Financial Jargon Demystified

Emergency Fund:

It is a fund set aside to be used in case of emergencies like a job loss, illness or major expense. The objective of setting aside this is to meet regular expenses and also avoid taking high interest debts in such situations.

Why building an emergency fund is necessary these days? Since most of us work in private companies which show us the pink slip at short notice, in the event of a job loss, we still need to pay our utility bills, children's education fees and EMIs for any loans taken.

It is easier to manage such expenses, if you have an emergency fund to sustain, till you find another job.

What if a medical emergency befalls you or your family members resulting in a major expense? Such expenses may be higher than your average savings account balance.

Many argue that, they have saved and invested well throughout their working life and hence, they don't need to create a corpus for emergency. They can always withdraw from their existing assets. However, withdrawing the assets earmarked for your goals will set you back from achieving them.

Typically, an emergency fund should equal 3-6 months of your expenses and it should be kept in an instrument which is highly liquid and easily accessible such as Savings account, a liquid fund, an ultra short term debt fund or just a flexi fixed deposit option with your bank.

The objective is to have access to the same with ease and at short notice.

The corpus should include your monthly expenses, your children's education fees, EMIs of all your loans and any other essential expenses you may have.

Financial Goals

Financial goals are financial targets, that are personal in nature. Things, you want to achieve in the future, which require funding and planning. A financial goal should have a definite time frame and a cost value associated with it.

Goals can be short term, medium term or long term goals.

Short term goals are those goals that can be achieved within a year. For Eg. Buying an LED TV worth Rs.1,00,000 in 1 year.

Medium Term goals are that can be achieved within 2-3 years. For Eg. Building a corpus of Rs.5,00,000 for a Vacation abroad after 3 years.

For an individual, financial goals can include saving for retirement, saving to fund children's education, building a corpus for home purchase etc.

Why is it important to set goals?

Setting goals is putting down what you want to achieve with your money at a future date. It is like creating a blue print of your financial life.

Why should you set goals to save money?

More often than not, people save money but are not sure for why they are saving.

Setting goals, helps you to map how long and how much you should save, to achieve a goal.

When you just save money without aligning it to a goal, you might not be aware if the money saved is enough, or whether you are saving in the right instrument, does the instrument match your risk profile, does the duration of the instrument match the duration of your goal, and many such questions.

How do I set goals?

Before setting goals, it is important to understand the feasibility, current resources and time horizon needed to achieve the goal.

The cost and tenure of the goals should be aligned to your income level, net worth, current resources available and your current age. For example, a 55 year old salaried person, retiring in the next 5 years should plan for meeting his post retirement expenses.

It is important to determine your short term, medium term and long term goals. It is also important to prioritize each of the goal and also, classify the goals as essential and discretionary. The essential goals always have the highest priority.

Reviewing you goals periodically is as important as setting the goals. Your goals should be reviewed on an annual basis to understand the progress and take into consideration, any changes in your current financial condition, or the instruments you have invested in, or any macro or micro economic changes, changes in taxation that may affect the planned savings.

If the goals have changed or the priorities have changed with time, your plan must be realigned accordingly.

Cash Flow


Cash Flows in relation to Personal Finance refers to the amount of cash that moves through your household every month or every year. It is arrived at by deducting your expenses from your incomes and is used to assess the situation of one's finances.

It is always desirable to have positive Cash flows, as it means your expenses are less than your Income and that you are managing within your means. Expenses' being more than Income is not a desirable situation and results in Negative Cash Flows.

Negative cash flows over a period of time, can create an uncomfortable situation.The easiest way one can improve their cash flows is by tracking their expenses meticulously, maintaining a budget, and to cut down on discretionary spending, such as dining out, entertainment, impulse shopping or leisure travel.

A cash flow statement lists all your sources of income– salary, investment income, bonus, business income etc. and all your monthly and periodic, essential and discretionary expenses in a year. Expenses include groceries and utilities, debt repayments, education costs, insurance premiums etc.

Eg. Let us consider the income of a person over a period of one year.

Cash Flow Statement	
Income	**Expenses**
Earned Income ▪ Salary – Rs.2000000 ▪ Bonus – Rs.500000 **Other Income** ▪ Investment Income – Rs.50000 ▪ Interest income – Rs.50000 ▪ Dividends – Rs.25000 ▪ Capital gains – Rs.400000	**Fixed AnnualExpenses:** ▪ Mortgage/Rent – Rs.600000 ▪ Car payments – Rs.250000 **Annual Expenses:** ▪ Insurance premiums – Rs.50000 ▪ Property Taxes – Rs.5000 ▪ Investment contributions – Rs.500000

	Essential Monthly expenses: ▪ Groceries – Rs.10000 ▪ Utilities – Rs.20000 ▪ Medical care – Rs.2000 ▪ Maintenance/home or auto – Rs.10000 **Discretionary Monthly Expenses** ▪ Entertainment/hobbies – Rs.2000 ▪ Dining out-Rs.2000 ▪ Spending money-Rs.5000 ▪ Miscellaneous – Rs.2000

In the above example, the total annual income from all sources is Rs.3025000 and the total annual expenses add up to Rs.2041000.

Net Cash flow = Total Income – Total Expense

Rs.984000 = Rs.3025000 – Rs.2041000

This indicates the person has a positive cash flow and has potential to invest and grow his wealth.

Assets and Liabilities:

Assets are resources which have some economical value, which you own. People purchase assets with the hope of making a positive return on them. The positive return on an asset gets compounded year on year to generate significant returns. Assets could be physical assets like real estate, gold etc. and financial assets like equities, deposits, cash etc.

Liabilities, also known as debt are the amount you own to creditors or the companies that lend you money. Debts usually have interest charge associated with it i.e. you have to return the amount borrowed plus additional charges referred as interest, for borrowing it. To get rid of a debt, you have to pay more than you borrowed. With the interest charges accumulating year on year, you need a substantial amount to close the debt. Typical liabilities include home loans, education loans, credit card debt, auto loans etc.

It is recommended to have a higher value of assets and lesser value of liabilities as it will give you a positive net worth.

Assets can add to your cash flow through interest payments, dividends, capital gains etc. Liabilities decrease your cash surplus as the amount to pay back higher than the amount you borrowed.

Assets	Liabilities
Physical Assets:	
Real Estate	Home Mortgage Loan
Physical Gold	Personal Loans
Artwork, Antiques	Credit Card Debt
	Auto Loan
Financial Assets:	Unpaid Bills
FDs	Any Amount owed
Stocks and MFs	
Bonds	
Cash	
Intangible Assets:	
Intellectual Property	
Patents	

Let us consider an example of a person whose assets and liabilities are as below:

Assets:

Real Estate – Rs.7500000

Physical Gold – Rs.200000

FDs-Rs.2500000

Stocks and MFs – Rs.1000000

Liabilities:

Home Loan Outstanding – Rs.4500000

Credit Card Debt – Rs.200000

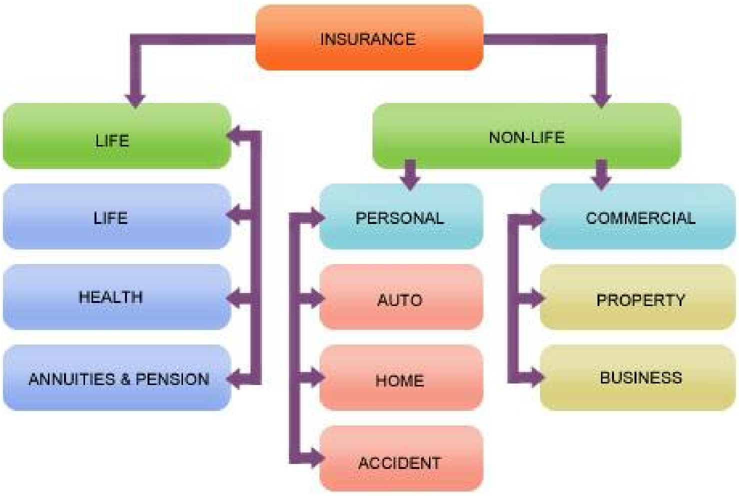
Auto Loan – Rs.700000

The net assets add up to Rs.1,30,00,000 and liabilities add up to Rs.54,00,000. He has a positive net worth of Rs.76,00,000.

However it is important to understand how well the assets can be used to map for his financial goals. Since the house is self-occupied, it cannot be considered as an appreciating asset.

Insurance:

Insurance is transfer of the risk of a loss, from one entity to another in exchange for money. It is form of risk management used to hedge against the risk of uncertain loss. In simple terms, Insurance is a contract in which an individual or an entity receives financial protection or reimbursements against losses, from an insurance company.



The amount of money charged for certain amount of insurance coverage is called Premium. The insured receives a contract, called insurance policy, which details the circumstances and conditions under which the insured will be financially compensated.

Insurance can be broadly classified into 2 – Life insurance and Non-Life Insurance. Life Insurance includes those risk covers which are related to human life and its value. Non-Life insurances are insurances which cover the loss of assets, loss of income etc.

Life Insurance: Life insurance is a cover taken by an individual to cover either the expense or the income generated by that person for the family.

Term insurance is the purest form of insurance which provides only risk cover for a fixed period.

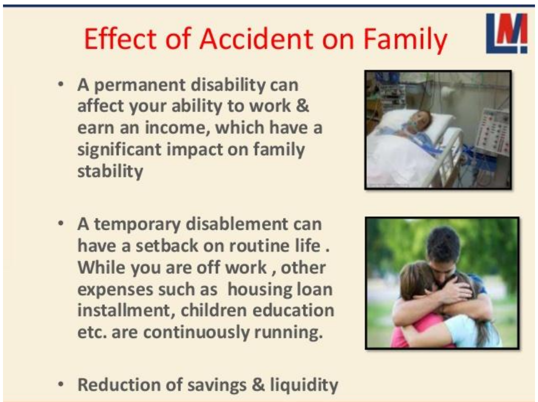
Whole life insurances provide life cover throughout your life expectancy. However in India, there are many products which provide both life insurance and investment options. Eg. ULIPs and Endowment Plans.

Health Insurance: Health insurance is a cover taken for the expenses incurred on hospitalization and any pre and post hospitalization expenses. Most Health insurances include day care procedures and any diagnostic scans and tests relevant to hospitalization cost. Health cover can be taken for an individual or for an entire family.

Critical Illness Insurance: This is an insurance policy which covers the insured for life threatening diseases like tumor, paralysis, cancer etc. which may threaten his ability to earn a regular income and may also, lead to a permanent disability. If you are diagnosed

with a critical illness, this policy provides you a lump sum to meet the treatment costs and day-day expenses. Hospitalization is not mandatory for this policy.

Personal insurance death or provide disabled for lot and



Accident Disability Cover: This covers the insured against accidental disability due to an accident. It will financial support to the insured if he is after an accident. This is a must policy youngsters and for people who travel a have higher risk of accidents.

Personal Finance Ratios

Liquidity ratio:

Liquidity ratio represents an individual's ability to meet committed expenses when faced with an emergency.

LIQUIDITY RATIO = CASH OR CASH EQUIVALENTS / MONTHLY COMMITTED EXPENSES

It is also defined as the ratio between liquid assets and net worth, the basic liquidity ratio is used in terms of analyzing existing emergency funds. It is advisable to maintain 3-6 months of expenses as your emergency fund, which means that the ideal levels of liquidity ratio range between 3 and 6.

Asset to debt ratio:

This ratio compares the assets accumulated by an individual against the existing liabilities.

ASSET TO DEBT RATIO = TOTAL ASSETS / TOTAL LIABILITIES

Total assets include both liquid and illiquid assets accumulated over years. Total liabilities include all forms of liabilities such as home loan, car loan, outstanding credit card balance and so on.

Ideally, this ratio should be greater than 1. This ratio stands as relative measure which helps in determining what you own vs. what you owe.

Current ratio:

This ratio represents the ability of an individual to service short-term liabilities in case of any financial emergency.

CURRENT RATIO = CASH OR CASH EQUIVALENTS / SHORT TERM LIABILITIES

Cash or cash equivalent component includes assets such as cash in hand, cash in bank and other such assets which can be liquidated immediately. Short-term liabilities include all your debt repayments that are to be made in the current year. Total EMI payments that are to be made in the current year, credit card outstanding balance and other such obligations, which are to be met in the current year, are also considered when calculating short-term liabilities.

Debt service ratio:

This ratio defines how comfortable one is making his/her EMI payments.

DEBT SERVICE RATIO = SHORT TERM LIABILITIES / TOTAL INCOME

This ratio indicates the percentage of income being accounted for debt repayment and the percentage of income left over for other mandatory household expenses and savings. Lower the ratio, better the debt management state of an individual.

Savings ratio:

This ratio compares the monthly surplus being generated by an individual against total cash inflows.

SAVING RATIO = MONTHLY SURPLUS / MONTHLY INCOME

It represents one's ability to achieve his/her future goals and gives an insight on how well your finances are being managed.A higher saving ratio translates to better money management skills.

Solvency ratio:

Solvency ratio compares an individual's net worth against total assets accumulated by him/her.

SOLVENCY RATIO = NET WORTH / TOTAL ASSETS

This ratio indicates the ability of an individual to repay all his/her existing debts using existing assets in case of unforeseen events. If this ratio is greater than 1, it indicates that the individual’s assets are of higher value than the total debt and in unforeseen circumstances, the debt can be cleared with the sale of assets without going bankrupt.

Investment assets to total assets:

This ratio compares liquid assets being held by an individual against the total assets accumulated.

INVESTMENT ASSETS TO TOTAL ASSETS = LIQUID ASSETS / TOTAL ASSETS

Investments in stocks, mutual funds or other such investments, which can be converted to cash easily, are considered as liquid assets. Total assets also include illiquid assets such as real estate or other such investments which require more time to convert to cash. It is recommended that liquid assets should be at least 20 per cent of his/her total assets.