies and products have inherent advantages and disadvantages and therefore are rarely appropriate for every client situation. When tax consequences are considered as well, there is even more divergence—some result in greater, some in lesser, tax liability. But it should be remembered that the most apparent route for an immediate (or even long-term) tax saving may not, in the final analysis, be the most advantageous. Tax and economic advantages and disadvantages must be balanced against the risk tolerance profiles and the objectives of each client. What works well for one client may not work at all for another in virtually the same position. What works well this year may be a disaster next year or several years down the road. As both the client's tax bracket and the level and complexity of his or her financial affairs increase, it becomes ever more urgent that the client seek and that the financial advisor provide sound tax planning as a central part of comprehensive financial planning.

It should be noted that the Tax Planning Checklist on pages 27–29 of the Fact Finder is not intended to be complete or to raise all of the questions that would be relevant to every client. At best the checklist introduces some of the more common considerations, knowledge of which will enable the advisor to take the client's tax temperature and factor the information into the financial planning process.

Personal Assessment of the Client

Before the client's financial plan is formulated, the financial advisor should sum up his or her observations and impressions about the client on page 26 of the Fact Finder in the section titled Observations from Planning Sessions. These observations and impressions are vital to the planning process and to the acceptability and ultimate success of the client's plan, which will incorporate some of the most profound and far-reaching decisions the client will have made about life and relationships. But the plan will not be implemented unless it reflects the kind of person the client is; or, if implemented, it will not be updated.

The financial planning process will have been wasted and a client relationship lost.

MONITORING THE CLIENT'S PLAN

When the individually tailored financial plan is developed, fine-tuned, presented to and accepted by the client, and implemented, the first cycle of the financial planning process will have been completed. The process will be renewed periodically in the ongoing monitoring and restructuring of the plan when necessary during the client's subsequent financial life. If the planning process has met the client's needs and directed him or her toward desired goals, and if the plan meets the client's expectations reasonably well, a long-term relationship between the client and the advisor will likely result.

To facilitate this ongoing relationship and to keep in touch with the client's changing circumstances, interests, and needs, the financial advisor must have some method for routinely reviewing the client's situation at specified periodic intervals—usually annually. The Checklist for Financial Planning Review on page 33 of the Fact Finder is a convenient checklist for keeping up with changes in the client's personal and financial circumstances. Mailing this form to the client or simply going through it in a telephone call will enable the advisor to keep up to date with the client.

When significant events have happened in the client's financial life, or are expected to, an appointment should be set up to evaluate the impact of these events on the client's financial plan and to make appropriate adjustments to the plan if necessary. Likewise when the advisor sees or foresees changes taking place in the financial markets, in tax laws, and/or in the general economy that have a significant effect on the client's plan, he or she should inform the client.

The ever-changing nature of economic conditions and of clients' lives makes it almost impossible for a financial plan, no matter how well it was initially conceived and executed, to continue performing indefinitely at maximum efficiency. Unless the plan is periodically reviewed and updated when necessary, the entire planning process may have to be repeated. Both clients and advisors will be well served if they recognize and act on this fundamental fact. Comprehensive financial planning that is monitored conscientiously serves the interests of both client and advisor in an ongoing professional relationship characterized by mutual respect and trust.

An important function of the Fact Finder is to gather enough information about the client so that his or her financial position and cash flow statements can be developed. Together these two statements provide a profile of the client's total financial condition as of a particular date, which is related to what has occurred in the past. However, to facilitate the monitoring of a comprehensive plan, it is useful to prepare projected financial statements for one or more years into the future. These projected statements show what the client's future financial statements are expected to look like if certain strategies are followed under specified assumptions. At some point in the future, the advisor will then

be able to compare current financial statements with past projected statements to see if the client's financial plan is on target. Next, let us look more closely at financial position and cash flow statements to see how they are used by advisors to help clients achieve their goals through application of the financial planning process.

PERSONAL FINANCIAL STATEMENTS IN FINANCIAL PLANNING

The preparation of organized financial information is an important but often ignored aspect of personal financial planning. Like businesses, individuals must often prepare financial information for external use. Banks and other lending institutions rarely make loans to individuals without first analyzing their current financial situations and their future ability to repay the loans. However, the primary use of financial information in personal financial planning is for the financial advisor and the client's use.

Financial analysis, planning, and control are important planning techniques, whether conducted by the individual or the individual assisted by a financial advisor. Personal financial statements summarizing a client's current financial situation, as well as those projecting future results, are both useful for internal purposes. It is difficult, if not impossible, to develop a financial plan and/or formulate strategies for achieving a client's financial goals without knowing the client's current financial situation and resources. Moreover, the ongoing analysis of the client's personal financial information is crucial in monitoring whether the client's financial goals are being achieved.

financial position statement
(balance sheet)
cash flow statement
(income statement)

In personal financial planning, the two primary financial statements advisors use are the *financial position statement* (known in business as the *balance sheet*) and the *cash flow statement* (the *income statement*). Before each is discussed in greater detail, a few general comments follow regarding the timing of their preparation and use.

While it is common to see personal financial statements that have been prepared only at the end of a calendar or fiscal year, the timing and frequency of financial statements can vary. When a lending institution needs personal financial information for a lending decision, it usually requires that the information be prepared as of the date of the loan application. Similarly, a financial advisor needs financial information at the time the planning process begins, and at each subsequent review. If reviews take place every 6 months, it is necessary to update the personal financial statements at these same intervals. In other words, personal financial statements are not prepared at arbitrary times but rather when the information is needed for the financial planning process.

FOCUS ON ETHICS: The Role of Ethics in Preparing Financial Statements

Ethics is important in preparing and using personal financial statements because the client places blind faith in the skills, knowledge, and integrity of the advisor who prepares them. Moreover, the information contained in personal financial statements is confidential. The client is entitled to confidentiality, and ethical responsibility demands it. Finally, it is the advisor's responsibility to help the client establish attainable goals, which set the ethical tone for the entire financial planning process. Therefore, the advisor must resist the temptation to push for goals that are unattainable and require that unrealistic projections and/or assumptions be used in pro forma statements.

pro forma

A client's current financial position and cash flow statements relate to what has occurred in the past. For purposes of financial planning, however, it is also necessary to prepare *pro forma* (or projected) financial position and cash flow statements. These pro forma statements illustrate what future financial statements are expected to show if certain activities are implemented under specified assumptions. Finally, current financial statements can be compared with past pro forma statements to see if the client's financial plan was realized.

WHAT IS A FINANCIAL POSITION STATEMENT?

The financial position statement shows an individual's (or family's) wealth at a point in time and reflects the results of the individual's past financial activities. It contains three basic classifications—assets, liabilities, and net worth—that make up the basic accounting equation:

$$\text{ASSETS} = \text{LIABILITIES} + \text{NET WORTH}$$

Financial advisors can choose from many different formats for the financial position statement since there is no standard. However, statements usually group the items that make up assets and liabilities into subclassifications that better enable the advisor to analyze the components of the client's total financial situation and to evaluate the mix of assets in relation to the client's objectives. *Table 5-1, Financial Position Statement for Jack and Jill Klient—June 30, 2007* shows a typical financial position statement.

Obviously, a financial statement should be in a format that is understandable, and uniformity is desirable. However, the actual format is really secondary to the quality of the information. It should be noted that the format of a financial position statement (and a cash flow statement) is often determined by the software system used by the financial advisor for analyzing data and producing reports.

Table 5-1
Financial Position Statement for Jack and Jill Klient—June 30, 2007

Assets		Liabilities and Net Worth	
Cash and Cash Equivalents		Liabilities	
Cash	\$ 12,000	Credit card balances	\$ 2,000
Money market fund	50,000	Consumer loans	4,000
Life insurance cash value	<u>18,000</u>	Automobile loans	12,000
	\$ 80,000	Mortgage loans	<u>220,000</u>
Other Financial Assets		Total Liabilities	\$ 238,000
Stock	\$ 150,000		
Bonds, taxable	90,000	Net Worth	\$ 692,000
Bonds, tax-exempt	80,000		
401(k)	<u>120,000</u>		
	\$ 440,000		
Personal Assets		Total Liabilities and Net Worth	\$ 930,000
Residence			
Automobiles	\$ 300,000		
Household furnishings, possessions, jewelry, art	\$ 30,000		
	<u>80,000</u>		
	\$ 410,000		
Total Assets	\$ 930,000		

As illustrated in *Table 5-1, Financial Position Statement for Jack and Jill Klient—June 30, 2007*, financial position statements have traditionally been presented in two columns—one containing assets, the other containing liabilities and net worth. The term balance sheet is derived from the fact that the two side-by-side columns must balance according to the accounting equation (total assets = total liabilities + net worth). However, it is now more common to present financial position statements in a single-column format. The major advantage of the single-column format is that it facilitates the preparation of pro forma financial position statements and the comparison of consecutive statements over time.

Assets

Assets are items the client owns. It is immaterial whether the items were purchased for cash, financed by borrowing, or received as gifts or inheritances.

Table 5-2**Financial Position Statement for Jack and Jill Klient—June 30, 2007**

ASSETS	
Cash and Cash Equivalents	
Cash	\$ 12,000
Money market fund	50,000
Life insurance cash value	18,000
	\$ 80,000
Other Financial Assets	
Stock	\$ 150,000
Bonds, taxable	90,000
Bonds, tax-exempt	80,000
401(k)	120,000
	\$ 440,000
Personal Assets	
Residence	\$ 300,000
Automobiles	30,000
Household furnishings, possessions, jewelry, art	<u>80,000</u>
	\$ 410,000
TOTAL ASSETS	\$ 930,000
LIABILITIES AND NET WORTH	
Liabilities	
Credit card balances	\$ 2,000
Consumer loans	4,000
Automobile loans	12,000
Mortgage loans	220,000
TOTAL LIABILITIES	\$ 238,000
NET WORTH	\$ 692,000
TOTAL LIABILITIES AND NET WORTH	\$ 930,000

Items that the client possesses but does not own, such as rented apartments or leased automobiles, are not shown as assets.

It is common practice for personal financial position statements to show assets at their current fair market values. These values may vary considerably from the original purchase prices. In contrast, business balance sheets list many assets on the basis of adjusted historical costs, net of depreciation. Valuation methods should be clearly noted on the balance sheet.

At a minimum, assets should be subdivided into two categories: financial assets and nonfinancial (or personal) assets. Many statement formats include other categories such as use assets, nonuse assets, personal assets, investment assets, and retirement assets. The financial position statements in *Table 5-1, Financial Position Statement for Jack and Jill Klient—June 30, 2007* and *Table 5-2* use three major categories of assets by separating total assets into (1) cash and cash equivalents, (2) other financial assets, and (3) personal assets. Other financial assets are sometimes further subdivided according to their relative liquidity, income characteristics, tax status, or growth characteristics. Financial advisors should endeavor to use generally accepted accounting principles in the corporate marketplace.

Liabilities

Liabilities are the debts of the client. While the financial position statement in *Table 5-1, Financial Position Statement for Jack and Jill Klient—June 30, 2007* does not separate liabilities into major subcategories, it is not unusual to see liabilities grouped by the time period in which they must be repaid. For example, the statement might show subtotals for short-term liabilities (due in one year or less), intermediate-term liabilities (due in more than one year but no more than 5 years), and long-term liabilities (due in more than 5 years).

In theory, the liabilities section of the financial position statement should show all liabilities as of the date of the statement—even if the client has not received a formal bill. This process may require the client to make estimates for such items as taxes due, utility charges owed, and credit card obligations. In practice, clients and advisors often ignore relatively small accruals for unaudited statements.

Net Worth

Net worth measures the client's wealth or equity at the date of the financial position statement. It is calculated by restating the basic accounting equation as follows:

$$\text{Net Worth} = \text{Total Assets} - \text{Total Liabilities}$$

or

$$\text{Ours} = \text{Own} - \text{Owe}$$

In other words, net worth is what remains if all the client's assets are sold at their fair market values and all debts are paid. If a client has a negative net worth, the client is considered to be bankrupt. However, such clients can avoid formal bankruptcy proceedings if cash flow is sufficient to service all financial obligations.

By itself, net worth reveals little about the nature of the assets or liabilities. A client with considerable net worth may have all his or her assets tied up in non-income-producing assets, such as homes, automobiles, and other personal possessions. Conversely, a client with a modest net worth may hold most assets in the form of financial assets that may be generating income, capital appreciation, or both. Further, it is possible for a client to have a positive cash balance with a negative net worth or to have a zero cash balance with a very high net worth. The key to understanding net worth is to recognize that it is simply a residual—the difference between total assets and total liabilities.

A client's net worth may increase or decrease during a period of time. Other things being equal, it will increase as a result of any one of the following:

- appreciation in the value of assets
- addition to assets through retaining income
- addition of assets through gifts or inheritances
- decrease in liabilities through forgiveness

The following are examples of actions that have no effect on net worth:

- paying off a debt. The cash account declines by the same amount that the liability declines, leaving the difference between total assets and total liabilities unchanged.
- buying an asset with cash. Total assets remain unchanged because cash declines by the same amount that the other asset category increases. However, commissions and other transaction costs cause net worth to decline because the cash that pays these costs is not reflected in the value of the purchased asset.

PREPARING A FINANCIAL POSITION STATEMENT

Since net worth is determined by subtracting total liabilities from total assets, preparing a client's financial position statement involves

- identifying each of the client's assets and liabilities
- valuing each asset and liability as of the date of the statement
- recording those values in an appropriate format that shows the client's net worth as the difference between total assets and total liabilities

Identifying the Client's Assets and Liabilities

Assets

As mentioned earlier, assets—that is, the items a client owns—can be categorized in a number of ways. One commonly used approach involves first dividing the client's assets into two groups—financial assets and nonfinancial (personal) assets. The results of the Federal Reserve Board's Survey of Consumer Finances³⁴ conducted in 2004 (hereinafter referred to as the FRB Survey) indicate that 42 percent of the value of all the assets held by the 4,522 families interviewed were financial assets and 64.3 percent were nonfinancial (or personal) assets.³⁵ Additional findings of the FRB Survey are presented throughout this section. They provide a sense of the relative roles played by various types of assets and liabilities in defining the financial positions of U.S. families.

Liabilities

Liabilities are debts a client incurs by borrowing. Individuals and families borrow for a variety of reasons. *Table 5-3, Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Purpose for Borrowing* shows the percentage breakdown of the total amount of debt of all families participating in the 2004 FRB Survey by purpose for borrowing. As indicated, borrowing to purchase a home accounts for the bulk of total family borrowing.

When clients borrow, they incur debts that must be repaid in the future—that is, they incur liabilities. Liabilities are generally identified by the type of debt incurred. The types of liabilities most commonly incurred by clients are

- balances for credit cards and other lines of credit
- mortgages and other loans secured by residential property
- installment loans to finance the purchase of items such as automobiles, furniture, and appliances
- other forms of borrowing such as loans from life insurance policies and retirement accounts

34. Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 92 (February 2006), p. A1–A38.

35. Bucks, p. A19.

Table 5-3
Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Purpose for Borrowing

Purpose for Borrowing	% of Total Amount of Debt in 2004
Home purchase	70.2
Home improvement	1.9
Other residential property	9.5
Investments excluding real estate	2.2
Vehicles	6.7
Purchase goods and services	6.0
Education	3.0
Unclassifiable loans against pension accounts	†
Other	.6
Total Debt	100
Source: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances," <i>Federal Reserve Bulletin</i> , vol. 92 (February 2006), p. A32.	

Table 5-4, Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Type of Debt shows the percentage breakdown by type of debt of the total amount of debt of all families participating in the 2004 FRB Survey. Regardless of the type of debt, debts that are due within one year of the date of the financial position statement are considered short-term (or current) liabilities; those due more than one year from the date of the statement are considered long-term liabilities.

As indicated in *Table 5-4, Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Type of Debt*, three-fourths of the total liabilities of families participating in the 2004 FRB Survey consist of home-secured debt—that is, first and second mortgages, and home equity loans and lines of credit secured by the primary residence. With the exception of the highest income and net worth groups, use of home-secured debt increases with family income and wealth. Use of home-secured debt peaks among families headed by persons aged 45 to 54; following that, it declines. In contrast to the recently growing share of total debt attributable to borrowing secured by the primary residence, the share represented by borrowing on other residential real estate continues to decline as it has over the past decade. Also, as indicated in *Table 5-4, Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Type of Debt*, the use of lines of credit other than home equity lines is not common.

Table 5-4
Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Type of Debt

Type of Debt	% of Total Amount of Debt in 2004
"Home-secured debt (mortgages and other borrowing secured by the primary residence)	75.2
Borrowing on other residential property	8.5
Lines of credit not secured by residential property	.7
Installment loans	11.0
Credit card balances	3.0
Other	1.6
Total Debt	100.0
Debt as a percentage of total assets	.15
Source: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances," <i>Federal Reserve Bulletin</i> , vol. 92 (February 2006), p. A25.	

Table 5-4, *Distribution of the Total Amount of Debt of All Families Participating in the 2004 FRB Survey by Type of Debt* indicates that the second largest share of the total liabilities of families participating in the 2004 FRB Survey consists of installment borrowing—that is, consumer loans that typically have fixed payments and a fixed term. Examples include automobile loans, student loans, and loans for furniture, appliances, and other durable goods. Use of installment borrowing was widespread in 2004 with the exception of the lowest and highest income groups, the highest net worth group, and families headed by persons aged 65 and older, where the use of installment loans was notably lower.

Another common personal liability arises from the use of credit cards to purchase goods and services. Credit cards consist of bank-type cards such as VISA, MasterCard, Discover, and Optima; travel and entertainment cards such as Diners Club and American Express; gasoline company cards; and store cards or charge accounts. The outstanding credit card balance on the date of the financial position statement is a liability.

Liabilities can also arise from a variety of other types of borrowing. Loans on insurance policies, loans against tax-advantaged retirement accounts, and borrowing on margin accounts should be shown as liabilities on the financial position statement. Also, amounts owed as of the date of the financial position statement for items such as taxes, rent, utility bills, and medical bills should be shown as liabilities on the statement.

Valuing Each Asset and Liability as of the Date of the Statement

Once a client's assets and liabilities have been identified, a value must be determined for each. Values are only accurate for the date they are recorded. Financial advisors must stress to their clients that balance sheets are "point in time" tools, and change constantly. Unlike business financial position statements (balance sheets) which must list many assets on the basis of historical cost adjusted for depreciation, assets should be listed on a client's personal financial position statement at their fair market value as of the date the statement is being prepared. Values for most financial assets can be determined from checking account, savings account, investment account, and tax-advantaged retirement account statements. For life insurance policies with fixed level premiums and guaranteed cash values such as traditional whole life policies, the amount of a policy's cash value can be determined from a table of lapse (nonforfeiture) option values contained in the policy or from the insurance company for ages not listed in the policy's lapse option table. For other policies whose cash values reflect actual or anticipated investment, mortality, and/or expense experience, statements sent periodically to the policyowner can be used to determine cash value amounts. The fair market value of other financial assets such as oil and gas leases, futures contracts, royalties, and stock options is often difficult to determine, especially when the asset is not traded on an established market.

A variety of techniques may be used in estimating the fair market value of different types of personal assets. For example, the current market value of a client's home can be estimated using information gathered from local newspapers and/or the Internet regarding the prices of similar houses in the area that are being advertised for sale or have recently been sold. On the other hand, the value of quality pieces of art and jewelry may best be estimated by an appraisal. Today the values of many types of personal assets can be estimated using Internet websites — including eBay. For example, values for automobiles can be determined by using a number of websites including *edmunds.com*, *kbb.com*, and *autos.yahoo.com*. In addition to automobile values, *NADAguides.com* provides value estimates for classic cars, motorcycles, boats, and recreational vehicles. Values of many collectibles are available at *orionbluebook.com*.

Determination of the fair market value of a client's net equity interest in a closely held corporate business is an especially complex task.³⁶ The IRS, for example, has identified the following factors to be considered in valuing a corporate business:³⁷

36. For an overview of the key factors considered and the variety of valuation methods used in estimating the fair market value of a closely held business, see T. Kurlowicz, J.F. Ivers III, and J.J. McFadden, *Planning for Business Owners and Professionals* (Bryn Mawr, PA: The American College, 2007), pp. 11.2–11.30.

37. Rev. Rul. 59–60, 1959–1 C.B. 237.

- the nature of the business and the history of the enterprise from its inception
- economic outlook in general, and the condition and outlook of the specific industry in particular
- the book value of the stock and the financial condition of the business
- the earning capacity of the company
- the dividend-paying capacity
- determination of whether the enterprise has goodwill or other intangible value
- sales of the stock and the size of the block of stock to be valued
- the market price of actively traded stocks of corporations engaged in the same or a similar line of business

Although all these factors should be considered in determining the fair market value of a client's interest in a closely held corporate business, judgment must be applied in determining the weights that should be accorded to each factor. Moreover, there are a number of different methods, some focusing on assets and others focusing on earning power that can be used in estimating the value of the business. Choice of the most appropriate valuation method or methods is also based heavily on judgment. Finally, the application of discounts for such factors as a minority interest and the lack of marketability of the interest introduce considerable judgment into the valuation process. Given the complexity and subjectivity of this procedure, the valuation of an interest in a closely held corporate business is virtually always handled by a qualified valuation appraiser.

Just as with assets, preparation of a financial position statement also requires that values be determined for each of the client's liabilities. Liabilities are valued by using the amount owed by the client as of the date the financial position statement is prepared. Thus, liabilities arising from the purchase of consumable goods and services are valued at the amount owed on the date of the statement regardless of whether a bill has been received. Likewise, even though a bill has not been received, the value of a liability arising from the use of a credit card is the outstanding balance on the date of the financial position statement. Liabilities resulting from mortgages and other types of loans are valued at the outstanding loan balance—that is, the amount of the unpaid principal—as of the date the financial position statement is prepared.

Some balance sheets may reflect multiple values for each asset. A home may have a tax appraised value, an insured value (replacement value), and fair market value (the amount the home could be sold for). Advisors need to clearly identify valuations, methods, and dates on statements of financial position.

Recording the Values of the Client's Assets and Liabilities in an Appropriate Format That Shows the Client's Net Worth

The final step in the preparation of a financial position statement involves recording the values of the client's assets and liabilities in an appropriate format

that shows the client's net worth as the difference between total assets and total liabilities. As mentioned earlier, although financial position statements have traditionally been presented in a two-column balance sheet format as illustrated in *Table 5-1, Financial Position Statement for Jack and Jill Klient—June 30, 2007*, it is now more common in financial planning to present financial position statements in a single-column format. As illustrated in *Table 5-5, Current and Pro Forma Financial Position Statements for Jack and Jill Klient*, the major advantage of the single-column format is that it facilitates the preparation of pro forma financial position statements and the comparison of consecutive statements over time. The current statement as of June 30, 2007, shows the Klients' actual financial position on that date. Pro Forma #1 projects the Klients' financial position one year if they continue to manage their cash flows, assets, and liabilities in the same manner as at present, and if the underlying assumptions regarding rates of return, asset appreciation and depreciation, debt repayment, and taxes accurately portray conditions occurring during the next year. Based on the same underlying assumptions, Pro Forma #2 reflects improved cash flow management through budgeting and reallocation of some assets as recommended in the Klients' financial plan for the next year; it also projects the impact of those changes on the Klients' financial position as of June 30, 2008. A comparison of the two pro forma statements indicates that if the Klients' follow the recommendations in their financial plan and the underlying assumptions are accurate, their assets and net worth would be \$9,720 greater in one year than if they were to continue managing their cash flows, assets, and liabilities in the present manner. Assuming the Klients adopted the cash flow management and asset reallocation recommendations in their financial plan, a comparison of the current statement for June 30, 2007, and Pro Forma #2 indicates that lower than anticipated rates of return resulted in their actual financial position (both assets and net worth) on that date being \$10,993 less than projected. However, a comparison of the two current statements indicates that with their assets increasing by \$80,267 and their net worth increasing by \$91,800, the Klients' financial position did improve between June 30, 2007, and the same date in 2008.

Table 5-5
Current and Pro Forma Financial Position Statements for Jack and Jill Klient

Assets	Current on 6/30/07	Pro Forma #1 6/30/08 With Same Asset Allocation	Pro Forma #2 6/30/08 With Planned Asset Reallocation	Current on 6/30/08
Cash and Cash Equivalents				
Cash	\$ 12,000.00	\$ 14,000.00	\$ 6,000.00	\$ 6,000.00
Money market fund	50,000	51,,700	20,680	20,510
Life insurance cash value	<u>18,000</u>	<u>19,000</u>	<u>19,000</u>	<u>19,000</u>
	\$ 80,000	\$ 84,700	\$ 45,680	\$45,510
Other Financial Assets				
Stock	\$ 150,000	\$165,000	\$ 192,500	\$ 187,250
Bonds, taxable	90,000	96,120	101,460	100,653
Bonds, tax-exempt	80,000	84,800	100,700	99,750
401(k)	<u>120,000</u>	<u>139,920</u>	<u>139,920</u>	<u>136,104</u>
	\$ 440,000	\$ 485,840	\$ 534,580	\$ 523,757
Personal Assets				
Residence	\$ 300,000	\$ 330,000	\$ 330,000	\$ 330,000
Automobiles	30,000	27,000	27,000	27,000
Household furnishings, possessions, jewelry, art	<u>80,000</u>	<u>84,000</u>	<u>84,000</u>	<u>84,000</u>
	\$ 410,000	\$ 441,000	\$ 441,000	\$ 441,000
Total Assets	\$ 930,000	\$1,011,540	\$1,021,260	\$1,010,267
<u>Liabilities and Net Worth</u>				
Liabilities				
Credit card balances	\$ 2,000	\$ 1,000	\$ 1,000	\$ 1,000
Consumer loans	4,000	3,200	3,200	3,200
Automobile loans	12,000	9,600	9,600	600
Mortgage loans	<u>220,000</u>	<u>212,667</u>	<u>212,667</u>	<u>212,667</u>
Total Liabilities	\$ 238,000	\$ 226,467	\$ 226,467	\$ 226,467
Net Worth	\$ 692,000	\$ 785,073	\$ 794,793	\$ 783,800
Total Liabilities and Net Worth	\$ 930,000	\$1,011,540	\$ 1,021,260	\$1,010,267

USING A FINANCIAL POSITION STATEMENT

In addition to providing a format for summarizing the asset and liability data gathered in step 2 (determine goals and gather data) of the financial planning process, properly prepared, a client's financial position statement provides an important source of information a financial advisor can use to help the client achieve his or her goals through the application of the financial planning process. The information provided by the statement is especially useful in the following steps of the financial planning process:

- Step 3: Analyze and Evaluate the Data
- Step 4: Develop and Present a Plan
- Step 6: Monitor the Plan

Use in Step 3: Analyze and Evaluate Data

A client's current financial position statement prepared from data gathered in step 2 of the financial planning process provides the financial advisor with a picture of the client's financial position at the beginning of the financial planning engagement. This information regarding the client's present financial position enables the financial advisor to answer a number of key questions including

- What are the types and amounts of the various assets the client currently holds?
- What are the types and amounts of the various liabilities the client incurred?
- What is the amount of the client's wealth—net worth—at the beginning of the financial planning engagement?
- Given this picture of the client's present financial position, will further discussion be required to help the client revise and/or prioritize the goals stated in step 2 of the financial planning process?

While a look at the current financial position statement may be sufficient to answer these questions, further analysis of the data is necessary for the financial advisor to identify the various obstacles that the client's current financial position presents to the achievement of personal goals. For example, obstacles may arise from the current distribution of assets and/or liabilities. Analysis of the distribution of assets in the current financial position statement may reveal that the achievement of the client's goals will be hampered because he or she

- holds too high a percentage of total assets in non-income-producing personal assets rather than in financial assets that provide income and/or appreciation
- holds too high a percentage of financial assets in cash and cash equivalents rather than in other financial assets that provide an opportunity to earn a higher return
- fails to take appropriate advantage of tax-advantaged retirement plans

Comparison of the holdings of various types of assets and liabilities may also reveal possible obstacles to the achievement of the client's goals. For example, comparing the amount of a client's liquid assets with the amount of total current debts by calculating the client's liquidity ratio may indicate either that the client could face serious difficulty in paying current debts if income were unexpectedly reduced or that the client could be holding an excessive amount of funds in liquid assets. The liquidity ratio is calculated as follows:

$$\begin{aligned} & \text{Liquidity Ratio} \\ &= (\text{Liquid Assets} \div \text{Total Current Debts}) \\ &= \text{Liquid Assets} \div (\text{Current Liabilities} + \text{Annual Loan Payments}) \end{aligned}$$

Jack and Jill Klients' current financial position statement indicates that on June 30, 2007, their liquid assets consist of \$80,000 of cash and cash equivalents and their current liabilities consist of \$2,000 of unpaid credit card balances. Assuming the total payments for their consumer, automobile, and mortgage loans will be \$25,400 in 2006, the Klients' total current debt is \$27,400 (\$2,000 + \$25,400) and their liquidity ratio is 2.92 (\$80,000/\$27,400) or 292 percent. This ratio indicates that the Klients hold enough liquid assets to cover nearly three times the amount of their existing total current (one-year) debt. This excessive current debt coverage suggests that the financial advisor recommend some reallocation of the Klients' total assets from cash and low-yielding cash equivalents to other financial assets with higher potential rates of return (as was done and is reflected in Pro Forma #2 and the Current Statement for 6/30/07 in the table). A more appropriate liquidity ratio would be greater than one but less than 2.

In contrast, suppose another client holds \$10,000 of liquid assets, has \$15,000 of current liabilities (credit card debt), and will need to make various loan payments totaling \$40,000 in the coming year. This client's liquidity ratio is .18 (\$10,000/[\$15,000 + \$40,000]) or 18 percent. This ratio indicates that the client can only cover 18 percent of his or her present one-year debt obligations with existing liquid assets. If, for example, the client were to lose his or her job, current liquid assets would cover existing total current debt for only a little over 2 months. In this case, the financial advisor should recommend some reallocation of the client's total assets to build up his or her liquid reserves to provide a longer period of protection. The length of the period of protection and thus the amount of liquid assets required would depend on such factors as the state of the relevant job market, other potential sources of income to help meet current debts, and the period of time with which the client is comfortable.

Another ratio, the solvency ratio, provides an estimate of the extent to which the market value of a client's total assets could decline before wiping out all of the client's wealth as measured by net worth. The solvency ratio is calculated as follows:

$$\text{Solvency Ratio} = \text{Net Worth} \div \text{Total Assets}$$

The Klients' solvency ratio is .74 (\$692,000/\$930,000), indicating that the market value of the Klients' total assets could decline by approximately 74 percent before wiping out their net worth. As with the high liquidity ratio, this high solvency ratio suggests that the Klients have room to reallocate some of their present financial assets to higher risk assets that also provide the potential to earn a higher rate of return.

As Pro Forma #1 illustrates in the table, another use of the financial position statement in step 3 of the financial planning process is to estimate the client's future wealth position if the client continues to manage cash flows and assets and liabilities in the same manner given realistic assumptions regarding future rates of returns, asset appreciation and depreciation, debt repayment, and taxes. Among other things, this projection of net worth can be used to determine whether or not the client is likely to be able to achieve his or her financial goals at various key points in the future, assuming no changes in cash flow and asset and liability management.

Use in Step 4: Develop and Present a Plan

After the information about the client has been analyzed and, if necessary, the goals have been refined, the advisor's next job is to devise a realistic financial plan for bringing the client from his or her present financial position to the attainment of those goals. The financial position statement can be used by the financial advisor in several ways in step 4 of the financial planning process.

As the financial advisor considers alternative strategies that might be included in a plan to achieve the client's goals, projected financial position statements, each reflecting a particular strategy, can be compared to determine the relative impact of the various strategies on the client's future wealth position under a given set of assumptions. This use is illustrated by comparing Pro Forma #2 with Pro Forma #1 in Table 5-5.

Implicit in plan development is the importance of obtaining client approval. In obtaining client approval, the financial advisor can compare a projection of the future financial position statement assuming the recommended plan is adopted (Pro Forma #2 in Table 5-5) with

- the projected future financial position statement assuming no change is made in cash flow and asset and liability management (Pro Forma #1 in Table 5-5) to illustrate the impact that plan adoption is expected to have on the client's wealth position and thus, achievement of the client's goals
- the current financial position statement (Current on 6/30/07 in Table 5-5) to illustrate the extent to which the client's wealth position is expected to change from the present one if the recommended plan is adopted

In practice, financial advisors typically use software programs to present financial plans to clients. Advisors need to be familiar with how the analysis and presentation components interact to generate output. Advisors may need to

modify output to highlight financial statement concerns, such as solvency ratio and liquidity constraints.

Use in Step 6: Monitor the Plan

Normally the advisor meets with the client at least once each year to review the plan or more frequently if changing circumstances warrant it. The first part of this review process should involve measuring the performance of the implementation vehicles. One way plan performance can be illustrated is to compare the client's actual financial position statement at the time the plan review is taking place (Current on 6/30/07 in the table) with the projected future financial position statement shown to the client in step 4 of the financial planning process. This projection assumed the plan would be adopted and the assumed rates of return, asset appreciation and depreciation, debt repayment, and taxes underlying the projection would accurately portray conditions that would actually exist in the future (Pro Forma #2 in the table).

WHAT IS A CASH FLOW STATEMENT?

The cash flow statement summarizes a client's financial activities over a specified period of time by comparing cash inflows and cash outflows, and indicating whether the net cash flow for the period is positive or negative. The cash flow statement has three basic components-income, expenses, and net cash flow-that are related as follows:

$$\text{INCOME} - \text{EXPENSES} = \text{NET CASH FLOW}$$

which can also be stated as

$$\text{Sources of Funds} - \text{Uses of Funds} = \text{Change in Cash Position}$$

or

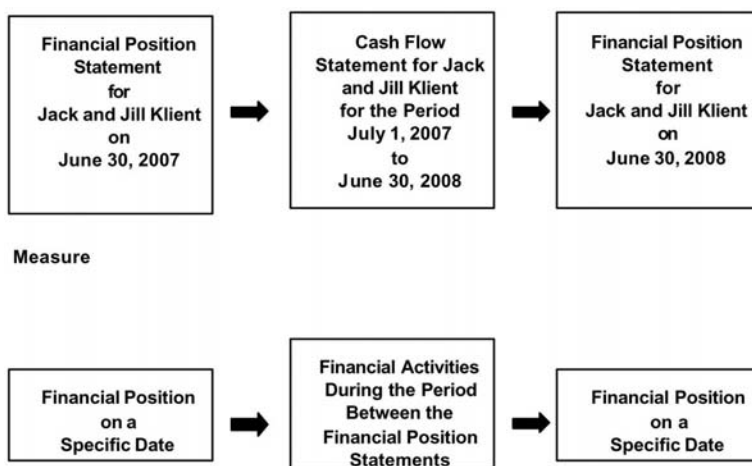
$$\text{Money In} - \text{Money Out} = \text{Change in Cash}$$

As illustrated in *Figure 5-2, The Relationship Between the Cash Flow Statement and the Financial Position Statement*, the cash flow statement for a given year indicates how the client's financial activities changed his or her wealth (net worth) position from that depicted in the financial position statement at the beginning of the year (the end of the previous year) to that depicted in the financial position statement at the end of the year.

When based on a client's past income and expenses, the cash flow statement (or income statement) provides the financial advisor with a summary of the client's financial activities for a specified period (generally one year) prior to the start of the financial planning engagement. This information can be used in analyzing the client's present financial situation. On the other hand, a pro

forma cash flow statement based on projections of future income and expenses for a specified planning period provides the financial advisor with a means for assessing the anticipated impact of various alternative planning strategies on the achievement of the client's goals in step 4 (develop and present a plan) of the financial planning process. Moreover, the pro forma cash flow statement (or budget) included in the financial plan adopted by the client provides a basis for implementing and subsequently assessing the performance of the plan. As such, the cash flow statement plays a central role in carrying out the various cash flow management activities involved in providing financial planning services to clients.

Figure 5–2 The Relationship Between the Cash Flow Statement and the Financial Position Statement



What Is Cash Flow Management?

cash flow management

Cash flow management is essentially a euphemism for the budgetary planning and control process. Financial advisors adopted the change in terminology partly because cash flow management is more inclusive than budgeting. More importantly, the word budget carries negative connotations for many clients, making them less likely to participate in the process. It may also be referred to as a spending plan, again because the term lacks the negative connotations of budgeting.

Cash flow management consists of three basic components: cash flow analysis, cash flow planning, and budgeting. In practice, many advisors mix aspects of each of the three and consider them a single process.

Cash Flow Analysis

cash flow analysis

Cash flow analysis, or income and expense analysis, is the process of gathering data concerning the client's cash flow situation, presenting the data in an organized format (the cash flow statement), and identifying strengths, weaknesses, and important patterns. Cash flow analysis is also a good starting point for the client and the financial advisor to develop goals and objectives in step 2 (determine goals and gather data) of the financial planning process. In addition, it reveals inefficient, ineffective, or unusual utilization of resources, highlights alternative courses of action, motivates the client, and makes family members aware of the need to conserve resources.

Cash Flow Planning

cash flow planning net cash flow

Cash flow planning involves identifying courses of action that will help optimize *net cash flow*. Net cash flow is defined as the difference between income and expenses. A positive net cash flow is available for any use, whether for consumption, investment, or gifting, although in most financial planning situations, the primary benefit of a positive net cash flow is to provide a source of investable funds.

Note that the goal is to optimize rather than to maximize. Maximizing net cash flow means to make it as large as possible. Pursuit of this goal suggests increasing income in any way possible. Presumably this mandate includes working longer hours, finding a second job, or seeking employment for the non-earning spouse. On the expense side, maximization implies having a less expensive home and automobile, quitting the club, and discontinuing vacations and eating out. Clearly these approaches represent changes in lifestyle and standard of living, not to mention family relationships. In contrast, optimization means seeking the best, not necessarily the largest, net cash flow.

Optimal net cash flow implies a balance between investing for the future and maintaining and/or improving the current lifestyle. While the distinction between maximizing and optimizing may seem arcane, this difference is important not only in substance but also in style. Optimization holds greater appeal to clients because it puts wealth accumulation in perspective. It also gives clients greater control since they ultimately decide their own funds allocation according to their own personal preferences.

Cash flow planning is interwoven through almost all aspects of financial planning. At the extreme, cash flow planning is a factor or a tool in each of the major planning areas:

- insurance planning and risk management
- employee benefits planning
- investment planning
- income tax planning
- retirement planning
- estate planning

Some advisors believe that cash flow planning involves each of the financial planning steps in a sort of microcosm of the larger, overall process. Some even view cash flow management as the framework within which all the major planning areas are analyzed and evaluated.

The more common approach is simply to use cash flow planning as an extension of cash flow analysis in an iterative process that involves the major planning areas. For example, cash flow analysis reveals opportunities for increasing net cash flow by addressing income and expense factors. Cash flow planning then considers what to do with the increase in net cash flow. The result may include an insurance or investment alternative that represents a financial commitment. Typically, the commitment raises expenses, thus lowering cash flow calculated in the cash flow analysis. Based on this new level, the client may consider another alternative for the remaining net cash flow.

Budgeting

budgeting

Budgeting is the process of creating and following an explicit plan for spending and investing the resources available to the client. In simplest terms, the process works via the establishment of a working budget model followed by a comparison of actual and expected results. By constantly monitoring the budget, the advisor and client can recognize problems as they occur and even anticipate them. Budgeting provides both a means of financial self-evaluation and a guideline to measure actual performance.

Budgeting does have some disadvantages, however. For example, many individuals have a psychological aversion to the record keeping required and may not maintain sufficient information for the budget to be useful. Obviously, to the extent the data utilized are inaccurate, the conclusions drawn from the budget may be misleading. For some clients, a rote dependence on budgeting numbers inhibits creativity, stifles risk taking, and encourages mechanical thinking.

Here are some guidelines for establishing a budget:

- Make the budget flexible enough to deal with emergencies, unexpected opportunities, or other unforeseen circumstances.
- Keep the budget period long enough to utilize an investment strategy and a workable series of investment procedures-typically one calendar year.
- Make the budget simple and brief.
- Follow the form and content of the budget consistently.
- Eliminate extraneous information.
- Estimate especially with insignificant items.
- Tailor the budget to specific goals and objectives.
- Remember that a budget is also a guideline against which actual results are to be measured. Unexpected results should be analyzed: they may be the norm and deserve to be incorporated in a revised budget.

- Pinpoint, in advance, variables that may influence the amounts of income and expenses. Income may vary because of expected annual raises and increases or decreases in interest or dividend rates. Expenses may vary because of fluctuating living costs, changing tastes or preferences, or changing family circumstances.
- Budgeting is a psychological process—a study of “what can be,” not “what is.” Mental accounting may not reflect actual spending habits and behavior.

Role of Cash Flow Management

Cash flow management is the backbone of the financial planning process. It drives recommendations and implementation, fundamentally determining what goals a client can afford and how the goals can be met. Ironically, financial advisors often find that clients resist the cash-flow management process more than any other technique even though it is critical to reaching a goal. Communicating the importance of cash flow management and talking the client through the process are among the advisor’s greatest services.

The advantages of cash flow management cut across all income levels. Cash flow management is always beneficial and is especially useful when the client needs to accomplish any of the following objectives:

- measure periodic progress toward the achievement of specific goals (a) within a defined time frame and (b) within the confines of limited resources
- monitor especially complex elements of economic activity
- provide guidelines for evaluating the economic performance of elements constituting the client’s cash flow
- communicate a planning strategy to those affected by the budget
- provide incentive (goals) for the performance of individuals involved
- control household expenses
- achieve desired wealth accumulation/savings goals, such as retirement or children’s educations
- monitor the performance of a specific investment, such as a securities portfolio, rental property, or a closely held business
- reposition assets to improve the likelihood of accomplishing goals

PREPARING A CASH FLOW STATEMENT

While budgeting requires looking to the future, past income and expense data must first be gathered from the client to permit the financial advisor to determine the client’s present cash flow situation. It is the client’s present cash flow situation depicted in a cash flow statement that provides the starting point for carrying out the three activities of the cash flow management process mentioned earlier—analysis, planning, and budgeting.

Financial advisors generally use a cash flow worksheet for gathering the income and expense data and inputting the data into a computer program to create the cash flow statement.

Since net cash flow is determined by subtracting total expenses from total income, preparing a client's cash flow statement involves:

- identifying the sources and amounts of gross income the client receives
- identifying the types and amounts of expenses the client incurs
- recording the amounts of income and expense in an appropriate format that shows the client's net cash flow as the difference between total income and total expenses

Although a cash flow statement can be prepared to reflect a client's income and expenses over any period of time, financial advisors commonly use a 12-month period. This period is comparable in length to the 12-month period most advisors use for budgeting. Regardless of whether a cash flow statement is being prepared in connection with gathering data, analyzing data for planning purposes or budgeting, the one-year period commonly used for a cash flow statement can be broken down on a month-by-month basis not only to show those cash flows that occur only in specific months, but also to permit more frequent monitoring of the performance of the client's cash flow plan.

Constructing a cash flow statement is largely a mechanical process involving very specific steps. Although some clients are in unusual situations, the majority fit into the following framework.

Identifying the Sources and Amounts of Gross Income Received by the Client

Identify the amount of gross (before-tax) income from each of the following:

- salary
- bonus
- commissions
- self-employment
- real estate
- dividends—closely held corporations
- dividends—publicly traded corporations
- interest—savings accounts
- interest—taxable bonds
- interest—tax-free bonds
- trust income
- other fixed-payment income
- variable sources of income

Basic sources of information regarding items of income include, among others, check stubs from work, bank and investment account statements, prior years' income tax returns, and personal financial position statements that show

income-generating assets as well as previously owned assets that have been sold. Clients that use Microsoft Money®, Quicken®, or other personal finance software packages have the ability to develop personal financial statements using that software. Even if the client is only using the software to facilitate transactions using the electronic bill payment feature, it still provides a cash flow history that the advisor can use to prepare a cash flow statement. The advisor's ability to use the client's software to generate financial statements could shorten the time spent in the data-gathering phase (step 2, determine goals and gather data) of the financial planning process and improve the accuracy of the statements.

Identifying the Types and Amounts of Expenses Incurred by the Client

Annual expenses can be classified as either fixed or discretionary. Fixed expenses involve payments the client makes for products and services essential to meet basic needs (for example, food and clothing) and/or to meet obligations established by contract or law (for example, mortgage payments or rent and income tax payments). Some fixed expenses involve equal periodic payments over time. Monthly mortgage or rental payments, installment loan payments, contributions to retirement plans, and insurance premiums are examples of this type of fixed expense. Other fixed expenses such as payments for food, clothes, household furnishings, medical needs, and utilities involve payments that vary from one time period to another. However, "fixed" applies only in the short run and can often be changed without imposing a radical shift in the client's lifestyle. Even the most fixed of all expenses, housing, can be changed if necessary.

With discretionary expenses, the client has considerable choice as to whether or not to incur the expense. Examples include payments for, among other things, vacations, other forms of recreation, charitable contributions, and education.

Identify the amount of expense from each of the following:

- fixed expenses
 - housing costs (mortgage or rental payments)
 - utilities
 - food, groceries, and so on
 - clothing and cleaning
 - federal, state, and local income taxes
 - Social Security and Medicare taxes
 - property taxes
 - transportation costs
 - medical and dental expenses
 - debt repayments
 - household supplies and maintenance costs
 - life and disability insurance premiums
 - property and liability insurance premiums

-
- current school expenses

 - discretionary expenses
 - vacations, travel, and so on
 - gifts and contributions
 - household furnishings
 - education fund
 - savings
 - investments
 - other

Basic sources of information regarding items of expense include, among others, checking account statements, credit card statements, investment account statements, and prior years' income tax returns. Expenses incurred for items purchased with cash must generally be estimated.

Note that a client's expenses can vary generally in the upward direction as a result of increased cost of living, unexpected business expenses, financial catastrophes (such as uninsured theft or fire losses), changes in tastes or preferences, and large-scale expenses (such as college costs). Some clients who tithe may initially consider monthly gifts in the fixed column. Advisors should consider encouraging clients to classify gifting (including tithing) as a variable expense.

USING A CASH FLOW STATEMENT

In addition to providing a format for summarizing the income and expense data gathered in step 2 (determine goals and gather data) of the financial planning process, properly prepared, a client's cash flow statement provides an important source of information for a financial advisor to use in helping the client achieve his or her goals through application of the financial planning process. The information provided by the statement is especially useful in the following steps of the financial planning process:

- Step 3: Analyze and Evaluate the Data
- Step 4: Develop and Present a Plan
- Step 5: Implement the Plan
- Step 6: Monitor the Plan

Use in Step 3: Analyze and Evaluate Data

A client's cash flow statement for the prior year prepared from data gathered in step 2 of the financial planning process provides the financial advisor with a picture of the client's cash flow situation at the beginning of the financial planning engagement. Analysis of the client's present cash flow

situation—referred to earlier as cash flow analysis—enables the financial advisor to identify various opportunities for, as well as potential obstacles to, achieving the client’s goals as a result of the way the client currently manages his or her cash flow. Key cash management issues such as these are often identified and discussed with the client before plan development begins:

- Is the client’s current rate of saving adequate to enable him or her to achieve the goals stated in step 2 (determine goals and gather data) of the financial planning process and if not,
 - to what level must the rate of saving be increased to achieve those goals?
 - is the client both willing and financially able to make the changes required to achieve this increased rate of saving?
 - is the client willing to modify either the timing of his or her goals and/or the factors influencing the amount of resources required to achieve them?

- If the client’s net cash flow is negative, what alternative courses of action are available for either increasing income or reducing expenses? Some possibilities include
 - reallocating some assets from low-yielding cash and cash equivalents to other financial assets with higher potential returns
 - reducing the amount of spending for discretionary expenses
 - reducing the amount of certain fixed expenses to the extent possible
 - refinancing the home mortgage at a lower interest rate
 - reducing income taxes through greater use of tax-advantaged retirement accounts and tax-exempt bonds
 - revising and/or prioritizing the goals stated in step 2 of the financial planning process
 - modifying the timing of some goals requiring the accumulation of savings

- If the client’s net cash flow is positive, what opportunities exist for the client to increase savings and investment and/or tax-advantaged gifts and contributions instead of spending the entire amount of the positive net cash flow on nonfinancial assets?

Whether responding to opportunities or obstacles found during cash flow analysis, clients should be realistic in identifying categories for revision—blind optimism is counterproductive. Financial advisors should encourage clients to avoid lowering the savings, investment, and education planning figures unless there is no alternative.

Saving is essential for achieving many, if not most, of a client’s goals. *Table 5-6, Reasons FRB Survey Participants Gave as Most Important for*

Their Families' Saving in 2004 shows the most important motivations for saving indicated by the 4,522 families participating in the 2004 FRB Survey. Regardless of the specific accumulation-type goal that is most important to a particular client, the percentage of after-tax income that is saved by a client is a critical factor in determining if and when that goal will be achieved.

Table 5-6
Reasons FRB Survey Participants Gave as Most Important for Their Families' Saving in 2004

Reasons	% of Survey Participants
Education	11.6
For the family	4.7
Buying own home	5.0
Purchases	7.7
Retirement	34.7
Liquidity (emergencies, possibilities of unemployment and health care costs, and having ready money)	30.0
Investments	1.5
No particular reason	.7
When asked for a reason, reported do not save	4.0
Total	100.0*

Source: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 92 (February 2006), p. A7.
 * Amounts do not sum to 100 percent because of rounding.

The percentage of after-tax income being saved by a client can be computed as follows:

$$\text{Savings Ratio} = \frac{(\text{Net Cash Flow} + \text{Amounts Already Bring Saved or Invested})}{\text{Annual After-Tax Income}}$$

Using the data from table 5-10, the Klient's savings ratio is calculated as follows:

$$\begin{aligned} \text{Savings Ratio} &= \\ &= \frac{(-\$4,500 + \$10,500)}{(\$153,000 - \$23,000 - \$7,500)} \\ &= \frac{\$6,000}{\$122,000} \\ &= .049 \end{aligned}$$

The numerator of the ratio includes the \$4,500 negative net cash flow and the \$10,500 currently being saved as indicated by the amounts listed for education fund, savings, and investments. The denominator shows the \$23,500 expense for income taxes; it also shows the \$7,500 expense for Social Security and Medicare taxes being subtracted from the Klient's total annual income of \$153,000.

The savings ratio indicates that the Klient is saving slightly less than 5 percent of their total after-tax income. Although the U.S. personal saving rate (adjusted by adding back capital gains, which were shifted by the government to business savings in 1998)³⁸ has declined yearly since 1992, on average, the savings ratio is different from the personal saving rate calculated by the government. The government calculates disposable income and subtracts from that number total consumption. The personal savings rate as calculated by the federal government actually turned negative in 2007 and has been in decline over the last two decades. While the Klient's savings ratio is less than the U.S. personal savings rate, it is the client's goals—not a national average—that should, along with other personal considerations, determine the percentage of after-tax income a client is willing to attempt to save. For example, the Klient might want to increase their rate of saving in order to achieve a goal requiring the accumulation of funds at a quicker pace than would be possible with their present 5 percent savings ratio. To both eliminate deficit spending and increase savings levels will require that the Klient make major changes in their spending and/or income if they want to increase their future rate of saving above 5 percent.

While adequate personal saving is important to financial planning, even more important is a client's ability to pay his or her debts promptly. The ability of a client to service his or her debts is a function of the level of the client's debt payments, and the income and assets the client has available to meet those payments. Although assets, especially cash and cash equivalents, can be and often are used to repay debt, personal debt burden has traditionally been measured by a debt service ratio that compares debt payments to net income, but does not include liquid assets in the denominator as a source of debt repayment. A client's debt service ratio is calculated as follows:

$$\text{Debt service Ratio} = \text{Total Debt Payments} \div \text{Net Income}$$

Using the values of Jack and Jill Klient's debt payments and gross income shown in Table 5–7, their debt service ratio is calculated as follows:

38. For an explanation of the modifications made to the definition of personal savings in 1998 by the Bureau of Economic Analysis, its impact on the magnitude of the personal saving rate, and past and projected personal saving rates adjusted to include capital gains, see Satyendra Verma and Jules Lichtenstein, "In Brief?The Declining Personal Saving Rate: Is There Cause for Alarm?" AARP Public Policy Institute, Washington, DC, March 2000. Available at: http://research.aarp.org/econ/inb16_rate.html.

$$\begin{aligned}\text{Debt service Ratio} &= (\text{Mortgage Payment} + \text{Debt Repayment}) \div \text{Net Income} \\ &= (\$15,500 + \$5,000) \div \$120,000 \\ &= \$20,500 \div \$120,000 \\ &= .171\end{aligned}$$

The Klients' debt service ratio indicates that their annual debt payments account for 17.1 percent of their annual income. The Klients should have little, if any, difficulty repaying their current debts with their income. The debt service ratio differs from front and back ratios (used in mortgage qualification). Front and back ratios utilize gross income in their denominator. Front and back ratios are covered in more depth in chapter 8.

Use in Step 4: Develop and Present a Plan

Once the information about the client has been analyzed and, if necessary, the goals to be achieved have been refined, the advisor's next job is to devise a realistic financial plan for bringing the client from his or her present financial position to the attainment of those goals. The cash flow statement can be used by the financial advisor to carry out cash flow planning and budgeting in step 4 (develop and present a plan) of the financial planning process.

Given the opportunities and obstacles identified in the analysis of the client's present cash flow situation in step 3 (analyze and evaluate the data) of the financial planning process, cash flow planning involves developing recommendations as to what the client should consider doing about

- the increase in net cash flow that is expected to result from taking advantage of the opportunities
- the obstacles to generating a net cash flow that is adequate to achieve the client's goals

Projected cash flow statements can be prepared to show the expected impact of each of the alternative courses of action available for consideration in developing an effective plan to take advantage of the existing opportunities or to deal with the existing obstacles. This is illustrated by the two pro forma cash flow statements in the table below. Pro Forma #1 shows the projected net cash flow for the period July 1, 2007 to June 30, 2008 if no changes are made in the Klients' cash management strategy. In this case, the only factors causing a change in net cash flow are the Klients' higher salaries and the resulting adjustment to income taxes. Pro Forma #2 shows the expected net cash flow for the same period if the Klients were to undertake an alternative strategy including certain changes in asset allocation and cash flow management.

Table 5-7
Actual and Pro Forma Cash Flow Statements for Jack and Jill Klient

	Actual 7/01/06 to 6/30/07	Pro Forma #1 7/01/07 to 6/30/08	Pro Forma #2 7/01/07 to 6/30/08	Actual 7/01/07 to 6/30/08
Annual Income				
Salary/Bonus—Jack	\$ 110,000	\$ 115,500	\$ 115,500	\$ 115,500
Salary/Bonus—Jill	30,000	31,000	31,000	31,000
Self-Employment (Business)	0	0	0	0
Dividends—Closely Held Corporation Stock	0	0	0	0
Dividends—Investments	3,000	3,000	5,000	4,500
Interest on Savings Accounts	2,000	2,000	2,600	2,450
Interest on Bonds, Taxable	5,000	5,000	5,600	5,400
Interest on Bonds, Exempt	3,000	3,000	3,600	3,500
Trust Income	0	0	0	0
Rental Income	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Other	0	0	0	0
Total Annual Income	<u>\$153,000</u>	<u>\$159,500</u>	<u>\$163,300</u>	<u>\$162,350</u>
Fixed Expenses				
Housing (Mortgage/Rent)	\$ 15,500	\$ 15,500	\$ 15,500	\$ 15,500
Utilities & Telephone	7,000	7,000	7,000	7,000
Food, Groceries, and so on	10,500	10,500	10,500	10,500
Clothing and Cleaning	7,000	7,000	7,000	7,000
Income Taxes	23,500	25,450	26,410	26,155
Social Security and Medicare Taxes	7,500	7,500	7,500	7,500
Real Estate Taxes	5,000	5,000	5,000	5,000
Transportation	8,000	8,000	8,000	8,000
Medical/Dental Expenses	8,000	8,000	8,000	8,000
Debt Repayment	5,000	5,000	5,000	5,000
Housing Supplies/Maintenance	6,000	6,000	6,000	6,000
Life Insurance	8,000	8,000	8,000	8,000
Property & Liability Insurance	5,000	5,000	5,000	5,000
Current School Expenses	<u>4,500</u>	<u>4,500</u>	<u>4,500</u>	<u>4,500</u>
Total Fixed Expenses	<u>\$120,500</u>	<u>\$122,450</u>	<u>\$123,410</u>	<u>\$123,155</u>

Annual Income	Actual 7/01/06 to 6/30/07	Pro Forma #1 7/01/07 to 6/30/08	Pro Forma #2 7/01/07 to 6/30/08	Actual 7/01/07 to 6/30/08
<u>Discretionary Expenses</u>				
Vacations, Travel, and so on	\$ 4,000	\$ 4,000	\$4,000.00	\$ 4,000
Recreation/Entertainment	5,000	5,000	4,000	4,000
Contributions, Gifts	7,500	7,500	7,500	7,500
Household Furnishings	5,000	5,000	3,000	3,000
Education Fund	5,000	5,000	5,000	5,000
Savings	3,000	3,000	3,000	3,000
Investments	2,500	2,500	2,500	2,500
Other	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>
Total Discretionary Expenses	<u>\$ 37,000</u>	<u>\$ 37,000</u>	<u>\$ 34,000</u>	<u>\$ 34,000</u>
Total Annual Expenses	<u>\$157,500</u>	<u>\$159,450</u>	<u>\$157,410</u>	<u>\$157,155</u>
Net Cash Flow	<u>-\$4,500</u>	<u>\$50</u>	<u>\$5,890</u>	<u>\$5,195</u>

*Discrepancies in totals are due to rounding

Implicit in plan development is the importance of obtaining client approval. In obtaining client approval, the financial advisor can compare a projection of the future cash flow statement assuming the recommended plan is adopted (Pro Forma #2 in the table below) with

- the projected future cash flow statement assuming no change is made in cash flow or asset management (Pro Forma #1 in the table above) to illustrate the impact that plan adoption is expected to have on the client's net cash flow and thus, achievement of the client's goals
- the actual cash flow statement (Actual for 7/1/06 to 6/30/07 in the table above) to illustrate the extent to which the client's net cash flow position is expected to change from the present one if the recommended plan is adopted

Once the client approves the financial plan, the pro forma cash flow statement included in the plan becomes a budget—that is, an explicit plan for spending and investing the resources available to the client if the financial plan is properly implemented.

Use in Step 5: Implement the Plan

The cash flow statement drives all implementation decisions. Saving, product purchase decisions and debt repayment strategies are only achievable with adequate free cash flow. Global evaluations of cash flow during initial

client meetings and annual reviews are paramount to the long term success of recommendations.

Use in Step 6: Monitor the Plan

In addition to providing a plan for spending and investing the client's resources, a budget is a tool for monitoring the performance of the client's cash management plan. In simplest terms, the process works via the comparison of a cash flow statement showing the actual results produced by the client's cash management plan (Actual for 7/1/07 to 6/30/08 in the table) with the expected results reflected in the pro forma cash flow statement (budget) contained in the client's financial plan (Pro Forma #2). In the situation illustrated, the Klient's actual cash flow in the period July 1, 2007 to June 30, 2008 (\$5,195) was somewhat less than the amount projected for the period (\$5,890) due to lower rates of return having been realized from the investment of financial assets than those that were assumed in the preparation of Pro Forma #2.

By constantly monitoring the budget, the financial advisor and client can recognize problems as they occur and even anticipate them. Cash flow statements, both actual and pro forma, can be broken down on a month-by-month basis to facilitate more frequent monitoring of the performance of the client's plan for spending and investing available resources. Budgeting provides both a means of financial self-evaluation and a guideline to measure actual performance.

RECORDING THE AMOUNTS OF THE CLIENT'S INCOME AND EXPENSES IN AN APPROPRIATE FORMAT SHOWS THE CLIENT'S NET CASH FLOW

Table 5-8, Cash Flow Statement for Jack and Jill Klient for the Period July 1, 2007, to June 30, 2008 illustrates a cash flow statement for Jack and Jill Klient prepared by using items and amounts of income and expense for the year prior to the beginning of the financial planning engagement. Subtracting total expenses from total income reveals the Klient's net cash flow. *Table 5-8, Cash Flow Statement for Jack and Jill Klient for the Period July 1, 2007, to June 30, 2008* indicates that with their present pattern of consumption, investment, and gifting/contribution activities, the Klient's net cash flow is negative—that is, they experienced a cash shortfall of \$4,500 during the period of July 1, 2007, to June 30, 2008. This shortfall was met by either reducing the Klient's cash and cash equivalents (a reduction of assets) and/or borrowing (an increase in liabilities). In either case, their net worth was reduced by \$4,500.

Table 5-8
Cash Flow Statement for Jack and Jill Klient for the Period July 1, 2007,
to June 30, 2008

Annual Income	Amount	% of Total Income
Salary/Bonus—Jack	110,000	71.9%
Salary/Bonus—Jill	30,000	19.6
Self-Employment (Business)	0	0.0
Dividends—Closely Held Corporation Stock	0	0.0
Dividends—Investments	3,000	2.0
Interest on Savings Accounts	2,000	1.3
Interest on Bonds, Taxable	5,000	3.3
Interest on Bonds, Exempt	3,000	2.0
Trust Income	0	0.0
Rental Income	0	0.0
Other	<u>0</u>	<u>0.0</u>
Total Annual Income	<u>\$153,000</u>	<u>100.1%</u>
<u>Fixed Expenses</u>		
Housing (Mortgage/Rent)	\$ 15,500	10.1%
Utilities & Telephone	7,000	4.6
Food, Groceries, etc.	10,500	6.9
Clothing and Cleaning	7,000	4.6
Income Taxes	23,500	15.4
Social Security and Medicare Taxes	7,500	4.9
Real Estate Taxes	5,000	3.3
Transportation	8,000	5.2
Medical/Dental Expenses	8,000	5.2
Debt Repayment	5,000	3.3
Housing Supplies/Maintenance	6,000	3.9
Life Insurance	8,000	5.2
Property & Liability Insurance	5,000	3.3
Current School Expenses	<u>4,500</u>	<u>2.9</u>
Total Fixed Expenses	<u>\$120,500</u>	<u>78.8%</u>

Annual Income	Amount	% of Total Income
<u>Discretionary Expenses</u>		
Vacations, Travel, etc.	\$ 4,000	2.6%
Recreation/Entertainment	5,000	3.3
Contributions, Gifts	7,500	4.9
Household Furnishings	5,000	3.3
Education Fund	5,000	3.3
Savings	3,000	2.0
Investments	2,500	1.6
Other	<u>5,000</u>	<u>3.3</u>
Total Discretionary Expenses	<u>\$ 37,000</u>	<u>24.3%</u>
Total Annual Expenses	<u>\$ 157,500</u>	<u>103.1%</u>
Net Cash Flow	\$ -4,500	-3.0%

*Discrepancies in totals are due to rounding.

Suppose another client experienced a positive net cash flow (that is, an excess of income over expenses) for a given year and that, as with the Klient, his or her discretionary expenses included amounts for savings, investments, and an education fund. Since the net cash flow is positive, the client can allocate even more to these categories (although most clients are more adept at finding ways to spend the money to enhance their lifestyles). A positive net cash flow for a given period can be used to increase assets and/or reduce liabilities, the net result of which is an increase in the client's net worth.

Individuals, like businesses, commonly experience some months with positive net cash flows and others with negative. In practice, cash or cash-equivalent balances simply grow in positive months and shrink in negative months. A vacation or holiday spending can reduce cash balances in the months surrounding these events.

FINANCIAL ASSETS

financial assets

Financial assets consist of cash and cash equivalents (or liquid assets) and other financial (or investment) assets. Cash and cash equivalents are liquid in the sense that they are either already cash or can be converted into cash relatively quickly with little, if any, loss in value. In addition to cash on hand, cash and cash equivalents also include various transactions accounts such as checking, savings and money market deposit accounts, money market mutual funds, call accounts at brokerages, and certificates of deposit maturing in the near future (generally, within one year). The cash value of life insurance policies can also be

considered as cash. Clients require cash and liquid cash equivalents to, among other things,

- pay daily expenses (Transactions)
- provide funds to cover unanticipated emergencies that may arise (Emergency Fund)
- provide funds to take advantage of unforeseen investment opportunities that may arise (Opportunistic)

Assets classified as "investment assets" for financial position statement purposes represent a variety of assets with wide-ranging degrees of risk in which clients may invest in an effort to earn a return. In addition to certificates of deposit that mature more than one year after the date of the financial position statement, investment assets include

- savings bonds
- other bonds—corporate and mortgage-backed bonds; federal, state and local government bonds; and foreign bonds that are more likely to be owned directly by families in the highest income and wealth (net worth) groups
- stocks—although also concentrated among high income and high wealth families, direct ownership of publicly traded stocks is more widespread than it is for bonds
- mutual funds (excluding money market funds)—directly held stock funds, taxable funds of government-backed bonds, tax-exempt bond funds, other bond funds and combination funds
- tax-advantaged retirement accounts—IRAs and employer-sponsored accounts such as 401(k) plan accounts, 403(b) plan accounts, profit-sharing plan accounts, stock bonus plan accounts, and ESOP accounts (Note: Undoubtedly, clients view their vested retirement benefits earned under a defined-benefit pension plan as being a valuable asset. However, since the current value of those benefits depends very heavily on a number of critical assumptions about future work-related events and economic conditions [and thus is quite difficult to estimate], the value of defined-benefit plan retirement benefits is generally not listed as an asset on a personal financial position statement.)
- other managed assets—personal annuities, trusts with an equity interest, and managed investment accounts
- other—a heterogeneous category including a variety of other assets generally acquired or held for investment purposes such as futures contracts, stock options, oil and gas leases, commodities, royalties, loans made to others, and proceeds from estates in settlement

NONFINANCIAL (PERSONAL) ASSETS

**nonfinancial (personal)
assets**

Nonfinancial (personal) assets include a client's

- primary residence
- other residential real estate
- net equity in nonresidential real estate such as commercial property, rental property, farm land, and undeveloped land
- net equity in privately held businesses such as sole proprietorships, various types of partnerships, subchapter S corporations, and other types of corporations that are not publicly traded
- vehicles such as cars, vans, sports utility vehicles, trucks, motor homes, recreational vehicles, motorcycles, boats, airplanes, and helicopters
- other tangible personal assets such as clothes, household furnishings, appliances, artwork, jewelry, antiques, hobby equipment, and collectibles

As mentioned earlier, nonfinancial (personal) assets accounted for 64.3 percent of the total value of all the assets held by the families participating in the 2004 FRB Survey. *Table 5-9, Distribution of the Total Value of Nonfinancial Assets Held by All Families Participating in the 2004 FRB Survey by Type of Asset* shows the percentage breakdown for these nonfinancial assets by type of asset. As compared with the findings of the 2001 FRB Survey, equity in residential real estate drove the increase, and the most significant decrease was in the decline in the holding of privately held businesses.

Table 5-9
Distribution of the Total Value of Nonfinancial Assets Held by All Families Participating in the 2004 FRB Survey by Type of Asset

Type of Nonfinancial Asset	Percentage of Total Value of Nonfinancial Assets Held in 2004
Vehicles	5.1
Primary residence	50.3
Other residential property	9.9
Net equity in nonresidential property	7.3
Net equity in privately held businesses	25.9
Other (artwork, jewelry, precious metals, antiques, hobby equipment, and collectibles)	1.5
Total Nonfinancial Assets	100.0
Source: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Survey of Consumer Finances," <i>Federal Reserve Bulletin</i> , vol. 92 (February 2006), p. A16	

CHAPTER FIVE REVIEW

Key Terms and Concepts

Risk/Return Investment Pyramid	cash flow analysis
financial position statement (balance sheet)	cash flow planning net cash flow budgeting
cash flow statement (income statement)	financial assets
pro forma	nonfinancial (personal) assets
cash flow management	

Review Questions

The answers to the review questions are in the supplement. Self-test questions and the answers to them are also in the supplement and on The American College Online.

- 5-1. Describe the types of information about the advisor that the typical disclosure form provides to the client. [5-1]

- 5-2. Explain the role of projected financial statements in monitoring a client's financial plan. [5-3]
- 5-3. Identify the various ways in which a client's net worth can increase during a period of time. [5-3]
- 5-4. Explain why the following actions have no effect on a client's net worth:
 - a. paying off a debt [5-3]
 - b. buying an asset with cash [5-3]
- 5-5. Identify the key components of a financial position statement and briefly explain what each component represents. [5-4]
- 5-6. Distinguish financial assets from nonfinancial (personal) assets. [5-4]
- 5-7. Explain how each of the following is valued for purposes of a client's personal financial position statement.
 - a. assets [5-4]
 - b. liabilities [5-4]
- 5-8. Briefly describe how a financial position statement is used. [5-6]
- 5-9. Briefly describe how a cash flow statement is used, and identify its three basic components. [5-7]
- 5-10. Explain the purpose for each of the following components of cash flow management:
 - a. cash flow analysis [5-7]
 - b. cash flow planning [5-7]
 - c. budgeting [5-7]
- 5-11. With regard to the preparation of a cash flow statement
 - a. describe and give examples of fixed expenses [5-7]
 - b. describe and give examples of discretionary expenses [5-7]
- 5-12. Explain the impact that a positive net cash flow for a given period has on a client's assets, liabilities, and net worth. [5-7]
- 5-13. If a client's net cash flow is negative, what alternative courses of action are available for either increasing income or reducing expenses? [5-7]
- 5-14. Describe the disadvantages associated with budgeting. [5-10]
- 5-15. With regard to a client's liquidity ratio
 - a. explain how it is calculated [5-11]
 - b. describe how it is used by the financial advisor [5-11]

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- 5-16. With regard to a client's solvency ratio
- a. explain how it is calculated [5-11]
 - b. describe how it is used by the financial advisor [5-11]
- 5-17. With regard to a client's savings ratio
- a. explain how it is calculated [5-11]
 - b. describe how it is used by the financial advisor [5-11]
- 5-18. With regard to a client's debt service ratio
- a. explain how it is calculated [5-11]
 - b. describe how it is used by the financial advisor [5-11]

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