Example 3.4

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?

	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.

Example 3.5

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?

	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 their five 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
- real estate appraisals

Key Concepts

1. Distinguish between sole ownership 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:

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

Below is a brief explanation of the types of ownership.

Sole 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 and 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. Alternatively, sole ownership may be delineated using (SP 1) for assets or liabilities belonging to spouse 1 only, and (SP 2) for assets or liabilities belonging to spouse 2 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 spouses 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 spouses 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. Community property 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 sole ownership, 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 an asset or liability is owned. For example, it may state whether an asset is owned individually or jointly. In addition, footnotes can provide information regarding a client's purchase price of an asset, the date an 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 12/31/20X1” or for “January 1, 20X1 – December 31, 20X1.” 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

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

Expenses

Recurring **expenses** represent those items that are paid regularly by the client during the time period being presented. Examples of recurring expenses include:

- Mortgage Principal and Interest
- Utilities
- Taxes
- Insurance
- Telephone
- Water

- Cable or Satellite
- Internet
- Cell Phone

Variable and Fixed Expenses

Expenses can be divided into variable and fixed expenses. **Fixed expenses** remain static for a specific period of time, regardless of changes in spending or income. For example, a homeowner cannot generally change the amount of property taxes. They remain relatively fixed. There is less discretion over fixed expenses in the short term. Examples of fixed expense accounts include:

- Mortgage Payment
- Car Payment
- Boat Payment
- Student Loan Payment
- Property Taxes
- Insurance Premiums
- Federal and State Income Taxes Withheld
- Social Security Payments Withheld

It is important to understand that fixed expenses can change with more extreme changes, such as selling a home or car. Actions, such as these, are sometimes required under extreme circumstances (for example, losing a job without an adequate emergency fund).

Variable expenses are more discretionary than fixed expenses over the short term. A client has more discretion over the amount of variable expenses, which often presents an opportunity for savings if variable expenses are closely monitored and controlled. Examples of variable expense accounts include:

- Entertainment Expenses
- Vacation Expenses
- Travel Expenses
- Charitable Contributions (may or may not be considered variable or discretionary)

Each financial statement provides a different perspective on the financial position of an individual. The statement of income and expenses is a compromise in accounting. Cash transactions that are non-recurring are not included or reported on the statement of income and expenses. Examples of cash transactions that are non-recurring include:

- the sale of stock
- an employer's contribution to a retirement plan
- giving or receiving a gift of cash, or
- an inheritance

In addition, transactions that are non-cash, non-recurring changes in the balance sheet are not reported on the statement of income expenses. Non-cash, non-recurring changes in the balance sheet include gifting (or receiving) stock and gifting (or receiving) personal use assets, and would only be reported in a statement of changes in net worth.

It is precisely because of the lack of perfection in the income statement that a planner should consider the balance sheet and the income statement together. The two documents provide a significantly more complete picture of the client's financial situation than either document alone.