Behavioral and Personal Finance
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Module – 02
Personal Finance
Lecture - 25
Personal Financial Statements

Hi there, welcome back to the personal finance module of the course Behavioral and Personal Finance. I start with this session with a simple question without looking into your pocket can you tell me how much money do you have? An associated question would be how much money have you spent or earned during the day or the month or maybe the year? Can you tell the answer to these questions? Well if your answer is no then probably you need to be more careful while discussing or listening to the session that we are starting, now. This session focuses on two major ideas or issues.

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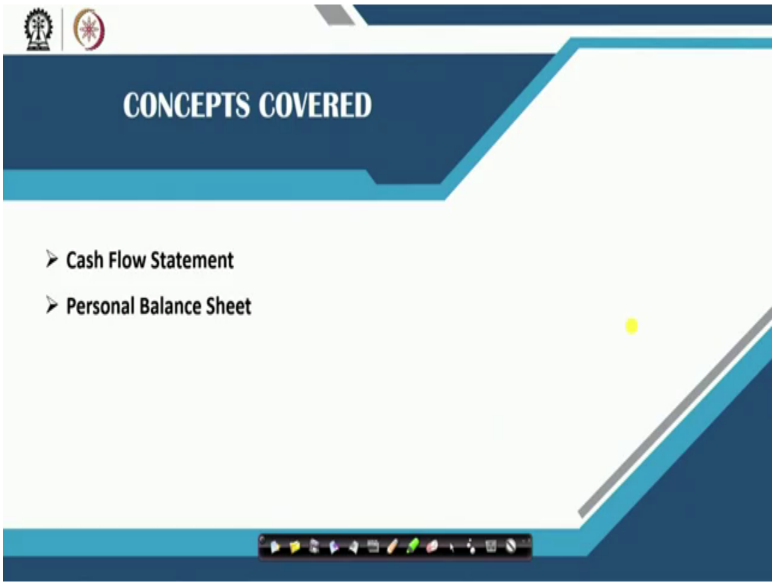

The first thing that we are going to discuss is the cash flow statement in terms of personal finance and the then the personal balance sheet. Basically, we are trying to discuss here the financial statements in the personal finance context well if you are not able to tell me how much money do you have in your pocket, it implies that you do not know what is your current financial status. And if you are not able to tell me how much money you have earned or spent in last 1 day or 1 week or 1 month or for that matter 1 year.

Then you are not able to trace or recall the cash flow that is associated with your personal financial income and expenses. Well this session discusses on these two aspects cash flow statement and personal balance sheet well.

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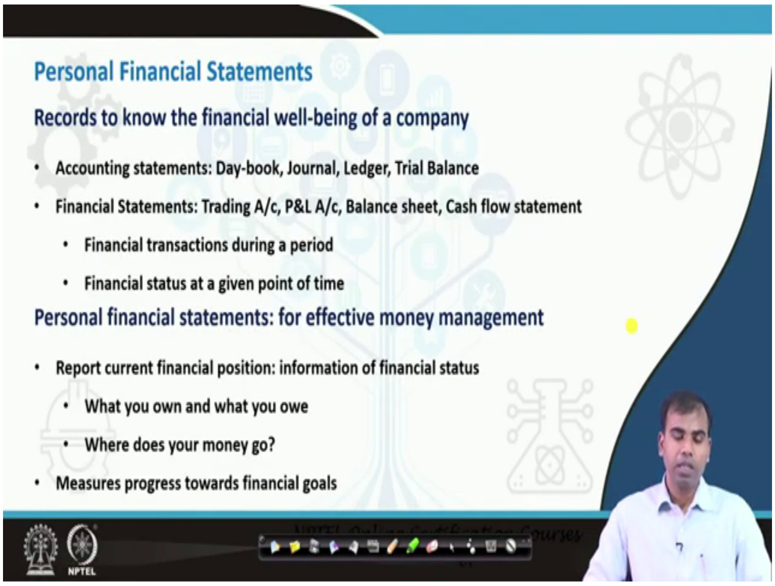

Cash flow statements basically any financial statement is an indicator of what is the current financial status of the organization or the individual and what is the flow of money associated with different activities. In the context of business management we learn about different financial statements. We in accounting we know that for businesses we try to maintain different accounting statements for example, daybook where we mention or include all transactions that we have done in the and the transactions that have some economic values.

And then we convert all these transactions into a journal book where we systematically, record all these transactions into debit or credit. I am sure you must have heard of debit and credit or you know a little bit about debit and credit system. Once we have done the journal entries we summarize all these transactions from journal entries to ledger and the ledger book has some balance at the end which is taken to the trial balance.

Once you transfer all the ledger balances to trial balance we are ready for taking these numbers from trial balance to financial statements and the financial statements, that we typically focus in any business organization include trading account profit and loss account cash flow statement and balance sheet. So, typically financial transactions during a particular period is reflected in trading profit and loss account and cash flow statement and financial status at a given point of time is reflected in the balance sheet.

Which means if for a given business you are looking at the cash flow statement or profit and loss account you are actually trying to understand what all type transactions or money flow has happened during the particular period and if you are checking the balance sheet of a company. It is going to give you an idea about the financial status at a particular date or particular point of time.

So, typically profit and loss account and cash flow statement tells us where the money has come from and where the money has gone and balance sheet tells us what we owe and what we own basically in cash flow statement. We include all cash inflows and outflows and in balance sheet we try to understand what are the assets and liabilities that we have. For personal finance context also maintaining a cash flow statement and balance sheet is very important, because it helps you to measure the progress towards your financial goal.

For example, if you do not maintain the records of all cash inflows and outflows which are basically expenses and incomes for yourself then you should not be able to track where are you spending most of your money or where the money is coming from in your pocket. So, to achieve the financial goals it is very important to maintain financial statements for personal financial decision making as well.

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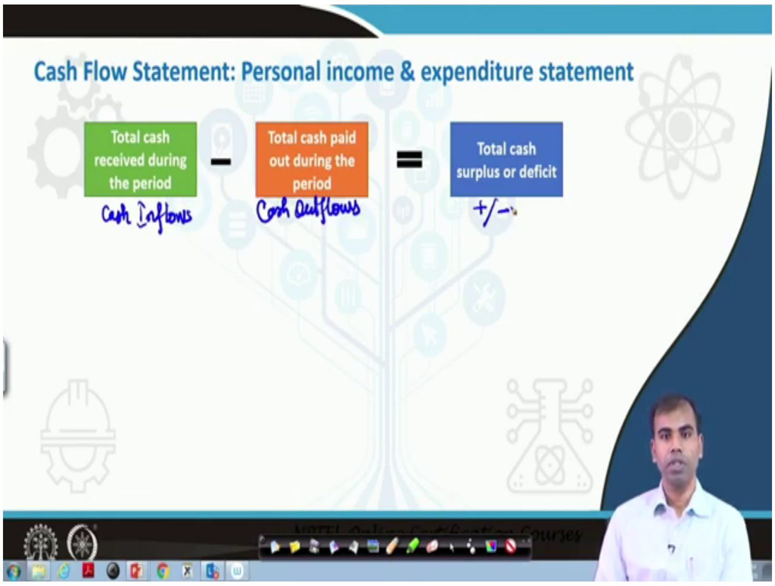

Now, to briefly discuss cash flow statement we know that this is personal income and expenditure statement. So, basically cash flow statements indicate at the total cash that we have received during a particular period minus total cash that we have paid out during a particular period. So, if we have left with something out of the money that we have received this basically tells us cash surplus or cash deficit.

So, for example, if we have received some money as salary that is our cash inflow and if we have spent some money on rent or travel or any other expenses, that is our cash outflow. So, at the end of the day if our cash inflow is more than cash outflow then we will be left with cash surplus if the inflow is less than the outflow then we will be left with the cash deficit.

So, if you try to understand this is basically our cash inflow, which is basically positive cash this is our cash outflows which is negative cash and this is surplus or deficit that you have at the end of the period. Now, for an individual to be financially happy it is important to have cash surplus the so, that this can be saved or invested in some investment of avenues.

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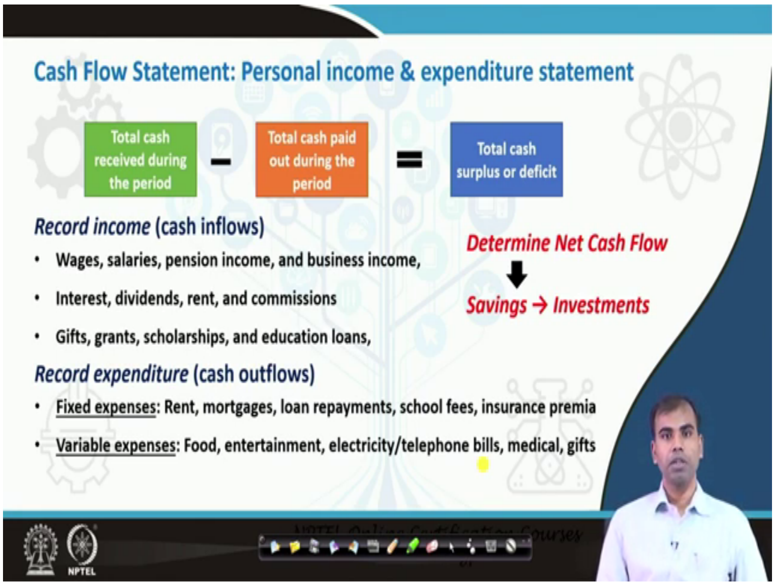

So, if you try to understand what could be the cash inflow and outflow look like for individuals, it basically includes all incomes or all cash inflows on one hand. So, inflows could be for example, wages, salaries pension incomes or business income or any other such in flow that you have you may have some interest earned on your deposits, on your bank investment dividends, on your share investment.

Rent that you have received from the property that you have rented to someone and commissions that you have received as the process of your business or other activities it could also include gifts, grants, scholarship and education loans if you have taken any. So, these are your cash inflows.

On the other hand the cash outflows are all the expenditures that we spend on different activities, these expenditure could be of two types fixed expenses and variable expenses. Fixed expenses are basically the expenses that we mandatorily have to make for example, rent that we have to pay more if we have we are living in a rented house mortgages that we have to pay if we have purchased the house on a loan and loan repayments if we have taken any for example, education loan.

So, you have to pay and school fees, because if you are attending the school then these are fixed expenses insurance premium, which we are paying for taking the insurance policy or insurance coverage on the other hand variable expenses are those expenses which vary from one period to another period. So, for example, food expenses it depends on how much and how many how often do you take food. So, food expenditure will be variable expenses entertainment expenses electricity and telephone bills.

Because it depends on the uses medical expenses and gifts these are some of the example of variable expenses. So, once you have recorded all the incomes on one side and all the expenditure on other side you should be able to know, what is the status of cash at the end of the period. So, if your income is more than your expenses then you will be left with surplus and if your income is less than the expenses then your you are left with cash deficit and cash deficit means it has to be compensated through some loans or borrowings or any other source of money, because you cannot live in cash deficit for long time.

So, once you have cash surplus by determining the net cash flow, that is basically the difference between cash inflow and cash outflow. So, you can use this as savings and savings can further be invested in some investment avenues. So, this is what a personal cash flow statement should consider when you make a personal financial plan.

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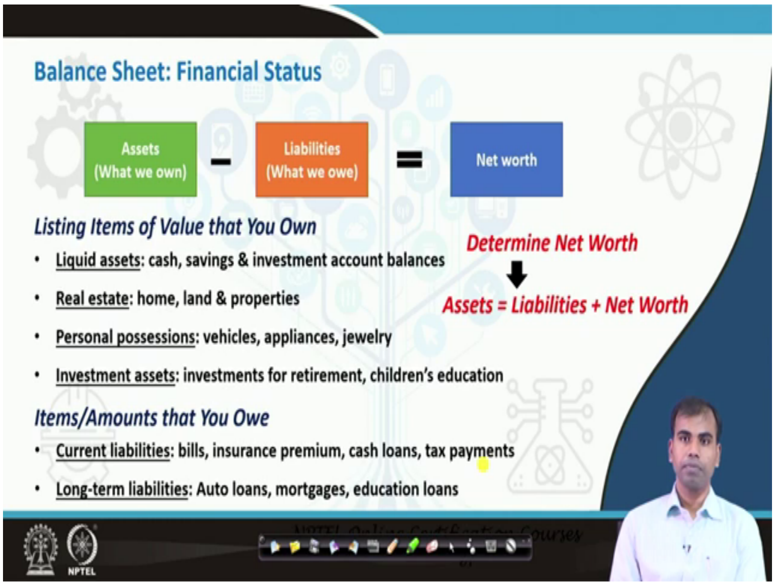

On the other hand if you try to understand the balance sheet for personal financial status. Basically it indicates the financial status of an individual at a particular point of time, it means that the status of the individual in terms of what he or she owns and what he or she owes at a given point of time. So, personal balance sheets should include the assets which basically include the things or the resources that a person owns and the liabilities that he owes to some other person or other organization.

So, basically if you see the total assets minus total liabilities you are talking about the net worth of that individual. So, when we try to understand the balance sheet of individuals or personal balance sheet and we have the data or information related to assets and the liabilities, we can easily determine the net worth of the company or the individual. So, what are the things that might come under assets and liabilities basically as following.

So, if you try to list the assets that an individual holds that could be liquid assets for example, cash or savings or investment in different accounts or different assets that will be your liquid assets. So, when I say liquid assets it means that the asset that can easily be converted into cash without much loss in value. So, these are the liquid assets then you have real assets basically real estate for example, house land properties and so on you have personal possessions like vehicles cars, two wheelers, four wheelers, appliances for example, TV, audio system and.

So, on and jewelry these are your personal possessions, which are basically listed under assets and then investment assets for example, shares, you have invested for retirement children’s education and other objectives. So, these are your investment assets. If you look at the items or account or amount that you have listed under liabilities basically liabilities can be of two types current liabilities and long term liabilities or fixed liabilities.

So, current liabilities are liabilities that are to be paid within 1 year or within short frame of time. For example, the electricity telephone bills insurance premium cash loans and tax payments. So, all these liabilities are to be paid within a short frame of time on the other hand long term liabilities could be auto loan, mortgages, education loan and so on. Basically those liabilities which are to be paid beyond 1 year are known as long term liabilities.

So, when you try to understand the personal balance sheet you try to see what are the different what are the assets and liabilities that you have under different categories and once you are able to estimate the items and amount of assets and liabilities under different categories, you should be able to determine the net worth of the individual. So, when we talk about net worth, basically it implies that assets should be equal to liabilities plus net worth and that will determine the balance of balance sheet of an individual.

So, one important thing that we need to consider here is the duration or the length of the assets and liabilities that we have. So, for example, if an individual has assets and liability completely balanced. Which means his or her assets are more than liabilities that does not necessarily mean that that person has always a positive net worth, what I mean to say by positive net worth here is that the assets might be having a different tenure. For example, short term and liquid assets versus the long term and fixed assets, whereas, the liability will also have different tenures for example, current liabilities and fixed liabilities.

So, if there is a mismatch between the tenures of assets and liabilities that might be a problem. For example, if I have more liquid assets let us say in terms of cash and bank balances and less current liabilities. Which are which I have to pay in sort a frame of time, for example, bills and tax payments and other short term liabilities this is not a good situation for an individual.

So, we should try to make sure that we have sufficient amount of liquid assets just enough to cover the current liabilities and similarly sufficient amount of long term investment or fixed assets to cover the long term liabilities. How do we evaluate this situation of different mismatch or matching of liabilities and asset in terms of tenure can be determined using certain financial calculations or ratios.

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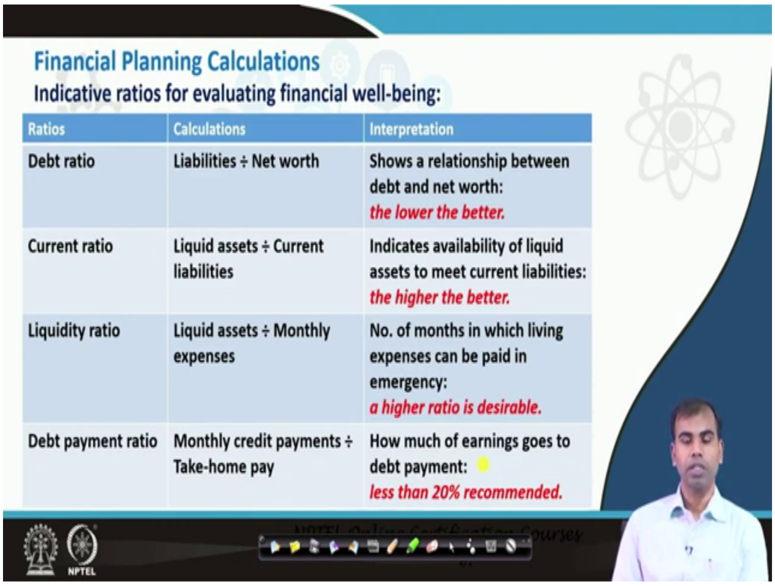

Which for which we can consider these ratios for example, here I have indicated for risky financial ratios that an individual should consider before financial planning or taking a financial at a plan action these ratios are as follows. So, the first ratio that we may consider in making financial decision is debt ratio, which is basically defined as the total liabilities divided by net worth it shows that a relationship between debt that a person carries and the net worth of that person.

So, for decision making purposes the lower debt ratio, the better it is which means, if you have lower debt ratio it implies that you are in a better position to cover your debt with your net worth. Similarly, second ratio is current ratio which basically can be calculated using liquid assets divided by current liabilities it shows the availability of liquid assets to pay off your current liability.

And the higher it is the better it is for an individual it essentially shows your comfortable position to pay off your short term liabilities or obligations with your current or liquid assets. Similarly, there the third ratio is liquidity ratio which basically is calculated as liquid assets divided by monthly expenses which shows the number of months in which living expenses can be paid in emergency. Which essentially shows or indicates that you have sufficient amount of liquid assets to cover your living monthly expenses for certain number of peak month.

Even in case of emergency when your cash inflows start reducing or you do not get salary for some time or you do not have any regular income for some time you can use your liquid assets to pay off your monthly living expenses. A higher ratio of liquidity ratio is desirable and that is comfortable for an individual another ratio that we can consider is debt payment ratio, basically it is calculated using monthly credit payment divided by take home pay or the net salary it shows how much of earning goes towards debt payment if it is less than 20 percent.

It is always recommended because it implies that one fifth of your net home pay is going towards the debt payment and debt could be short term as well as long term. So, these are certain ratios that we need to consider while making personal financial decisions and these things help in understanding our financial status as well as the flow of money that are associated with our lives in very productive way.

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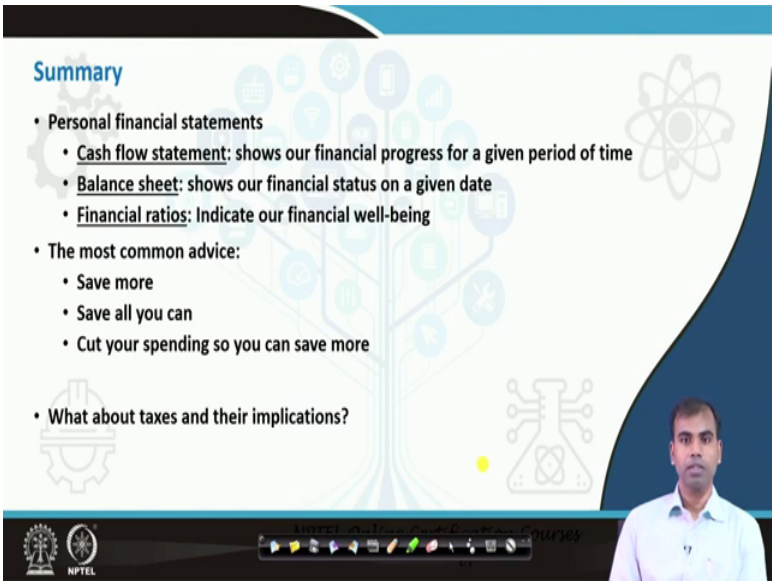

So, to summarize we can say that for individuals personal financial statements and maintenance maintaining their these personal financial statement is very important, these statements could be cash flow statement balance sheet as well as the calculation of financial ratios. So, cash flow statement indicates the financial progress of cash flow or the inflow or outflow of cash for a given period of time balance. It indicates our financial status for a given date or a particular point of time financial ratios suggest, our financial well being all these things are important to maintain or to measure the progress of financial decisions towards other financial objectives.

Because all our decisions related to finance must be targeted towards achieving certain financial goals. Now, in the process the most common advice that anyone would give you is you need to save more and save as much as you can so, that you can invest as much as possible and by cutting all you are spending or unnecessary expenses you can save more. So, that more can be invested.

Now, one important factor that is coming here is the taxes. So, how taxes can influence our personal financial decisions is also an important issue to understand for this session that is it we will discuss more about taxes and their implication in next session.

Thank you very much.