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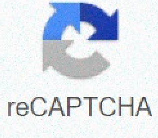

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A few years back, I had a little net worth bashing session. Over time (and increased net worth) my view on this financial metric has softened a bit, but not much. A softer side comes from an increased appreciation for tracking the full value of all of the assets you have. It is hard to know where you are at, where you want to get to, and how long it will take to get there if you do not have something to measure. What do I still not like about net worth as a financial indicator? Before I explain, first, a quick recap of how to calculate net worth. At it's simplest: net worth = total assets – total liabilities Common assets include: market value of real-estate property, bank deposits, non-retirement investments, retirement accounts, depreciating assets (vehicles, boat, basically any possession you can sell). Common liabilities include: mortgage/home equity loan debt, student loan debt, auto loans, credit card debt, medical debt, or any other outstanding debts. With that clarified, the thing that still bothers me about net worth comes from the context in which it is used. 99% of net worth conversations, articles, and online forum discussions are centered around retirement and early retirement. In fact, outside of applying for student financial aid, a new loan, celeb jealousy rants, or bragging in a way that makes you lose friends – I can't think of any other times net worth is brought up. Taking things a step further, net worth is often used as a measuring stick in retirement discussions to judge ones retirement picture. Here's the problem with that – what value is there in net worth (outside of ego boosting) if you cannot use that net worth to generate income or live off of? Is there value in including the equity in a $1.5M Bay Area home in net worth, when the owner occupant has no intent to leave? Is there value in including a debt-free $100K home in net worth calculations, when no matter where the owner moved, they would probably end up paying more for the next home (or increase expenses through renting)? Is there value in adding the full balance of 401K, IRA, stock options, or other pre-tax deferred compensation in to net worth (as most do) versus a calculated after-tax number? And is there value for an aspiring early retiree to add in retirement investments if they want to judge their ability to retire early, when they have no plan to withdraw those investments until retirement age? I don't think so. Usable Net Worth I don't want to dismiss the net worth metric completely, but I have created a modified version that makes it more useful for retirement and early retirement purposes. I like to call it "usable net worth". Maybe it works for you, maybe you'd rather stick to the standard net worth calculation – either way, let me know what you think. usable net worth = total usable assets – total liabilities Usable assets include: market value of current home minus estimated market value of next home (if no intent to move, = $0. If a negative amount, add to liabilities) market value of rental property bank deposits non-retirement investments after tax retirement accounts (Roth) pre-tax retirement accounts and deferred comp AFTER estimated post-tax value non-essential depreciating assets (if you need a car, do not add its value. If you have a boat and intend to sell it, add the expected market value at the time of sale) Total liabilities include: Mortgage/home equity loan debt Student loan debt Auto loan debt Credit card debt Medical or any other outstanding debt You'll notice that the big differences are all on the asset side. Here's a little more on each: Home: the problem with including home value in net worth is that everyone needs a roof over their head. If you have no intent of selling your current home in favor of another cheaper home and pocketing the cash to use or invest, then why add this value to your net worth? What value is there in calculating net worth if 30, 50, 70% of it is tied up in a home or will be tied up in your next home? Pre vs. Post Tax Balances: I see very few people factor in taxes to their pre-tax (Traditional 401K, IRA) retirement accounts and deferred compensation. You will have to pay taxes on it at some point, so why include the taxable portion in your net worth? For simplicity, I assume my current tax rate. In reality, when I start withdrawing these assets, my tax rate will probably be lower, but I'd rather be conservative and consider any additional assets a bonus. Depreciating Assets: as noted, unless you intend to sell your current asset, there is no point in adding its market value to your net worth. What remains, after the modifications, are the assets that you can actually use to invest or cover your living expenses. No ego, no inflated number that has no real world use, just good old rubber-meets-the-road usability that can give you a much more accurate picture of how close you are to financial independence, or secure you are if already achieved. And isn't that what's important? Related Posts: Return on assets is a measure of a company's profitability. In investing, the return on assets ratio provides a snapshot of how much profit a company is able to keep from every dollar it makes in sales. It's important because it helps show whether a company is using its money wisely. Here's how to calculate it. The equation for calculating return on assets looks like this: Net income divided by total assets. You can find both these numbers in a company's annual report. For this example, we'll use Microsoft's 2007 annual report. The company lists its net income (found on the income statement) as $14.1 billion, and its total assets (found on the balance sheet) as $40.2 billion. So the math looks like this: $14.1 billion / $40.2 billion = 0.351. Move the decimal point two places to the right, and you get a return on assets of 35 percent. So what does this number mean? Well, a higher ROA is better, because it means a company is making more money on less investment (assets). For example, if Microsoft's total assets were $80 billion while its net income remained the same at $14.1 billion, its ROA would be 18 percent. In that scenario, Microsoft would have spent almost twice the money ($80 billion compared to $40.2 billion) to achieve the same amount of income ($14.1 billion) -- thus, its return on assets would be much lower. Tips Average return on assets varies widely by industry. Make sure you look at the average ROA for an industry at large when you are interpreting your results. Warnings If you're comparing ROA between companies, make sure they are in the same industry. The ROA of a software company such as Microsoft and the ROA of a shoe company such as Crocs, for example, will be very different because of the nature of their businesses. Always compare apples to apples. Without assets, your business could not run. Everything from light bulbs and printer paper to buildings and equipment adds value to your business since these items facilitate the running of your operations and can help you to generate revenue. As a line item on the balance sheet, total assets represent the resources that your business owns at a given point in time. It's a crucial metric for determining your business' net worth, whether for sale or investment purposes. Calculate total assets by adding up the total recorded value of all the company's cash, accounts receivable, investments, inventory, fixed assets, intangible assets and anything else of value. Assets are anything of value owned by your company. Some assets are obvious because you can see and touch them – things like buildings, machinery, vehicles and computers fall into this category. Other assets are intangible but still create revenue for your business, such as domain names, accounts receivable and investments. As things of value, assets get recorded on the company's balance sheet. The company will record them at the time of purchase, so the balance sheet should always reflect what the company owns at a given point in time. Asset classification is a system for placing your assets into groups of like items, based on common characteristics. Companies typically will cluster these groups for reporting purposes on the balance sheet. Broadly, the categories in which assets may be classified include: Cash, including petty cash and cash in the bank. Accounts receivable, which is unpaid bills. Prepaid expenses. Inventory, including raw materials, work in progress and finished goods awaiting sale. Fixed assets such as real estate, vehicles, computer equipment and furniture. Intangible assets. Goodwill Other assets. Some businesses say that their employees are their most valuable asset. That may be true, but you can't put a value on your talented team, so employees don't feature on the balance sheet. For reporting purposes, most businesses divide their assets into current assets and long-term assets. Current assets are things you're going to use up or sell within one year. Everything else is a long-term asset. Within these two categories, it's conventional to list assets in order of liquidity. Liquidity refers to how quickly you can turn an asset into cash. Cash always appears at the top of the list of current assets, closely followed by accounts receivables, inventory and short-term investments. Also, a company will report prepaid expenses as current assets. For example, if you bought a year-long insurance policy and paid the premium up front, the portion that is not used up yet will be listed on the balance sheet. It's a current asset because you're going to use it up within one year. The next section on the balance sheet is for long-term assets, which are also called "non-current" assets. This section features harder-to-sell items like real estate, vehicles and machinery. There are also some assets that you cannot see or touch, such as web domain names and product trademarks. These assets are called intangible assets, and you'll list them beneath your fixed assets on the balance sheet. Whenever the business buys an asset, it should classify and record the asset in the appropriate spot on the balance sheet. The line item will also record the asset's purchase value. Once you've listed all the assets, the sum of all their valuations gives you total assets. It really is that simple – no accounting equation required! Lenders and investors are attracted to businesses with plenty of assets on their balance sheets since it shows you have a large portfolio of assets you can sell to raise money if times get tough. If you apply for new credit, owning cash accounts, inventory and substantial equipment show an ability to pay debt, even when your profit is modest. It also gives you lots of options for reinvestment and growth. Knowing the total assets on the balance sheet also tells you how much money is tied up in the business. If your growth or cash flow is poor, but your total asset number is high, it could be a signal that you need to sell or transfer assets to reinvest and increase the efficiency of your business. In a similar vein, an understanding of total assets can help you achieve potential savings. Sometimes, leasing assets may be cheaper than buying them outright – calculating the total assets you're carrying can help you to figure out your tolerance for buying versus leasing. If you are thinking of selling your business, one conventional method of valuation is to add up your total assets and deduct the value of the company's liabilities. Identifying assets and placing the correct value on them is crucial in figuring out your business' net worth in the event of a sale. By now, you've probably noticed a key point about total assets: it represents the historical cost of the assets you own, not their market value. Over time, the value of an asset may increase or diminish due to appreciation or depreciation. In the case of buildings, the value of the asset may rise. In the case of vehicles or computer equipment, the value of the asset may fall as both wear and tear and obsolescence affects their value. In accounting terms, you have to depreciate fixed assets over the number of years you're going to use them, a period that is known as the asset's useful life. A standard depreciation methodology involves writing off the purchase cost at a fixed amount, year-after-year, for each year of the asset's useful life. So if you bought a new vehicle for $30,000, you'd depreciate it at $3,000 per year for each year of its 10-year useful life. Most businesses will assign the same useful life to every asset in a particular category, for example, computer equipment. Doing so makes it easier to depreciate all the assets in this group. Looking at the total assets in isolation doesn't tell you very much, and it's much more useful to track the change in total assets over time. This can give valuable clues about a company's health and prospects. To calculate the year-on-year change in total assets, simply subtract last year's total assets from this year's total assets. Divide the resulting number by last year's total assets and multiply the result by 100 to see the percentage change. If the result is positive, then the total assets grew. If the result is negative, then the total assets declined. The higher the percentage, the greater the year-on-year change. Here's an example. Suppose Company X had total assets last year of $150,000 and this year its total asset number is $220,000. The percentage change is (220,000 - 150,000)/ 150,000, or 46 percent. Once you've done the math, the next step is to ask yourself why the change happened. Did you buy or sell a major fixed asset? Is there an increase in accounts receivable, and if so, does that translate to a rise in sales or have you dropped the ball in terms of your credit management? Do you have a customer who hasn't paid? Your total assets are a direct result of decisions and events that occurred. Understanding them can give you a better view of the overall health of your business. Operating assets are the things a business uses to make money, such as inventory, patents, equipment and accounts receivable. A company's net operating assets (NOA) is the value of its operating assets less the company's operating liabilities. It's a useful measure of how well a business uses its assets to generate income. A company's operating assets may include inventory, prepaid expenses, accounts receivable, fixed assets such as buildings and equipment, and intellectual property. What these assets have in common is that they're all used in company operations to generate revenue. Non-operating assets include financial investments and old assets no longer used in operations. Tips To calculate net operating assets, take the company's total assets and subtract the value of cash, investments and total liabilities. Then, add in the total of the company's long-term debt. That's the NOA formula. The ratio of total assets to operating assets shows how much of the business is actually generating revenue and how much is just sitting there. The ratio of operating assets to revenue measures how well the company uses its moneymaking assets. Numbers don't tell the whole story, though: A company that's expanding into new areas may have a poorer ratio as it taps its resources to penetrate the market. Operating liabilities are short-term debts resulting from the business's operations, such as accounts payable, income taxes and accrued liability. If you receive a $500 bill from a supplier, that adds $500 to accounts payable. If you haven't received a bill by the end of the accounting period, you write down $500 as accrued liability. Non-operating liabilities are financial expenses such as interest-generating debts. These affect the overall financial health of the company, but they don't measure the costs and expenses of regular business operations. To make an NOA calculation, take the company's assets and subtract non-operating assets such as securities and other investments. That gives you the operating assets. To calculate operating liabilities, subtract financial liabilities from total liabilities. Subtract operating liabilities from operating assets and you get net operating assets (NOA). An alternative NOA formula is to take total assets, then subtract all liabilities and all financial assets. Add financial liabilities back in. Once again, the final result of the formula is net operating assets. For example, suppose the ABC Computer Company has $1.5 million in assets including $.5 million in investments, and $300,000 in liabilities including $100,000 in financial liabilities. Subtracting $.5 million and $300,000 from the assets gives you $700,000. Add the $100,000 in financial liabilities and the company has $800,000 in net operating assets. Like operating assets, net operating assets are useful for measuring a business's efficiency. You do this by comparing it with net operating profit, which is revenue minus expenses, excluding tax and interest expense. You use the result to judge how well a business uses its assets to generate revenue. The advantage of this approach is that both NOA and net operating profit focus on business operations and exclude investments. A company's profitable investments can make it look successful even if it doesn't generate much revenue from operations. Interest payments can make operations look less successful. Looking at operating profit and operating revenue can give you a clearer picture. By calculating net operating profit as a percentage of NOA, you can also compare different businesses of different sizes more objectively. If two businesses in the same industry have the same percentage, they may be equally efficient even if one is twice the size of the other.

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