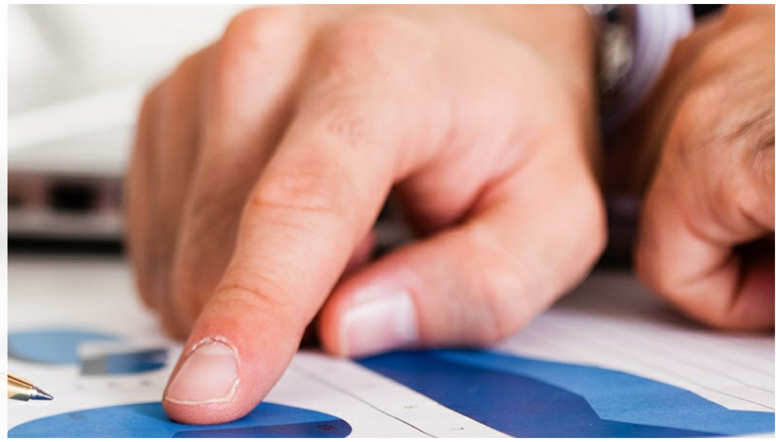
Cash Flow Analysis



Overview

Cash flow analysis is an on-going process which involves several steps:

- Identifying current financial inflows and outflows.
- Analyzing the short and long-term effects of the inflows and outflows on the financial portfolio through the development of numerical projections.
- Developing strategies to adjust cash flow if the projections indicate the portfolio will be depleted prior to an individual's death or the deaths of both husband and wife at reasonable life expectancies.
- Monitoring the cash flow on an ongoing basis by utilizing a systematic approach to keeping track of financial inflows and outflows.
- Cash flow analysis is a critical component of the comprehensive financial planning process. It is important in all client situations, since knowing whether or not an individual or a family has a positive or negative cash flow impacts all other aspects of a financial plan.

Description

Cash flow analysis begins with identifying income inflows and outflows. The process of gathering accurate inflows and outflows data is crucial to the process – "forgetting" certain inflows and/or outflows may have disastrous effects on a client's long-term financial situation. Client checklists of income inflows and outflows can be very valuable in the process, and decrease the likelihood that the client will overlook certain information.

Cash Inflows

Inflows to cash flow include a variety of income sources:

- Wages, salaries, and other earned income (e.g., director's fees)
- Commissions
- Other work compensation sources – bonuses, profit-sharing plans, expense allowances (e.g., car, cell phone)

- Interest income (taxable and non-taxable), dividend income, realized capital gains, investment real estate income, royalty income, trust income, annuity income, severance income, and "other" income
- Gifts and inheritances
- Transfer type payments – Social Security benefits, veteran's benefits, tax refunds, child support, and alimony

Cash Outflows

Outflows from cash flow include expenses, planned savings, gifts, child support paid, and alimony paid. There are three main categories of expenses – nondiscretionary, partially discretionary, and discretionary.

Nondiscretionary expenses tend to be fixed in amount and the client has very little if any control over them. Examples are:

- Mortgage or rent payments
- Utilities, generally including electricity, gas, water, sanitation, telephone, television (e.g., cable, satellite), and internet service
- Federal, state, and local income taxes
- Real and personal property taxes
- Insurance premiums (e.g., life, medical, long-term care, disability, automobile, homeowner's, renter's, flood, fire, personal liability, professional liability)
- Household expenses (e.g., homeowner's or condo association dues, home maintenance expenses and services)
- Medical expenses (e.g., doctor, dentist, deductibles, co-pays, prescription drugs, over-the-counter medications)
- Educational expenses
- Loan and liability payments
- Child support and alimony
- Support of aging parents and/or other dependents
- Retirement plan contributions

Partially discretionary expenses are expenditures that cannot be completely eliminated but may be somewhat controllable. Examples are:

- Food, including eating out
- Household expenses
- Home furnishings
- Clothing
- Personal care (e.g., cosmetics, personal care products, hairdresser, manicurist)
- Transportation (e.g., price of vehicles purchased, use of mass transportation, auto fuel, auto maintenance and repair)
- Charitable contributions, depending upon the client's attitude and beliefs (e.g., tithing to one's place of worship may be considered an expense that cannot be totally eliminated)

Discretionary expenses are expenditures that can be totally eliminated from the family budget if necessary. Examples are entertainment, recreation, travel, hobbies, gifts, subscriptions, and other luxury items. Charitable contributions may be included here, depending upon the client's attitude.

Once inflows and outflows data have been collected, a financial planning professional can utilize long-term projection software to analyze the short and long-term effects of the inflows and outflows on the client's financial portfolio. If the projections indicate the portfolio will be depleted prior to an individual's death or the deaths of both husband and wife at reasonable life expectancies, then strategies can be developed to adjust cash flow.

A family budget can be created to assist in decreasing or eliminating unnecessary expenses and show a better use of income flows by taking into account the family situation, family ages, etc. A budget can help to recognize possible spending pattern problems, identify opportunities to overcome those spending problems, and assist in wisely allocating family financial resources. A budget serves as a control system that helps to coordinate spending and saving actions with the goals and objectives the planner helped the client to determine early in the financial planning process.

A financial planning professional can help clients create a budget through the following steps:

- **Establish realistic goals and objectives.** The family needs to agree on long-term goals and objectives such as retirement, children's education, a new home, etc., as well as short-term and medium-term goals and objectives. This also involves developing realistic estimates of costs associated with the family's goals and the effects of inflation on such costs.
- **Determine the current financial condition.** Having a client record all monthly cash receipts and expenditures helps them to not miss frequently overlooked items, such as payroll deductions, interest and dividend income, and automatic loan and bill payments. Another advantage of recording is that it discourages unnecessary spending by the client. By providing a minimum of the last 6 months of income and expense flows, the financial planning professional can determine in which expense categories the family may be over-spending.
- **Utilize appropriate budget forms.** Once the planner is familiar with the client and his cash flow situation, the planner can help to select the appropriate budget forms for the family to utilize.
- **Determine major expenditure amounts and forecast estimated timing.** Major expenditures need to be included in the budget since unanticipated and significant outflows can have deleterious effects on the family budget. Examples of such expenses are home improvement costs, significant home maintenance and repairs, new vehicle purchases, major vehicle repairs, and vacations.
- **Determine how much and how frequently the client should save for expected and unexpected major expenditures.** The planner can help the client determine how frequently (i.e., monthly, quarterly, annually) the client should or is financially able to set money aside for such expenditures. The general consensus in financial planning is to have an "emergency fund" that equals 6 months' (3 months' at a minimum) salary.
- **Determine in which expense categories over-spending is occurring and establish "targeted" expenditure amounts.** A planner's expertise in this area of financial planning can be extremely beneficial in assisting the client to get control of expenses.
- **Periodically compare actual expenditures to the "targeted" expenditure amounts that were determined and revise spending and/or targets as needed.** It is critical to monitor expenses on a regular basis (preferably monthly) so needed adjustments can be implemented as soon as possible. Otherwise, the achievement of established long-term goals and objectives may be jeopardized.

One of the positive outcomes of cash flow analysis is the client's potential realization of the need for establishing a sound recordkeeping system. The best recordkeeping system is one that is extensive enough to be effective for the client, yet easy enough to use to encourage regular use. A financial planning professional who knows the client's objectives and organizational style can recommend a recordkeeping system that is appropriately suited to the client's unique situation.

The financial planner can use the actual data to analyze the current cash flow situation, to develop cash flow projections that are based upon sound information, and to make realistic recommendations on any needed adjustments to the client's cash flow situation.

Tax Implications

A good recordkeeping and budgeting computer software program can be invaluable to a client in tax planning. It helps the client to record deductible expenses so as not to "miss" deductions at tax preparation time. It also saves time during tax return preparation and provides support information in the event of an IRS audit. Such a program helps to track and substantiate potentially tax-deductible expenses, such as:

- Medical and dental expenses, including mileage (see IRS Publication 502, "Medical and Dental Expenses," for details on allowable deductions)
- Taxes paid (e.g., state and local income taxes, real estate taxes, personal property taxes)
- Charitable contributions
- Unreimbursed employee business expenses (e.g., job travel, job education)
- Tax preparation fees
- Certain miscellaneous deductions (e.g., investment management fees paid, safe deposit box rental fees, certain legal and accounting fees)
- Other miscellaneous expenses (see IRS Publication 529, "Miscellaneous Deductions," for a list of allowable deductions)

The IRS requires taxpayers to maintain supporting documents and records of their business expenses to qualify for deductions. See IRS Publication 535, "Business Expenses," for further details.

The IRS also requires taxpayers to keep records supporting income and deduction items claimed on a tax return until the statute of limitations runs out, which is typically three years from the due date or filing date of the return (Section 6001 and Section 6501).

A good software program assists in keeping cost basis information, which is especially useful when an investment is sold and the taxpayer needs proof of the cost basis for calculating capital gains. Tracking cost basis information is particularly helpful with stocks and mutual funds in the case where dividends and/or capital gains are reinvested instead of being distributed.

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