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Budgets and Cash Flows

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Why is the preparation of financial statements important during the divorce process?

Before a reasonable property settlement can be negotiated, it's important for both spouses in a divorce to disclose all assets, liabilities, sources of income, and expenses. By arranging this information in standard financial statements and by analyzing these statements, a financial planner or attorney with financial expertise can help you: (1) develop a realistic budget to follow prior to divorce; (2) devise a fair divorce agreement at the appropriate time; and (3) create an appropriate budget for your post-divorce life.

What information should you provide your attorney or financial advisor?

To help you plan effectively, your financial planner or attorney will need information from both spouses regarding:

- Wages and salaries (including pay stubs, W-2 statements, 1099 Forms, and employment contracts)
- Pensions, retirement plans (including IRAs), and employee benefit information
- Home ownership or rental documentation (including deeds, leases, insurance data, appraisals, and tax bills)
- Income tax returns for the past three to five years
- Life, health, and disability insurance policies
- Wills and trusts
- Investment portfolio information
- Bank account balances and ownership
- Partnership or family business tax returns for the past three to five years (along with other information about ownership interests and valuation)
- Liabilities, debt, and periodic expenses (including credit cards, student loans, taxes, automobile loans and insurance, and other obligations)
- Data regarding amount of--and sources for--periodic income, and
- Data regarding the value of personal assets, including furniture, antiques, collectibles, boats, equipment, automobiles, etc.

Tip: *Courts, as part of the divorce process, typically require each spouse to complete a* financial affidavit *disclosing information regarding periodic income and expenses.*

What is a net worth statement?

A net worth statement is also known as a balance sheet. Its purpose is to provide a snapshot of your assets and liabilities today (or as of a particular date). For obvious reasons, this document will be helpful to your attorney when he or she is contemplating dividing marital property (assets) between you and your spouse. Your net worth (or net loss) may be defined as your total assets minus your total liabilities.

Very likely, three sets of balance sheets will be drawn up: (1) reflecting your financial situation, (2) reflecting your spouse's position, and (3) showing your worth as a couple. This is because some assets (and liabilities) may be joint and others individual. Additionally, state laws will influence how these assets and liabilities will be divided. This, of course, involves the notion of community property versus equitable distribution.

A net worth statement can serve as:

- A record of your financial progress over time
- A record of property ownership and value for insurance planning purposes
- A tool for creating a will (or settling an estate)
- A tool to help you apply for a mortgage, personal loan, or credit card

- A measure of your total debt and home equity
- A record of retirement savings (that is, your vested pension benefits and total IRA contributions), or
- A planning and decision-making tool for your financial advisor or attorney

How does a net worth statement work?

To begin your net worth statement, list your assets on the left side of a piece of paper, along with the value of each asset as of a particular date (use the same date for each asset). You need to obtain the fair market value of your personal assets--not their original cost to you. With respect to investments, your broker (or a business newspaper) can give you the value. You should separate your list of assets into four major groups: cash (and cash alternatives), investments, retirement funds, and personal assets. Within these groups, include assets in the following manner:

- Cash and Cash Alternatives:
    1. Savings accounts
    2. Checking accounts
    3. Money market accounts
    4. Certificates of Deposit (a year or less in maturity)
    5. Money market mutual funds
    6. U.S. Treasury bills, and
    7. Any other cash on hand
- Investments:
    1. Stocks
    2. Bonds
    3. Mutual fund investments
    4. Certificates of Deposit (over a year maturity)
    5. Cash value life insurance
    6. Gold, silver, and gems
    7. Investment real estate
    8. Land
    9. Limited partnerships
    10. Municipal bonds
    11. Ownership interests in businesses
    12. U.S. savings bonds
    13. U.S. Treasury notes and bonds
    14. Stock options
    15. Interests in law suits, and
    16. Trust Funds
- Retirement Funds:
    1. Pensions (current accrued benefit and lump sum present value)
    2. IRAs
    3. Keogh and other retirement plans
    4. Employee savings plans (401(k) plans, SEP, ESOP), and
    5. Tax-sheltered annuities (403(b) plans)
    6. Governmental savings plans (Federal TSP plan, 457(b) plans)
    7. Nonqualified deferred compensation plans
- Personal Assets:
    1. Principal residence
    2. Other real property

3. Antiques
4. Art and collectibles
5. Automobiles
6. Home furnishings
7. Furs
8. Boats
9. Computers and other small business equipment
10. Jewelry, and
11. Other

After you've listed all assets, total them up at the bottom of your page. Next, you need to list your liabilities (and their pay-off figures) on the right side of your piece of paper. In this section, you should include:

- Charge account balances
- Student loans
- Personal loans
- Automobile loans
- 401(k) loans
- Home mortgages
- Investment loans
- Home equity loans
- Life insurance loans
- Estimated income tax liability, and
- Additional debts owed to others

After you've listed all liabilities, place the total at the bottom of the page. Subtract your total liabilities from your total assets to arrive at your net worth (or net loss). Your net worth is the amount you would have if you turned all of your assets into cash and paid off your debts. Different ratios derived from a net worth statement can provide useful insights. For instance, by dividing cash and cash alternatives by liabilities (excluding a mortgage), you can ascertain your liquid asset to debt ratio (i.e., your ability to handle your financial obligations). Over the course of a year or longer, analysis of your net worth statements can also illustrate whether your assets and liabilities have increased or decreased, how the equity in your home has changed, and whether you have established an adequate emergency fund. A net worth statement is easy to prepare once you've gathered the appropriate facts. The following example shows a simplified net worth statement:

Example(s): *Assume Mary has the following assets and liabilities: $10,000 in a money market account, $40,000 in stocks, $2,000 in an IRA, a $200,000 house with a $150,000 mortgage, a $20,000 student loan balance, a $5,000 automobile with a $5,000 loan, and a $2,000 credit card balance. Her net worth statement would look like this:*

Net Worth Statement	
Assets	**Liabilities**
Cash Alternatives • Money Market - $10,000 Investments • Stock - $40,000 Retirement • IRA - $2,000 Personal Assets • House - $200,000 • Car - $5,000	• Mortgage - $150,000 • Student Loan - $20,000 • Money Loan - $5,000 • Credit Card - $2,000
Total Assets = $257,000	Total Liabilities = $177,000

Net Worth = $80,000

What is a cash flow statement?

A cash flow statement tracks income and expenses, showing how much money you earned and spent during a given time period. At the end of a month, if you've earned more money than you've spent, you've got a positive cash flow. Consistent negative cash flows, on the other hand, will indicate that you're depleting your savings or using borrowed funds (and credit cards) too much. Analyzing your cash flow statements will help a financial advisor devise a spending plan or budget for you to improve your financial position.

You'll need to keep detailed records for at least one month (preferably for three or four months) to see where your money comes from and where it goes. Begin by listing your cash balance at the beginning of a month. Next, list all sources of income. Make a similar list of all expenses, including personal savings. Cash flow is determined by comparing your total monthly income to your total monthly expenses. As with the net worth statement, you may want to prepare three sets of documents: one for you, one reflecting your spouse's financial situation, and one reflecting your position as a couple. Alternatively, you could put all of this information on one statement by using three columns (you, spouse, and couple).

How does a cash flow statement work?

To begin, divide a piece of paper into two sections: income and expenses. Because the expense section is more complicated, you'll want to subdivide that category into smaller categories. For instance, you could use savings and investments, fixed expenses, and variable expenses as your sub-headings within the general heading of expenses.

Next, list your beginning cash balance (as of a particular date) at the top of the page. Under the income section, write down the sources and amounts of your income. You should include the following sources of income (if applicable):

- Salary and wages
- Periodic bonuses
- Commissions
- Trust, estate, and royalty income
- Business income
- Pension and retirement income
- Social Security
- Unemployment compensation
- Disability income
- Interest and dividends
- Net rental income
- Alimony
- Child support
- Annuities
- Inheritances, and
- Tips

Total your income at the bottom of this section. Next, list all of your expenses according to the sub-headings you've chosen. For instance, you may wish to include:

- Savings and Investments
    1. Personal savings (bank account, CDs, Christmas club)
    2. Individual retirement accounts (IRAs)
    3. Employer plans, such as 401(k) accounts
    4. Keogh plans
    5. Stocks and money markets, and

6. Tax-sheltered annuities and thrift plans

- Fixed Expenses
  1. Mortgage payments
  2. Installment debt
  3. Personal loan payments
  4. Insurance premiums
  5. Rent
  6. Car loans
  7. Payroll deductions, and
  8. Property taxes
- Variable Expenses
  1. Groceries
  2. Utilities and cable fees
  3. Car maintenance
  4. Home repair and grounds-keeping
  5. Child care
  6. Clothing
  7. Entertainment and meals outside the home
  8. Water and telephone bills
  9. Gasoline
  10. Grooming
  11. Gifts
  12. Vacations
  13. Club memberships
  14. Magazine subscriptions
  15. Dental and medical expenses
  16. Legal and professional fees
  17. Tax withholdings, and
  18. Transportation and parking

Total your expenses at the bottom of this section. Next, subtract your total expenses from your total income. If the result is a positive number, you have a positive cash flow for the month. This means that you'll be able to increase savings and set the money aside to attain a future goal. If your cash flow is negative, you'll need to analyze the statement (particularly the variable expenses) to see where you can cut back. For instance, you may wish to stop impulse shopping on credit cards or skip the weekly restaurant lunch. Also, you may want to increase income by taking on a second job or by turning a hobby into a side business. But note that some of your expenses may be paid off in the near future if, for example, you have only a short time left to pay on your car loan. From a divorce perspective, you'll want to know your cash flow situation right now, as well as your spouse's situation. This will help your attorney negotiate temporary alimony and child support payments. Additionally, your attorney will need to predict your future cash flow position according to your proposed divorce agreement or property settlement. If, for example, you're not paying alimony right now but will have to commence payments after the divorce is finalized, your cash flow statement will be dramatically different in the future. The same holds true if you'll end up with the house (and its mortgage, property taxes, and insurance costs) post-divorce.

Example(s): *Assume George has the following monthly expenses and sources of income: $3,500 net salary, $200 interest, $100 dividends, $1,200 mortgage, $250 car loan, $200 insurance, $300 food, $200 utilities, $60 transportation, and $400 miscellaneous. His cash flow statement would look like this:*

Cash Flow for the Month Ending March 31, 20XX	
Income	**Expenses**

Net Salary - $3,500 Interests - $200 Dividends - $2,000	Fixed Expenses • Mortgage - $1,200 • Car - $250 • Insurance - $200 Variable Expenses • Food - $300 • Utilities - $200 • Transportation - $60 • Miscellaneous - $400
Total Income - $3,800	Total Expenses of $2,610 + Net Cash Flow $1,190
Cash Balance at End of Month - $2,690	

What is a budget?

A budget is a financial planning tool serving many functions. It can ensure that you have enough cash (and other liquid assets) to conduct your ongoing financial affairs, and it can create an adequate emergency fund to help you meet unforeseen problems (such as a job loss). Additionally, it can create long-term savings to help you attain your future goals (such as retirement, purchase of a house, etc.), and it can help you to eliminate debt.

How does a budget work?

Budgeting may be defined as the ability to estimate the amount of money to be received and spent for various purposes within a given time frame. The budget process begins with a discussion of your financial goals. What are your short-term goals? What are your long-term goals? Some people want to eliminate negative cash flows, and others want to increase savings for retirement (and other) purposes. Certainly, being able to survive a financial emergency (such as a job loss) is a priority for many people. Additionally, most people want to establish control over their expenditures, eliminate wasteful spending practices, and retire certain debts.

Saving is an important part of any budget, and one of the cardinal rules of financial planning is to pay yourself first. You should treat yourself as an important creditor; when it comes time to pay your monthly bills, be sure to deposit a particular sum of money into your own savings account as well. It's wise to build an emergency fund equivalent to three to six months of your expenses. Additionally, you can save money by engaging in the following practices:

- Bank your bonuses, tax refunds, and one-time windfalls
- Start a Christmas club account
- Participate in your employer's 401(k) or thrift plan, and
- Use direct deposit of your paycheck to contribute a monthly amount to an IRA

Just as savings is an important part of your budget, it's equally important to cut your expenses. To cut your expenses, consider the following approaches: Stop buying on impulse (some financial planners suggest that when you see something you like, think about it for three days before buying it)

- Stop using credit cards to make purchases
- Buy clothes and seasonal equipment when they're on sale rather than when they're first introduced in the stores
- Compare prices at different stores to get the best deal, and
- Payoff credit cards and other small loans

To construct a budget, you need to first estimate your annual income and annual expenses. Begin by identifying your sources and amounts of fixed income. Next, identify sources and amount of expenses. You should break expenses down into two categories: fixed expenses and variable expenses. By subtracting total expenses from total income, you'll arrive at your total yearly savings or cash flow. To increase this figure, you should consider the above methods for increasing savings and decreasing expenses. Once you've gained an overview of your financial picture, create a monthly cash flow statement to determine how much money can be set aside each month for savings and to ensure that you don't overspend. From a divorce standpoint, you'll need to construct and follow one budget during the period of separation and another budget after the divorce has become final. Your attorney or financial planner should consider not only issues of alimony, child-support, and division of property but also financial questions regarding your future living expenses and spending habits.

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice. State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters. The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors.

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