

NISM Series X-A: Investment Adviser Level 1

Evaluating the Financial Position of Clients

LEARNING OBJECTIVES: Cash Flow • Household Budget • Net Worth • Personal Ratios • Contingency Planning

1 Chapter Overview

<p>01</p> <p>Cash flow management is the starting point — matching timing of income to expenses prevents costly short-term debt.</p>	<p>02</p> <p>A Household Budget separates mandatory (taxes, EMIs), essential (groceries, rent) and discretionary (entertainment) expenses.</p>
<p>03</p> <p>The Income & Expenditure Statement records flows on an accrual basis — when earned/incurred, not when cash moves.</p>	<p>04</p> <p>Budgeting & Forecasting requires basis, assumptions, and continuous monitoring. Actuals vs budget reveal trends to correct.</p>
<p>05</p> <p>A Personal Balance Sheet shows all assets and liabilities at a point in time. $\text{Net Worth} = \text{Total Assets} - \text{Total Liabilities}$.</p>	<p>06</p> <p>Personal Finance Ratios — savings, leverage, liquidity, debt-to-income — give a numerical snapshot and guide corrective action.</p>
<p>07</p> <p>Contingency Planning: emergency fund (6 months in liquid assets), life insurance, health insurance, spouse asset distribution.</p>	<p>08</p> <p>The Emergency Fund is the first financial goal — held in liquid assets, replenished immediately after use, reviewed annually.</p>

2 Cash Flow Management

Cash Flow Management

The process of handling income and expense flows so there is always a proper balance between the need and availability of cash. Even a slight mismatch forces costly short-term debt, which reduces future savings and causes financial stress.

- ◆ Income must arrive when expenses fall due — salaried workers enjoy natural matching; self-employed face timing risk.
- ◆ Keep a surplus buffer in the bank to cover delayed reimbursements or bunched expenses at month-start.
- ◆ Cash management \neq Emergency Fund. Buffer handles short-term mismatch; emergency fund handles income disruption.
- ◆ Cash flow mismanagement causes financial stress, family tension, and can compound into health problems.

3 Household Budget

ABC Family Monthly Budget



Category	Particulars	Mr. A (Rs.)	Ms. B (Rs.)	Total (Rs.)
INCOME	Gross Salary	50,000	60,000	1,10,000
	Income from Investment	15,000	12,000	27,000
	Total Income	65,000	72,000	1,37,000
MANDATORY	Contribution to PF	4,000	5,000	9,000
EXPENSES	Tax	5,000	7,000	12,000
	Loan Repayment	—	—	12,000
ESSENTIAL	Grocery			12,000
EXPENSES	Fees & Education			15,000
	Rent & Maintenance			15,000
	Transportation			10,000
	Telephone & Internet			7,000
	Utilities			5,000
	DISCRET.	Entertainment		
	Lifestyle Expenses			10,000
	Total Expenses			1,12,000
INVEST.	Direct Investments	10,000	8,000	18,000
METRICS	Monthly Surplus in Hand			7,000
	Total Savings			34,000
	Savings Ratio			24.8%

Savings = PF contributions + Direct investments + Monthly surplus. Emergency fund target (6 months): 6 x Rs.91,000 = Rs.5,46,000.

4 Income & Expenditure Statement

Income & Expenditure Statement

Records actual income earned and expenses incurred on an **accrual basis** — items are recorded when earned or incurred, not when cash moves. Compare actuals against budget to identify variances and improve future planning.

Feature	Income & Expenditure Statement	Cash Statement
Basis	Accrual — when earned/incurred	Cash — when received/paid
Salary due 31st, paid 1st	Included in previous month	Included in next month

Credit card purchase	Included when purchase made	Included when bill paid
Purpose	Understand surplus & expense trends	Manage liquidity & cash timing

5 Budgeting & Forecasting

Steps to Create a Budget

- Step 1** List and total all regular, definite income sources for the period.
- Step 2** Deduct mandatory expenses (tax, loan EMIs) to arrive at disposable income.
- Step 3** Identify and deduct essential living expenses from disposable income.
- Step 4** List discretionary expenses; the remainder is the savings.

Monitoring the Budget

Record actuals continuously and compare with budget. Persistent variances signal planning errors or behavioural issues requiring correction.

Forecasting requires: a specific basis, stated assumptions, expert input for complex decisions, and review against actuals. Experience improves accuracy over time.

Raising the Savings Rate

- ◆ Target raising the savings rate by 10% — achievable without severe lifestyle cuts.
- ◆ Once achieved, set the next target — continuous improvement mentality.
- ◆ Eliminate wasteful expenditure; cut discretionary expenses first.
- ◆ Divert all lump-sum receipts (bonus, incentives) directly to savings.
- ◆ Never commit income increases to new expenses — let them boost the savings rate first.

6 Personal Balance Sheet & Net Worth

Lakshmi's Personal Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Net Worth	24,15,000	House	18,12,000
Housing Loan	12,02,000	Car	3,25,000
Credit Card Dues	5,000	Mutual Funds	8,40,000
		PPF	3,20,000
		Shares	2,80,000
		Cash & Bank	45,000
Total	36,22,000	Total	36,22,000

Net Worth = Rs.36,22,000 – Rs.12,07,000 = **Rs.24,15,000**. Total assets look large, but net worth is modest because most assets were acquired with debt. Track net worth growth over time — not just total assets.

Numerical Snapshot of Financial Health

Calculated annually and tracked over time; identify areas needing corrective action.

Ratio	Formula	Benchmark / Interpretation	Example
Savings Ratio	Savings / Annual Income	Higher is better; build toward 30%+	Rs.60K/Rs.6L = 10%
Expenses Ratio	Annual Expenses / Annual Income	= 1 - Savings Ratio; lower is better	Rs.5.4L/Rs.6L = 90%
Savings to Income (Accumulated)	Total Savings / Annual Income	Target \geq 3x income by early 40s	Rs.15L/Rs.12L = 1.25x
Leverage Ratio	Total Liabilities / Total Assets	< 0.5 healthy; > 1.0 = insolvent	Rs.13L/Rs.65L = 20%
Solvency Ratio	Net Worth / Total Assets	= 1 - Leverage Ratio; > 50% preferred	Rs.52L/Rs.65L = 80%
Liquidity Ratio	Liquid Assets / Monthly Expenses	4-6 months is comfortable	Rs.13L/Rs.1.5L = 8.66
Financial Assets Ratio	Financial Assets / Total Assets	Higher as goals near realisation	Rs.27L/Rs.50L = 54%
Debt to Income Ratio	Monthly Debt Service / Monthly Income	< 35-40%; above = financial stress	Rs.60K/Rs.1.5L = 40%

WORKED EXAMPLE — NFG's LIQUIDITY RATIO

Monthly expenses (incl. loan repayments): Rs.1.5 lakh Liquid assets: Savings bank Rs.7L + Short-term FDs Rs.2L + Liquid MF Rs.4L = Rs.13L Excluded: Equity shares (price volatile), closed-end MF (illiquid) Liquidity Ratio = Rs.13L / Rs.1.5L = **8.66** (comfortable — above 6-month benchmark)

Protecting the Household from Risk

Life Insurance

Protects dependents if an earning member passes away. Critical in dual-income families — if either income stops, all expenses must still be met.

Emergency Fund

6 months' expenses in liquid assets — the first financial goal. If income is secure: 3 months liquid + 3 months in slightly less liquid but higher-return assets.

Asset Distribution

Distribute holdings between spouses — alternate first/joint holder status. Aligns ownership with income source for tax and estate planning.

Health Insurance

Covers large, unexpected medical costs — one of the biggest financial shocks a family can face.

Income Diversification

Dual-income families have built-in insurance against job loss. If one partner loses employment, the other's income provides a bridge.

Account Segregation

Each partner maintains a separate salary account (other as joint holder). Transfer to a joint household account for expenses. Simplifies tracking.

Joint Property

Partners can be joint property owners and joint loan borrowers — enables tax benefits and simplifies estate planning.

Separation / Divorce

Pre-nuptial agreements detail financial arrangements in case of separation. Their legal status in India has not been established.

9 Budget & Savings Plan

Seven Steps to a Robust Plan

- (a) Gather all income and expense details — accurate information is the most critical input.
- (b) Cross-check that no income or expense head is missing — wider coverage = better budget.
- (c) Base estimates on actual past expenses, or realistic expected figures if circumstances changed.
- (d) Account for seasonal variation — vegetable prices, festivals, birthday months.
- (e) Include a contingency figure — absorbs sudden shocks and keeps the budget robust.
- (f) Set required savings based on financial goals — this drives the allowable expense level.
- (g) Automate savings via direct transfer before the money hits the spending account.

10 Quick Revision Sheet — Chapter 3

CASH FLOW & BUDGET

- Cash flow = matching timing of income and expenses
- Mismatch -> short-term debt -> extra cost -> less savings
- Budget order: Income -> Mandatory -> Essential -> Discretionary
- Savings
- Monitor actuals vs budget; correct persistent variances
- Savings Ratio = Savings / Income; Expense Ratio = 1 - Savings Ratio
- Automate savings: direct debit before discretionary spending

KEY RATIOS

- Savings Ratio: Savings / Income (higher = better)
- Leverage Ratio: Liabilities / Assets (lower = better)
- Solvency Ratio: Net Worth / Assets = 1 - Leverage
- Liquidity Ratio: Liquid Assets / Monthly Expenses (target 4-6)
- Debt to Income: Monthly Debt Service / Income (< 35-40%)
- Financial Assets Ratio: Financial Assets / Total Assets

PERSONAL BALANCE SHEET

- Physical assets: real estate, gold (illiquid, large ticket)
- Financial assets: deposits, MF, equity (more liquid, standardised)
- Net Worth = Total Assets - Total Liabilities
- Track net worth over time; rising = improving financial health
- Exclude self-occupied home from goal-planning asset calculations
- Leveraging to invest in financial assets is risky - avoid

CONTINGENCY PLANNING

- Emergency fund = 6 months expenses in liquid assets (first goal)
- Replenish immediately after use; review annually or after big EMI changes
- Life insurance: protect dependents if earner passes away
- Health insurance: cover large unexpected medical costs
- Distribute assets between spouses for tax and estate efficiency
- Segregate salary accounts; joint account for household expenses

MC
Q

Practice Questions — Chapter 3

Test your understanding of Chapter 3. The correct answer and explanation are shown below each question.

Q1 Which of the following best describes cash flow management in personal finance?

(A) Investing surplus funds in equity markets

(B) Ensuring income is available when expenses fall due, to avoid costly short-term debt

(C) Maximising discretionary expenditure using credit cards

(D) Maintaining a zero bank balance at all times

Answer: (B) — Cash flow management matches timing of income to expenses to prevent the need for costly short-term borrowing.

Q2 In the ABC Family budget, which category of expenses should be reduced first to improve savings?

(A) Mandatory expenses (tax, PF, loan EMI)

(B) Essential living expenses (grocery, rent)

(C) Discretionary expenses (entertainment, lifestyle)

(D) Investment contributions

Answer: (C) — Discretionary expenses are non-essential and can be cut or postponed without affecting basic needs or mandatory obligations.

Q3 What is the key difference between an Income & Expenditure Statement and a Cash Statement?

(A) I&E records cash flows; Cash Statement records accruals

(B) I&E uses accrual basis; Cash Statement uses cash basis

(C) Both are identical in personal finance

(D) I&E only covers income; Cash Statement covers both

Answer: (B) — I&E records items when earned/incurred (accrual basis). Cash Statement records when cash is actually received or paid.

Q4 Lakshmi has total assets of Rs.36,22,000 and total liabilities of Rs.12,07,000. What is her net worth?

(A) Rs.48,29,000

(B) Rs.12,07,000

(C) Rs.24,15,000

(D) Rs.36,22,000

Answer: (C) — Net Worth = Total Assets - Total Liabilities = Rs.36,22,000 - Rs.12,07,000 = Rs.24,15,000.

Q5 NFG has liquid assets of Rs.13 lakhs and monthly expenses of Rs.1.5 lakh. What is the liquidity ratio?

(A) 5.5

(B) 8.66

(C) 6.0

(D) 10.0

Answer: (B) — Liquidity Ratio = Liquid Assets / Monthly Expenses = Rs.13L / Rs.1.5L = 8.66 (above the 4-6 month benchmark).

Q6 An investor has total assets of Rs.65 lakh and total liabilities of Rs.13 lakh. What is the leverage ratio?

(A) 5%

(B) 20%

(C) 80%

(D) 50%

Answer: (B) — Leverage Ratio = Total Liabilities / Total Assets = Rs.13L / Rs.65L = 20%.

Q7 What does the Solvency Ratio measure?

(A) How much of monthly income goes to debt repayment

(B) The proportion of assets funded by liabilities

(C) Net worth as a percentage of total assets

(D) The number of months of expenses covered by liquid assets

Answer: (C) — Solvency Ratio = Net Worth / Total Assets. It equals 1 - Leverage Ratio and measures how debt-free the asset base is.

Q8 ABC earns Rs.6 lakh annually and saves Rs.60,000. What is the Savings Ratio?

(A) 90%

(B) 10%

(C) 15%

(D) 6%

Answer: (B) — Savings Ratio = Savings / Annual Income = Rs.60,000 / Rs.6,00,000 = 10%.

Q9 What is the recommended size of an emergency fund?

(A) 1 month of expenses

(B) 3 months of mandatory expenses only

(C) 6 months of total expenses in liquid assets

(D) 12 months of income in equity mutual funds

Answer: (C) — The emergency fund should cover 6 months of total expenses (including loan repayments) held in liquid assets for quick access.

Q10 Which personal finance ratio measures ability of monthly income to service all debt obligations?

(A) Leverage Ratio

(B) Solvency Ratio

(C) Liquidity Ratio

(D) Debt to Income Ratio

Answer: (D) — Debt to Income Ratio = Monthly Debt Servicing / Monthly Income. Above 35-40% indicates excessive debt burden and financial stress.