Chapter 17

PERSONAL FINANCIAL STATEMENTS

INTRODUCTION

Personal financial statements provide a summary of an individual’s financial position. The financial statements most commonly thought of in a business context are the balance sheet and the income statement. In personal financial planning, the financial statements that are most commonly used are the balance sheet—the American Institute of Certified Public Accountants (AICPA) refers to this as a “statement of financial condition” and the “cash flow statement.”

As with business financial statements, a personal balance sheet reflects a person’s assets, liabilities, and net worth as of a given date. A personal cash flow statement shows an individual’s cash receipts (e.g., income) and cash disbursements (e.g., expenses) for a given period of time. The cash flow statement is often presented in conjunction with a statement of an individual’s taxable income.

HOW DOES IT WORK?

The preparation of personal financial statements requires the compilation of the individual’s personal financial data into the formal statements used in the financial planning process. Some individuals have developed the habit of maintaining financial statements on a regular basis. Other clients will not begin the financial statement process until a specific need arises, and often will need professional help. These statements are essential before a financial planner can effectively begin the planning process.

Figure 17.1 is an example of a personal balance sheet, using the format illustrated in the AICPA’s Personal Financial Statements Guide. Such statements of financial condition are generally accompanied by notes, which are an integral part of these statements. Note 1 is a general statement that the assets are stated at their estimated current values, and the liabilities at their estimated current amounts. The other notes are referenced at the end of the description of the specific assets and liabilities to which they apply. They generally describe the methods used to determine the estimated current values of assets and the estimated current amounts of liabilities and any other information warranting disclosure to the users of the statements.

#### Figure 17.1

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| **Robert and Rebecca StoneStatement of Financial ConditionDecember 31, 2011 and 2010** |
|  |
|  **December 31,** |
|  **2011 2010** |
| **ASSETS** |
| Cash $ 7,400 $  31,200 |
| Bonus Receivable 40,000 20,000 |
| Investments     |
|  Marketable Securities (Note 2) 321,000 281,400 |
|  Stock Options (Note 3) 56,000 48,000 |
|  RobReb Limited Partnership (Note 4) 96,000 84,000 |
|  Stone & Stone, Inc. (Note 5) 1,100,000 950,000 |
| Vested Interest in deferred profit sharing plan 222,800 197,800 |
| Remainder interest in testamentary trust (Note 6) 343,800 257,600 |
| Cash value of life insurance ($87,200 and $85,800), |
|  less loans payable to insurance companies |
|  ($76,200 and $75,400) (Note 7) 11,000 10,400 |
| Residences (Note 8) 380,000 360,000 |
| Personal effects (excluding art and jewelry) (Note 9) 110,000 100,000 |
| Art and Jewelry (Note 9) 80,000 73,000 |
| Total Assets  $2,768,000 $2,413,400 |
|       |
| **LIABILITIES**     |
| Income taxes (current year balance) $ 17,600 $ 800 |
| Demand 6.0% note payable to bank 50,000 52,000 |
| Mortgage payable (Note 10) 196,400 198,000 |
| Contingent liabilities (Note 11) |
| Estimated income taxes on the differences between the |
|  estimated current values of assets and the estimated |
|  current amounts of liabilities and their tax bases |
|  (Note 12) 478,000 320,000 |
| Total Liabilities 742,000 570,800, |
|  |
| **NET WORTH** $2,026,000 $1,842,600 |

**Contingent liabilities** are listed on the balance sheet without specific amounts reflected. This is because it is not possible to determine whether or how much the individual may be required to pay. An example of a contingent liability is a personal guaranty of a debt of a closely held corporation controlled by the individual. Such contingent liabilities generally receive substantial explanation in the notes to the financial statements.

Figure 17.2 is an example of a combined personal statement of cash flow and taxable income that can be extremely useful in the financial planning process. (A blank form for this statement suitable for photocopying appears in Figure 17.3 at the end of this chapter.)

#### Figure 17.2

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| --- |
| **Robert and Rebecca StoneStatement of Cash Flow and Taxable IncomeCalendar Year 2011** |
|  |
|   CASH FLOW TAXABLE INCOME |
| **CASH RECEIPTS & INCOME:** |
|  Salary – Husband $70,000   $70,000 |
|  Wife 90,000   90,000 |
|  Bonus – Husband 25,000   25,000 |
|    Wife 5,000   5,000 |
|  Interest 3,500   3,500 |
|  Maturity [Cash-in] of |
|  Notes Receivable, etc.       |
|  Dividend 2,500   2,500 |
|  Cash Distributed/Taxable Income from Business:       |
|  Assets Sales:       |
|  Sales Proceeds 25,000 $25,000   |
|  Less: Basis   (5,000)   |
|  Equals: Gain (Loss)     20,000 |
|  Rental Property:       |
|  Rental Income 14,000   14,000 |
|  Less: Depreciation     (3,000) |
|  Less: Debt Service (6,500) (6,500)   |
|  Add Back:       |
|  Principal Payments     1,200   |
|  Equals: Interest Expense     (5,300) |
|  Less: Other Expenses (4,500)   (4,500) |
|  Partnership Cash Distributed/Taxable |
|  Income (Loss) 3,000   (1,500) |
|  Cash Distributed/Taxable Income (Loss) |
|  from Other Investments       |
|  Other Cash Receipts/Taxable Income |
|  [Trusts, Gifts, Loans, etc.]    5,000      5,000 |
| Total Cash Receipts & Income $232,000 $220,700 |
|         |
| **CASH DISBURSEMENTS & EXPENSES:** |
|  Employee Business Expenses $2,500   $2,500 |
|  IRA-Keogh Contributions\* 8,000   8,000 |
|  Alimony Paid       |
|  Medical Expenses 2,500   2,500 |
|  Less: Nondeductible Amount     (2,500) |
|  State & Local Taxes:       |
|  Income 6,000   6,000 |
|  Real Estate 2,500   2,500 |
|  Personal Property 1,200   1,200 |
|  Federal Income Taxes Paid or W/H 50,000     |
|  Other Deductible Taxes       |
|  Nondeductible Taxes (e.g., FICA) 11,950     |
|  Debt Service Payments –       |
|  Mortgage – Interest 9,500   9,500 |
|  – Principal 1,200 |
|  Other – Interest 4,500 |
|  – Principal 8,000     |
|  Charitable Contributions 15,000   15,000 |
|  Political Contributions       |
|  Casualty Losses (Net of Insurance Proceeds)       |
|  Other Deductible Amounts 3,000   3,000 |
|  Nondeductible Personal Expenses |
|  (Food, Clothing, Vacations, Education, |
|  Furnishings, Gifts, etc.) 62,000     |
|  Investments 30,000     |
|  Standard Deduction       |
|  Personal and Dependency Exemptions‡   14,600 |
| Total Cash Disbursements & Expenses $217,850   $ 62,300 |
|  |
| **NET CASH INFLOW (OUTFLOW) &** |
|  **TAXABLE INCOME** $ 14,150   $158,400 |
|         |
| \*Neither spouse participated in an employer-sponsored retirement plan.‡The couple has two dependent children and the exemption amount for 2011 is $3,700.  |
|  |

WHEN IS THE USE OF
THIS TECHNIQUE INDICATED?

1. When it is the essential starting point in the determination of personal financial goals. The financial statements are critical in order to determine: (a) what an individual has; and (b) what an individual needs to get where he/she wants to be.

2. When an individual would like to borrow money for an investment and must prove to the lender an ability to make debt service payments and assure the creditor that there is adequate security for the loan.

3. When a tax shelter or other investment is contemplated and the investor must prove to the promoters that all the financial criteria established in the prospectus can be met. These criteria typically include:

(a) a minimum income and marginal tax bracket; and

(b) a minimum net worth of the prospective investor.

The net worth required will vary significantly, depending on such factors as the risk involved in the investment and the amount of future funding the investor may be called upon to provide.

4. As the starting point for the budgeting process.

5. As the starting point for the income or cash flow projection process (e.g., does the individual have enough to retire?).

6. When a capital needs analysis is required to determine life or disability income insurance shortfalls.

ADVANTAGES

1. Provides a means for summarizing an individual’s financial position in a format commonly used in financial analysis.

2. Provides an individual with an orderly reference point to evaluate his current financial position relative to financial goals.

3. May force an individual to focus realistically on what needs to be done to achieve projected goals and provide motivation for the appropriate action.

DISADVANTAGES

1. May be difficult and time consuming to compile, especially if financial statements are not maintained on a regular basis.

2. A fair market value balance sheet may require expensive appraisals and asset valuations. Balance sheets prepared under generally accepted accounting principles are usually based on the original or depreciated cost of assets, rather than their current fair market value. Such statements tend to understate net worth.

HOW IS IT IMPLEMENTED?

The financial records of most individuals are both informal and incomplete. In many cases, a client will have organized and recorded only a small portion of his assets and liabilities. This means that the financial planner must be prepared to assist the client in gathering the necessary information from numerous sources, such as:

1. income tax returns;

2. real estate and personal property tax returns;

3. the client’s accountant;

4. bank records, including checking and savings account statements, loan balance statements, etc.;

5. the client’s attorney;

6. stock brokers' statements;

7. property and life insurance records;

8. a listing of safe deposit box contents; and

9. the client.

The following basic guidelines, suggested by the Personal Financial Statements Guide of the AICPA, should be considered in creating personal financial statements:

1. Reflect assets and liabilities on an accrual rather than cash basis. For example, if Lara Leimberg, the famous author, had earned $30,000 of royalties which she had not yet received, that amount should be shown as an account receivable on her personal balance sheet. This would be the case even if she reported income for tax purposes on a cash basis.

2. Assets and liabilities should be presented by order of liquidity and maturity. The most liquid assets, such as cash, should be at the top. This helps to highlight the ability to meet immediate cash needs, the amount of liquid assets available for immediate consumption, or to take advantage of investment opportunities. From an estate planning perspective, listing assets in order of liquidity also emphasizes the importance of adequate cash (or equivalents) to meet estate settlement needs.

3. Statements should include only the proportionate interest of a joint or community property owner. The extent of that interest and its value must be determined under the property laws of the appropriate state. An attorney’s advice might be necessary to ascertain whether an interest should be included and, if so, to what extent.

4. If a business interest comprises a significant portion of a client’s total assets, it should be segregated and shown separately from other investments.

5. If real estate or a business interest is encumbered with a large debt, that debt should be presented separately from the asset. This is particularly true if the liability may be satisfied from sources unrelated to the investment. For example, if Charlee Leimberg, the real estate investor, purchased a $600,000 building and obtained a $400,000 mortgage on which she was personally liable, the real estate and the related mortgage should be presented separately.

6. Assets should be presented at estimated current values. Likewise, liabilities should be shown at their estimated current amounts. The current value of an asset is the amount at which an exchange would occur between a hypothetical informed and willing buyer and seller, neither of whom is under compulsion to consummate the transaction.

Any material transaction costs, such as commissions, should be considered when estimating current values. Taxes on unrecognized gain that would be incurred upon the conversion of the asset to cash are often shown separately as a liability. For instance, assume an investor purchased land for $300,000 which is now worth $700,000. Obviously, upon the sale of the land the investor would recognize a $400,000 gain. The estimated tax liability should be shown in order to realistically reflect the true net worth of the asset. Similarly, if an individual has a vested pension worth $500,000, the tax to be paid when the money is taken should be included on the balance sheet as a liability.

Value can generally be determined through:

(a) recent sales of similar assets;

(b) capitalization of past or prospective earnings;

(c) liquidation values;

(d) adjustment of historical cost based on changes in a specific price index;

(e) the use of appraisals; specialists may have to be consulted in estimating the value of works of art, jewelry, real estate, restricted securities, and closely held businesses; or

(f) the use of the discounted amounts of projected cash receipts and disbursements

7. Receivables should be discounted using appropriate interest rates as of the date the financial statement is compiled.

8. Marketable securities, which include both debt and equity investments, should be shown at their quoted market prices. If the security is traded on an exchange, the determinative value will be the closing price of the security nearest to the date of the financial statements. If the security is traded over the counter, the mean of the bid prices or of the bid and asked prices will generally provide a fair estimation of current value. These quotations are available from a number of financial reporting services.

9. Adjustments should be made to recognize the importance of a majority, minority, or large block interest in equity securities. A controlling interest may have proportionately more value than a recently sold minority interest, but a large block of stock might not sell at as high a per share price as a small number of shares recently sold.

10. Restrictions on the transfer of a security may indicate the desirability of an adjustment to recent market price.

11. In the absence of a published price for an option, the value of an option should be determined by reference to the value of the assets subject to the option. The planner should also consider both the exercise price and the length of the option period.

12. Life insurance should be valued at its interpolated terminal reserve value plus any unearned premium as of the balance sheet date. The amount of any loans against the policy can be netted against the policy value.

BUSINESS VALUATION

 The projected flow of income from a business or other asset can be converted into an estimate of its present value. This is called capitalizing the income. Capitalization of income is a simple, reasonably accurate and commonly accepted means to estimate fair market value.

If a business generates $100,000 of annual earnings, its value would approximate $500,000 if the capitalization rate assumed is 20% ($100,000 annual earnings divided by 20% equals the capitalized value of $500,000).

Another way of computing the value of a business or other asset using capitalized earnings is to multiply the annual income amount ($100,000) by the number of years earnings are reasonably estimated to continue (5 years). Thus, an earnings multiplier of 5 times earnings produces the same value as applying a capitalization rate of 20%.

Two questions must be answered before the financial planner can use a value arrived at through this method: (1) what adjustments must be made to earnings to realistically reflect the true earnings of the business or other asset? and (2) what capitalization rate is appropriate?

The earnings of a business must be adjusted to take into consideration: (1) excessive, or unrealistically low, salaries and other forms of compensation paid to shareholder-employees; (2) excessive, or unrealistically low, rents paid to shareholders; (3) nonrecurring or unusual income or expense items, such as fire losses or insurance recoveries; (4) excessive depreciation; (5) major changes in accounting procedures; (6) widely fluctuating or cyclical profits; (7) strong upward or downward earnings trends; and (8) other factors that may distort the reflection of normal earnings.

In determining the appropriate capitalization rate, or earnings multiplier to be applied to a particular valuation, consider the following:

1. A higher capitalization rate results in a lower value. For instance, a business producing after-tax income of $50,000, capitalized at 6%, would be valued at $833,333. The same income, capitalized at 15%, would result in a valuation of $333,333. A 6% capitalization rate is the same as using an earnings multiplier of approximately 16.67. A 15% capitalization rate is the same as multiplying the earnings by about 6.67.

2. A lower capitalization rate, and therefore a higher valuation, is appropriate when you are dealing with a stable business, one with a large capital asset base, and one with established goodwill.

3. A higher capitalization rate, and therefore a lower valuation, is appropriate when you are dealing with a small business, one with little capital, a relatively short financial history, or shallow management resources. A business involved in a speculative venture or one that depends on the presence of only one or two key people will generally warrant a higher capitalization rate.

There are situations where the capitalization of earnings approach is inappropriate or will lead to an unrealistic valuation. For example, raw land, producing no current income, but expected to result in substantial appreciation for the investor, cannot be valued using this method.

Using Book Value

Book value (book value of assets minus book value of liabilities) is an appropriate method of valuation when the business is:

1. an investment company with essentially no intrinsic value other than the underlying value of its assets;

2. a real estate development business and land and/or buildings are the major profit making factor;

3. dependent on one or two key individuals for its success—such businesses are typically worth only liquidation value upon the death, disability, or termination of employment of such key people;

4. in the process of liquidation—the financial planner should consider the impact of a sacrifice sale as well as the resulting tax liability in determining the net realizable value to the owner;

5. highly competitive but only marginally profitable—in such cases profits of the past are an unreliable tool to measure potential future earnings;

6. relatively new; or

7. experiencing large deficits.

Book value should not be used when invested capital is a minor element in the generation of profits or the client does not have enough voting power to force the liquidation of the business. Book value should rarely be used as the sole determinant of valuation; it should be used in conjunction with or as a means of testing the relevancy of the capitalization of earnings and other methods.

Most financial planners begin with an accountant’s balance sheet, prepared in accordance with generally accepted accounting principles. Such balance sheets are generally based upon historic data and do not reflect the current market value of the underlying assets. Consider making adjustments under the following circumstances:

1. when assets are valued at original cost, thus not reflecting any subsequent appreciation or depreciation;

2. when assets have been depreciated more rapidly than their economic value has actually declined;

3. when one or more assets with significant economic value have been written off;

4. when the business possesses material off balance sheet assets, such as a long-term lease at an unusually favorable rent;

5. when the business carries franchises, goodwill, results of successful research and development, or other intangible assets on its books at nominal, if any, cost;

6. when the business has poor experience in the collection of accounts receivables;

7. when the firm possesses inventory that is either obsolete or for some other reason is not readily marketable;

8. when the firm’s working capital or liquidity position is unfavorable;

9. when the assets of the business are encumbered with significant long term debt; or

10. where the retained earnings are high only because they have been accumulated over a long period of time; such a business may have poor current earnings and its potential for future profits may be minimal.

Goodwill and Going Concern Value

In the broadest sense, goodwill is synonymous with the entire intangible value inherent in the operation of a business. But, in the narrower and more technically accurate sense, the intangible value attributable to identifiable intangible assets, such as franchises, patents, secret formulas, trademarks, exclusive licenses, favorable leases, and customer lists, should be separately identified.

What is left, therefore, is a much more restrictive definition of goodwill: the expectation of repeat sales due to such factors as: (a) advantageous location; (b) superior management expertise; and (c) relationships built between customers and employees.

Goodwill, in its most restrictive sense, is therefore the ability of location, management expertise, and customer relationships to generate earnings that are in excess of the fair market value and that can reasonably be anticipated on the net tangible and identifiable intangible assets of the business.

Going concern value is that element of value possessed by a firm that is an existing establishment, doing business, with earnings sufficient to realize a fair rate of return on the net tangible assets required for continued business operations.

A planner should examine the following factors to determine if an enterprise has a going concern value: (1) experienced management; (2) trained and functioning sales and production personnel; (3) in-place operating facilities; (4) established sources of supply; (5) an established and operative system for distributing the products and services offered by the business; (6) consumer demand for the firm’s products; and (7) the ability to continue – uninterrupted – the business and production functions described above in the event of a change of ownership for any reason. The absence of any of these factors may substantially impair the going concern value of the enterprise.

#### Figure 17.3

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| **Statement of Cash Flow and Taxable Income Calendar Year \_\_\_\_\_** |
|  |
|   CASH FLOW TAXABLE INCOME |
| **CASH RECEIPTS & INCOME:** |
|  Salary – Husband \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Wife \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Bonus – Husband \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Wife \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Interest \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_   |
|  Maturity [Cash-in] of Notes Receivable, etc.     |
|  Dividend \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Cash Distributed/Taxable Income from Business:     |
|  Assets Sales:     |
|  Sales Proceeds \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Less: Basis   \_\_\_\_\_\_\_\_\_\_\_ |
|  Equals: Gain (Loss) \_\_\_\_\_\_\_\_\_\_\_    |
|  Rental Property:     |
|  Rental Income \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Less: Depreciation \_\_\_\_\_\_\_\_\_\_\_    |
|  Less: Debt Service \_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_  |
|  Add Back:     |
|  Principal Payments   \_\_\_\_\_\_\_\_\_\_\_    |
|  Equals: Interest Expense \_\_\_\_\_\_\_\_\_\_\_ |
|  Less: Other Expenses \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_   |
|  Partnership Cash Distributed/Taxable  |
|  Income (Loss) \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Cash Distributed/Taxable Income (Loss) |
|  from Other Investments |
|  Other Cash Receipts/Taxable Income |
|  [Trusts, Gifts, Loans, etc.] \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Total Cash Receipts & Income                                                 |
|       |
| **CASH DISBURSEMENTS & EXPENSES:** |
|  Employee Business Expenses \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  IRA-Keogh Contributions \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Alimony Paid |
|  Medical Expenses \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Less: Nondeductible Amount \_\_\_\_\_\_\_\_\_\_\_ |
|  State & Local Taxes – |
|  Income \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Real Estate \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Personal Property \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  Federal Income Taxes Paid or W/H \_\_\_\_\_\_\_\_\_\_\_ |

|  |
| --- |
|  Other Deductible Taxes |
|  Nondeductible Taxes (e.g., FICA) \_\_\_\_\_\_\_\_\_\_\_ |
|  Debt Service Payments – |
|  Mortgage – Interest \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_ |
|  – Principal \_\_\_\_\_\_\_\_\_\_\_ |
|  Other – Interest \_\_\_\_\_\_\_\_\_\_\_ |
|  – Principal \_\_\_\_\_\_\_\_\_\_\_ |
|  Charitable Contributions \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Political Contributions     |
|  Casualty Losses     |
|  (Net of Insurance Proceeds)     |
|  Other Deductible Amounts \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_    |
|  Nondeductible Personal Expenses     |
|  (Food, Clothing, Vacations, Education, \_\_\_\_\_\_\_\_\_\_\_ |
|  Furnishings, Gifts, etc.)     |
|  Investments   \_\_\_\_\_\_\_\_\_\_\_   |
|  Standard Deduction     |
|  Personal and Dependency Exemptions                                                  |
|  Total Cash Disbursements & Expenses                                                  |
|       |
| **NET CASH INFLOW (OUTFLOW) &** |
|  **TAXABLE INCOME**  |

WHERE CAN I FIND OUT MORE ABOUT IT?

1. *Personal Financial Statements (New York, NY: American Institute of CPAs, 2006).*

2. *Compiling Personal Financial Statements (New York, NY: American Institute of CPAs, CPE Self-Study, 2011)*

3. *Garner., Ernst & Young’s Personal Financial Planning Guide (New York, NY: John Wiley, 2002).*

4. *NumberCruncher (Bryn Mawr, PA: Leimberg & LeClair, Inc.). Software planning tool, updated annually.*