## General Principles of Financial Planning – Application Questions – Topic 1

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GENERAL PRINCIPLES
OF FINANCIAL PLANNING

Topics 1 – 12
GENERAL PRINCIPLES OF FINANCIAL PLANNING

Financial Planning Process (Topic 1)

CFP Board Student-Centered Learning Objectives

(a) Diagram the personal financial planning process as defined by the CFP Board’s Job Task Domains (located in Appendix B of this text) and Financial Planning Practice Standards.

(b) Recognize unethical practices in the financial planning profession based on the CFP Board Standards of Professional Conduct.

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Part 1: Financial Planning Process

PURPOSE, BENEFITS, AND COMPONENTS OF FINANCIAL PLANNING

Personal financial planning requires development of comprehensive strategies to achieve personal financial objectives. The purpose of the financial planning process is to provide a road map for clients to follow to achieve financial goals.

The disciplined approach of the financial planning process can reveal existing or potential financial problems that may impede a client from attaining goals and objectives. The organization of resources that is required during financial planning can also help with decision making and with determining the resources available to attain financial goals.

In addition to providing an organized approach, the financial planning process encourages exploration of client issues and facilitates creation of various solutions toward the accomplishment of goals. The financial planner makes recommendations from among the possible solutions, communicates ways in which client concerns can be resolved, and provides professional management to help clients achieve financial objectives.

The Art and Science of Financial Planning

Financial planning can be defined by the six step process that a planner uses to assist clients with reaching financial goals. While the process is essentially the same for each client, the end result will be unique to each individual. Not all planners will formulate the same recommendation from the same client facts, and not all clients in similar situations will be best served by the same solution. Moreover, very different financial planning results can arise from very small differences or changes in values, beliefs, or levels of risk tolerance. A good financial planner will seek first to understand the client’s needs and then create the best solution for that particular client. Consequently, students should recognize that planning is both art and science.

SIX STEPS IN THE FINANCIAL PLANNING PROCESS – EGADIM

We use the acronym EGADIM to help students remember the six steps of the financial planning process. The following several pages provide an overview of what happens in each of these six steps.
Trust is the glue of life. It’s the most essential ingredient in effective communication. It’s the foundational principle that holds all relationships. “

Stephen Covey

EXHIBIT 1 – 1
The Financial Planning Process

<table>
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<td>Step 1: E – Establish Relationship</td>
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<td>Step 2: G – Gather Information</td>
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<td>Step 5: I – Implement</td>
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<td>Step 6: M – Monitor</td>
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Step 1: Establishing Client-Planner Relationships

The first step in the financial planning process is to establish and define the terms of the relationship that will govern the activities of the planner and the client. This step will include describing each person’s responsibilities during the working relationship. Defining the scope of the engagement also means clients will express their expectations and needs, and the planner will limit his or her engagement to those responsibilities that are warranted.

This first step is to be completed before any financial planning service is provided and entails a mutual defining of the scope of the engagement. Among the topics to be addressed in this step are:

- Identifying the services that will be provided
- Describing how the planner will be compensated, i.e., commissions, fees, or other basis
- Identifying the specific responsibilities of both the planner and the client
- Deciding on the time frame of the engagement
- Discussing any potential conflicts of interest that may exist between the planner or firm and the client
- Discussing any other matters needed to define or limit the engagement’s scope

While many planners prefer to set forth these topics in a letter of engagement or similar written document, there is generally no requirement that these topics be reduced to writing.

Notice that the relationship begins with a conversation regarding the items listed in the bullet points above. The prospective client and planner are trying to determine whether the planner has the skills, capacity, and ability to assist the client, and whether there is any reason they cannot or should not work together. The planner and client will need to be compatible, and the planner must be sufficiently self-aware to realize when the relationship will not allow the planner to continue with the financial planning process. Not every prospective client will become a client, and sometimes the process will proceed no farther than the first step.
If the initial conversation results in the decision to engage the planner’s services, additional documentation may be required. Documents that must be prepared are specified by various regulatory organizations and/or by the CFP Board of Standards if the planner is a CFP® certificant.

(NOTE: Sample moves to Step 3.)

**Step 3: Analyzing and Evaluating the Client’s Current Financial Status**

*Focusing on the Present Picture*

The third step in the financial planning process is for the planner to evaluate all the data and documents that have been gathered in order to arrive at an overall picture of the client’s present financial status. Here, the planner seeks to identify strengths and weaknesses that will help or hinder the achievement of the goals that have been articulated. Examples of weaknesses that may be uncovered are a lack of liquid funds for emergency purposes, an imbalance between the client’s investment portfolio and his or her risk tolerance, an unnecessarily high income tax or estate tax burden, or a pure risk loss exposure that has not been addressed. One result of the analysis may be a need to gather more information. Another may be the need to scale back some of the client’s objectives to more realistic levels.

> “Analyzing what you haven’t got as well as what you have is a necessary ingredient of a career.”
> *Orison Swett Marden*

Part of the planner’s analysis should be based on realistic planning assumptions with respect to such factors as economic conditions, inflation rates, tax rates, and interest rates. Also, the analysis should include an assessment of the client’s present position relative to special goals, including charitable planning, adult dependent needs, closely held business planning, terminal illness planning, and education planning.
The Stages of Analyzing and Evaluating

(1) Review existing insurance policies and other legal documents such as wills, trust agreements, and buy-sell agreements;

(2) Create and review the statements of the client’s financial position and current cash flow;

(3) Analyze the information to determine the strengths and weaknesses in the client’s financial position;

(4) Evaluate the client’s objectives in view of available resources; and

(5) Evaluate economic conditions as they impact future resources and cash flow for the client.

As you approach the mounds of financial data provided by a client, your first action should be to organize all of it into a coherent format. Break down the data into topic areas and apply a consistent analytical tool to each objective, like SWOT (Strengths, Weaknesses, Opportunities, Threats, discussed more fully below).

Here is a simple example to illustrate the point.

<table>
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<td><strong>Strengths</strong></td>
<td><strong>Weaknesses</strong></td>
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<td>-- Use of tax-advantaged accounts for retirement</td>
<td>-- Current investments hold excessive money markets; -- Existing equities have inadequate diversification; -- Insufficient 401(k) plan contributions</td>
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Once you’ve completed this step in the financial planning process for each topic area and objective, you’re ready to begin the next step of developing recommendations from a set of viable alternatives.

**Using SWOT Analysis as an Analytical Tool**

This time-tested analytical tool is quite useful in the process of financial planning: **SWOT**

- Strengths
- Weaknesses
- Opportunities
- Threats

You will be examining the client’s current financial situation to determine the strengths, weaknesses, opportunities, and threats to the client’s goals and objectives. If the client has a goal of providing a college education for two children in 10 years, then the existence of a program of regular savings toward that goal would be a potential strength. A failure to set up a 529 plan might be a weakness. An ability to increase savings due to a recent salary raise may be an opportunity, and the increasing costs of college educations might be a threat.

Identifying the SWOT in a case study allows the planner to begin the process of formulating recommendations for the satisfaction of client objectives. In real life situations, it also gives the planner the opportunity of first congratulating clients on what they have done correctly before pointing out what remains to be done.

Regardless of the specific analytical tools the planner elects to use, the challenge is to improve the financial condition of the client through the prudent allocation of limited resources. Planners will need to evaluate which options will be viable for achieving the established objectives (i.e., examining the products and strategies that may be selected for implementing the final plan).
APPLICATION QUESTIONS

1. (Published question released November, 1994)

Arrange the following financial planning functions into the logical order in which these functions are performed by a professional financial planner.

(1) Interview clients, identify preliminary goals
(2) Monitor financial plans
(3) Prepare financial plan
(4) Implement financial strategies, plans, and products
(5) Collect, analyze, and evaluate client data

A. (1), (3), (5), (4), (2)
B. (5), (1), (3), (2), (4)
C. (1), (5), (4), (3), (2)
D. (1), (5), (3), (4), (2)
E. (1), (4), (5), (3), (2)

2. Which of the following stated goals of a client is most workable for financial planning purposes?

A. To get out of debt
B. To enjoy a comfortable retirement lifestyle
C. Of most importance, to purchase a vacation home within 5 years at a cost of about $100,000
D. To increase the amount of life insurance owned
E. To diversify his or her investment portfolio

3. Which of the following items of information would not be in the category of Estate Planning Information in a typical fact-finding form?

A. Status of current will
B. Planned gifts
C. Potential impact of inflation
D. Risk tolerance
E. Current trust provisions
4. (Published question released January, 1999)

You receive a phone call from an individual you have not spoken with previously. The caller is excited, just having heard that a new mutual fund is positioned to deliver large gains in the coming year. The caller wishes to purchase shares of the fund through you. Keeping in mind stages of the overall personal financial planning process, which of the following questions that address the first two stages of the financial planning process should you ask the caller?

(1) What are your goals for this investment?
(2) What other investments do you have?
(3) What is your date of birth?
(4) Do you want your dividends reinvested?

A. (1) and (3) only
B. (2) and (4) only
C. (1), (2), and (3) only
D. (1), (2), and (4) only

5. Which of the following areas of analysis in financial planning for a client make use of data in the client’s personal financial statements?

(1) Analysis of the client’s risk exposures
(2) Analysis of the client’s investment portfolio allocation
(3) Analysis of the client’s income tax burden
(4) Analysis of the client’s resources for retirement
(5) Analysis of the client’s potential estate tax burden

A. (2) and (3) only
B. (1), (2), and (4) only
C. (2), (3), and (4) only
D. (3), (4), and (5) only
E. (1), (2), (3), (4), and (5)

6. In which step of the financial planning process should the financial planner and the client identify their specific responsibilities?

A. Step 1 – Establish the relationship
B. Step 2 – Gather information
C. Step 4 – Develop a plan
D. Step 5 – Implement
ANSWERS AND EXPLANATIONS

1. **D** is the answer. Of the functions listed in the question, the first is (1) to interview the client and establish the goals. Then comes (5) data gathering, followed by (3) plan preparation, (4) implementation, and (2) monitoring the plan.

2. **C** is the answer. A workable goal for financial planning purposes should be specific, prioritized, and quantified. A, B, D, and E fail to meet these criteria.

3. **D** is the answer. Information about risk tolerance would most likely be in the General Information or Investment Information section of the typical fact-finding form.

4. **C** is the answer. The following is the CFP Board’s Council on Examination clarification of the question: (1), (2), and (3) all relate to the second step of the financial planning process, namely, “Gathering client data and determining goals and expectations.” The first step is “Establishing the client-planner relationship.”

5. **E** is the answer. All five of the listed areas of analysis utilize data provided by personal financial statements.

6. **A** is the answer. The financial planner and the client should identify their responsibilities in Step 1 when they establish their relationship.