EXAMPLE 3.3

Lisa has a $300,000 mortgage on her house, with a 30-year term at 6% interest. She expects to pay a total of $21,583.81 this upcoming year, including $3,684.04 in principal reduction and $17,899.77 in interest expense. The loan should be properly categorized as a liability on the balance sheet as follows:

Short-Term Liabilities
Mortgage on Primary Residence = $3,684.04

Long-Term Liabilities
Mortgage on Primary Residence = $296,315.96

Total Liabilities = $300,000.00

Note: Even though Lisa knows how much interest expense she will be paying in the next 12 months ($17,899.77), it is not reported as a liability until the interest expense is incurred. If the interest is paid as incurred, it will not be recorded as a liability but rather simply be reflected in the monthly or annual income statement. She is not legally obligated to pay the interest until it accrues each month. Another way to think about this is to consider that she could pay $300,000 today to retire the debt and thus, avoid the interest next year.

VALUING ASSETS AND LIABILITIES

As previously stated, it is important that assets reflect their fair market value and that liabilities are stated at their current outstanding principal balance as of the date of the balance sheet.

NET WORTH

The **net worth** of the client as reflected on the balance sheet represents the amount of total equity (assets - liabilities = net worth) a client has accumulated as of the date of the balance sheet. When evaluating a client's financial position, net worth is an important consideration because it represents an absolute dollar amount reflective of a client's financial position. A positive net worth may imply the client has done a good job of saving, investing, and managing debt. A negative net worth implies that the client is insolvent and potentially facing bankruptcy.

Unfortunately, due to the real estate crisis in years 2008 to 2010 and the high home foreclosure rate, a negative net worth was a reality for many households. In 2009 alone, California experienced a 20 percent decline in real estate values, which was in addition to the 19 percent decline in 2008. For many homeowners, this collapse led to the value of their homes declining significantly below the outstanding debt on the homes. In other words, they are "upside down" on their mortgage (also known as underwater). For some clients who have accumulated savings and investment assets of $200,000 to $300,000, it is possible to have a negative net worth simply due to the decline in real estate values.

Exhibit 3.1 illustrates a balance sheet for Mr. and Mrs. Zacker that reflects the three types of assets, short-term liabilities, long-term liabilities, and the resulting net worth.

EXHIBIT 3.1

BALANCE SHEET EXAMPLE

Statement of Financial Position
Mr. and Mrs. Zacker
Balance Sheet as of 12/31/16

Assets				Liabilities and Net Worth			
Current Assets				**Current Liabilities**			
JT	Cash & Checking	$5,000		W	Credit Cards	$5,000	
JT	CD Maturing in 6 months	$25,000		H	Auto # 1	$5,000	
JT	Money Market	$50,000		W	Auto # 2	$6,000	
				JT	Personal Residence	$10,000	
Total Current Assets			$80,000	**Total Current Liabilities**			$26,000
Investment Assets				**Long-Term Liabilities**			
H	401(k) Plan	$30,000		H	Auto # 1	$14,000	
W	IRA	$50,000		W	Auto # 2	$17,000	
JT	Brokerage Account	$100,000		JT	Personal Residence	$450,000	
W	Value of Business Interests	$500,000					
W	Education Savings	$75,000		**Total Long-Term Liabilities**			$481,000
Total Invested Assets			$755,000				
				Total Liabilities			$507,000
Personal Use Assets							
JT	Personal Residence	$500,000		**Total Net Worth**			$1,008,000
JT	Furniture, Clothing	$125,000					
H	Auto # 1	$25,000					
W	Auto # 2	$30,000					
Total Personal Use Assets			$680,000				
Total Assets			$1,515,000		**Total Liabilities and Net Worth**		$1,515,000

H = Husband Owns
W = Wife Owns
JT = Jointly owned by husband and wife

The balance sheet formula is: Assets = Liabilities + Net Worth.

Alternatively, we can restate the formula, such that: Assets – Liabilities = Net Worth.

These formulas help us understand how financial transactions impact a client's net worth.

Lisa buys a house for $400,000. She makes a $50,000 down payment and finances the balance with a mortgage. How is her net worth impacted from this transaction?

EXAMPLE 3.4

	Assets	-	Liabilities	=	Net Worth
Cash and Cash Equivalents	($50,000)				($50,000)
Personal Use Assets	+ $400,000				+ $400,000
Mortgage on New House			$350,000		($350,000)
Net Impact	$350,000	-	$350,000	=	$0

Lisa exchanges one asset ($50,000 cash) for another ($400,000 home) and increases her liabilities ($350,000 mortgage). Therefore, her net worth is not impacted by purchasing the house. However, as time goes by, the increase or decrease in the value of the house will impact her net worth as will the reduction in the principal obligation of the mortgage. The principal reduction is funded mostly by income that would otherwise have increased another asset category on the balance sheet, such as cash or investments.

One year ago, Elaine purchased a house for $400,000. Today, the house is worth $425,000 and she has reduced her outstanding mortgage principal by $10,000. What is the impact to Elaine's net worth?

EXAMPLE 3.5

	Assets	-	Liabilities	=	Net Worth
Personal Use Assets	+ $25,000				$25,000
Reduction in Outstanding Mortgage Balance			($10,000)		+ $10,000
Net Impact	$25,000	-	($10,000)	=	$35,000

Elaine's net worth increased as a result of the value of her house increasing ($25,000), plus she has paid down her mortgage throughout the year. Since her liabilities have decreased by $10,000, the two actions result in Elaine's net worth increasing by a total of $35,000.

EXAMPLE 3.6

Laureen, her husband, and 5 children went on vacation to Disney World for one week. Laureen spent $7,000 on the family vacation and paid for it with money in her savings account. What is the impact to her net worth?

	Assets	-	Liabilities	=	Net Worth
Cash and Cash Equivalents	($7,000)				($7,000)
Net Impact	($7,000)	-		=	($7,000)

Laureen's net worth has decreased by the $7,000 she spent on the vacation. Although they are certainly priceless, she cannot capture the good times and memories she has from the vacation and report them on her balance sheet.

SOURCES OF INFORMATION

In order to properly and accurately prepare personal financial statements, the financial planner needs source documents from the client to properly value assets and liabilities. Source documents include:

- bank statements
- brokerage statements
- loan amortization schedules
- tax returns

KEY CONCEPTS

1. Distinguish between property owned fee simple and tenancy in common.
2. Distinguish between property owned JTWROS and tenancy by the entirety versus community property.
3. Identify the importance of footnotes to financial statements.

ACCOUNT OWNERSHIP

As part of the balance sheet presentation, it is important to disclose how an asset or liability is titled (owned). The most common forms of ownership are:

- Fee Simple
- Tenancy in Common
- Joint Tenancy with Right of Survivorship (JTWROS)
- Tenancy by the Entirety
- Community Property

Fee simple ownership is the complete ownership of property by one individual who possesses all ownership rights associated with the property, including the right to use, sell, gift, alienate, convey, or bequeath the property. Typically, a car is owned fee simple and is titled in the name of one person. When preparing a balance sheet for a husband and wife, (H) is used to designate the asset or liability belongs to the husband only and (W) is used if the asset or liability belongs to the wife only.

Tenancy in common is an interest in property held by two or more related or unrelated persons. Each owner is referred to as a tenant in common. Tenancy in common is the most common type of joint ownership between nonspouses. Each person holds an undivided, but not necessarily equal, interest in the entire property.

Joint Tenancy with Right of Survivorship (JTWROS) is typically how a husband and wife own joint property. Joint tenancy is an interest in property held by two or more related or unrelated persons called joint tenants. Each person holds an undivided, equal interest in the whole property. A right of survivorship is normally implied with this form of ownership, and at the death of the first joint tenant, the decedent's interest transfers to the other joint tenants outside of the probate process according to state titling law. Probate is the process whereby the probate court retitles assets and gives creditors an opportunity to be heard and stake a claim to any assets to satisfy outstanding debts. Because of this right of survivorship, joint tenancy is often called joint tenancy with right of survivorship.

Tenancy by the entirety is similar to property owned as JTWROS between a husband and wife because property ownership is automatically transferred to the surviving spouse upon death. The two tenants own an undivided interest in the whole asset. However, the ownership cannot be severed without the consent of the other spouse.

Community property is a civil law statutory regime under which married individuals own an equal undivided interest in all property accumulated during their marriage. During marriage, the income of each spouse is considered community property. Property acquired before the marriage and property received by gift or inheritance during the marriage retains its status as separate property. However, if any separate property is commingled with community property, it is often assumed to be community property. The states following the community property regime are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Community property does not usually have an automatic right of survivorship feature although some states, including Texas and California, have a survivorship option.

Quick Quiz 3.2

1. Fee Simple ownership is an interest in property held by two or more related or unrelated persons.
   a. True
   b. False

2. If property is owned tenancy by the entirety or as community property then probate is avoided.
   a. True
   b. False

False, False.

As previously indicated, an important distinction between fee simple, tenants in common, and sometimes community property versus JTWROS and tenancy by the entirety is that property owned by the former will pass through probate at the death of the owner. Property owned JTWROS and tenancy by the entirety avoids probate and the decedent's interest transfers automatically. Property owned in a revocable trust would be listed on the balance sheet as trust assets.

Footnotes to the Financial Statements

Footnotes are an important source of information regarding the financial statements. Footnotes listed on financial statements can provide information such as how the asset or liability is owned. For example, it may state whether the asset is owned individually or jointly. In addition, footnotes can provide information regarding a client's purchase price of an asset, the date the asset or liability was acquired, how the value of an asset was determined and much more. When reviewing financial statements, it is important that the financial planner always read the footnotes.

STATEMENT OF INCOME AND EXPENSES

A **statement of income and expenses** (income statement) represents all income earned or expected to be earned by the client, less all expenses incurred or expected to be incurred during the time period being covered. The heading of the statement of income and expenses identifies the person or persons that the statement applies to, the type of financial statement, and the time period covered by the statement. To indicate the reporting period, the time period is generally listed as "For the Year Ended 12/31/xx" or for "January 1, 2017 – December 31, 2017." Although financial planners typically prepare and work with annual financial statements, the income statement can also be prepared for a monthly or quarterly period of time.

Key Concepts

1. Identify the main categories listed on the statement of income and expenses.
2. Identify examples of recurring income.
3. Identify examples of savings contributions.
4. Distinguish between variable and fixed expenses.
5. Determine how net discretionary cash flow is calculated.

Income

Examples of recurring **income** accounts earned by the client are:

- Salary
- Interest
- Dividend
- Pension
- Retirement Account Withdrawal
- Business Income
- Alimony Received

Note:
Dividend and interest income may not be included on the Income Statement because they are often reinvested and included in the portfolio rate of return. Therefore, they are not included on the Income Statement or in the annual savings rate.

Savings Contributions

Along with expenses, recurring **savings contributions** must be reported on the statement of income and expenses. Examples include savings contributions to the following types of accounts:

- 401(k) plan
- 403(b) plan
- 457(b) plan
- IRA (Traditional or Roth)
- Education Savings
- Any other type of savings account contributions
- Reinvested dividends, interest, or capital gains