Keir’s Introduction to Financial Planning textbook is designed to introduce students to personal financial planning and to develop the concept of comprehensive financial planning where all of the elements of life that are impacted by financial choices come together.

Each chapter provides an overview of an area of personal financial planning such as insurance planning, investments planning, or retirement planning. The end of each chapter includes multiple-choice questions to help students test their knowledge and comprehension of the information found in that chapter. If a student does not score a 75 percent or higher for a particular Chapter, the student probably has not mastered the material in accordance with examination standards. A grade of less than 75 percent would suggest the student should, as a minimum, review the detailed answers for every question missed and the related paragraphs in the Chapter.

In the preparation of these multiple choice questions, Keir made no attempt to anticipate specific cases or questions that are likely to appear on the final examination for a college course. No one can outguess the class professor. What we have attempted to do is select questions that test a student’s understanding of important concepts presented in the study materials.

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The Financial Planning Process

Personal financial planning involves the development and implementation of coordinated, 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.

A disciplined approach to financial planning can reveal existing or potential financial problems; moreover, protection and preservation of assets are basic to financial planning. The organization of resources during financial planning can help with choice making and in determining the resources available to attain financial goals. In addition to providing an organized approach, the financial planner makes recommendations and provides professional management that will help people to achieve their financial objectives.

The financial planning process can be divided into the following six stages:

- Establish client-planner relationships
- Gather data, including objectives
- Analyze the information
- Develop the plan
- Implement the plan
- Monitor the plan

SIX STEPS IN THE FINANCIAL PLANNING PROCESS

The first step of financial planning is establishing the relationship with the client. This step includes defining the nature of the engagement and explaining what will be needed from the client and what can be expected by both the planner and the client.

The second step of the financial planning process is gathering data. In this stage, the financial planner will undertake the task of assisting the client in completing a data survey form or questionnaire. Most planners will use a financial planning computer program to process, store, and retrieve the data that has been obtained. The interview and questionnaire should provide information on the client’s resources and other qualitative and quantitative information.

Qualitative data provide general information concerning a family’s goals and objectives, lifestyle, health status, and risk-tolerance level. Quantitative data provide basic, but specific, identifying information concerning a family and details concerning the family’s financial status.
Also, part of this step is to help the client define his or her objectives. The tasks associated with determining the client’s objectives are: (a) quantifying specific financial goals in dollar terms and within definite time frames (generalized aspirations must be made specific), (b) ranking of the objectives according to the client’s priorities, and (c) examining the objectives with due regard to the client’s resources and possible constraints.

The third step of the financial planning process is analyzing the information gathered. In this stage, the financial planner will undertake:

(a) a review of existing insurance policies and other legal papers such as wills, trust agreements, and buy-sell agreements
(b) preparation of a statement of the client’s financial position and a current cash flow statement
(c) analysis of the information to determine the strengths and weaknesses in the client’s financial position
(d) evaluation of the client’s objectives in view of available resources
(e) evaluation of economic conditions as they relate to future resources and cash flow for the client’s family.

In this third stage, the planner evaluates the viable options for achieving the established objectives.

The fourth step is developing a comprehensive financial plan for the client. The tasks associated with recommending a comprehensive financial plan are: (a) identifying the strategies and products available for achieving the client’s objectives and (b) selecting the most appropriate from those available.

The fifth step in the financial planning process is implementing the plan. In this stage, the financial planner will work closely with other professionals to carry out the financial plan designed for the client. The client may need help in obtaining products and in pursuing strategies identified in step four.

The last step is monitoring the plan. Periodically, the financial planner should review the plan to determine the significance of any changes in federal tax laws, economic conditions, and available investment techniques, and the planner will schedule review sessions with the client to evaluate progress toward achieving the client’s objectives. Modifications can be made in the financial plan as may be suggested by changes in personal or family circumstances.
The Six Steps in the Financial Planning Process

1. Establish and define the relationship
2. Gather information/Goal setting
3. Analyze and evaluate the current financial position
4. Develop the recommendations
5. Implement
6. Monitor

In the financial planning process, the preparation of financial statements is an indispensable part of evaluating the client’s financial situation and can assist the planner in identifying appropriate techniques for constructing and implementing the client’s financial plan. The two principal personal financial statements used by planners are the Statement of Financial Position and the family Cash Flow Statement. These two types of financial statements are described and analyzed thoroughly in Chapter 3.

THE PYRAMID APPROACH TO FINANCIAL PLANNING

Typically, the financial planning process will need to focus first on removing financial uncertainty through the protective actions of insurance planning, accumulation of an emergency fund, and execution of a will and power of attorney (POA). After this secure foundation is established, the planning process can move on to focus in the next stage on wealth accumulation through investment planning. In the third stage, the focus will finally move to retirement planning and estate planning. For each of these three stages, a client’s financial position should be examined for strengths and weaknesses based, in part, on a review of financial statements. Undertaking the construction of financial well-being in these three stages is sometimes referred to as the pyramid approach to financial planning.
THE PSYCHOLOGY OF FINANCIAL DECISIONS

Psychology is an important part of any decision-making process, including financial decisions. Ideally, a client would carefully consider all options and make the most rational, objective choice in any situation, but financial planners will find that is not always (or even usually) the case. Different clients have very different responses to various elements of the financial plan. One client may embrace budgeting while another client resists it. One client may feel that insurance is not necessary while another client may purchase too much insurance. One client may be comfortable with high-risk investments, while another client is not comfortable with investment risk at all.

People often make decisions for emotional reasons, and their thought process is subject to various biases. Much has been written about these mental tendencies, and dozens of them have been identified, but in this introductory course we will touch on only a few.

Anchoring bias is the tendency to put too much emphasis on past information, usually the first piece of information you encounter on a topic. Thus a person who hears about a company through a negative article on the internet is less likely to develop a favorable opinion toward that business or consider investing in it, no matter how many positive stories are presented. This bias also affects other financial decisions, whether it’s a salesman quoting an initial high price for a product or a prospective employer stating a low salary range. The results of subsequent negotiations probably won’t stray too far from this original number, so the buyer could end up overpaying and the employee could lose out on a bigger paycheck.
Another possible influence is *bandwagon bias*, the tendency to follow the crowd. If all of your friends are raving about this exciting new technology or some sure-fire money-making scheme, you might want to get in on it too, even if it isn’t the best fit toward your needs or goals. Bandwagon bias can influence a person to spend money foolishly or commit to a questionable investment because everyone says it is such a good deal and a great opportunity.

There is also *familiarity bias*, in which a person favors what he or she already knows. This might cause investors to concentrate on domestic stocks over foreign investments, failing to sufficiently diversify a portfolio. It can lead to overinvesting in an employer’s stock, which is a risky strategy and has been a financial disaster for many (think Enron or Kodak). It can also adversely affect other financial decisions, such as staying with the same insurance company even as they keep raising their rates, or hiring a home improvement contractor with a familiar name, rather than researching and considering other options, which could be better values.

Many decisions are affected by *recency bias*, when a person believes a condition will always be the same as it has been lately, and overlooks the longer historical evidence. One example of this occurred prior to the housing market crash in 2007 and 2008. During the years preceding the crash, many homeowners held the belief that housing prices would always increase, which led many people to take on more mortgage debt than they could reasonably afford. There is also *confirmation bias*, people’s tendency to recognize only factors that support their beliefs and decisions, and the *clustering illusion* of seeing patterns in random occurrences.

Other factors that can play a part in poor decision making are particular blind spots a person might have, a general distaste for change, aversion to any kind of loss, a tendency to dwell on past negative events, and often overconfidence in their own knowledge and abilities.

Financial planning has been called “more of an art than a science” and part of this art is getting people to overcome their biases and make more rational decisions. The planner often has a more objective view and can develop techniques to help a client see a situation more clearly, perhaps by reframing the issue, asking questions, or even just pointing out fallacies in the client’s reasoning.

As part of step 2 in the planning process, when the planner is gathering qualitative data, a risk-tolerance questionnaire may be used to assess the client’s tolerance for
investment risk. This measures a person’s capacity to deal psychologically and emotionally with exposures to financial loss. A high tolerance for investment risk means a full night’s sleep even after investing 90% of the family’s savings in a speculative offering. Investment risk tolerance does not necessarily correlate with a person’s ‘lifestyle’ risk tolerance. Someone who jumps out of airplanes as a hobby might stock up on antacids when the stock market is volatile, while a person who is afraid of flying doesn’t give his or her portfolio any thought. (Investment planning is discussed further in Chapter 12 of this textbook.)
Chapter 1

The Financial Planning Process

1. What is the first step in the financial planning process?
   A. Developing a plan
   B. Establishing objectives
   C. Analyzing information
   D. Gathering data
   E. Establishing the nature of the client-planner relationship

2. After establishing objectives, what is the proper sequence of steps in the financial planning process?
   A. Monitor the plan, develop the plan, implement the plan, analyze information.
   B. Gather data, analyze information, develop the plan, implement the plan.
   C. Analyze information, develop the plan, monitor the plan, implement the plan.
   D. Implement the plan, analyze information, monitor the plan, develop the plan.

3. During the stage of the financial planning process requiring processing and analyzing information, the financial planner will undertake all the following actions, EXCEPT:
   A. Evaluate current economic conditions relating to the client’s financial condition.
   B. Quantify specific financial goals in dollar terms with definite time frames.
   C. Prepare a cash flow statement for the client.
   D. Prepare a statement of the client’s financial position.

4. Personal financial planning consists of the development and implementation of:
   A. Comprehensive personal objectives
   B. Coordinated, comprehensive strategies
   C. Asset allocation techniques
   D. Cash flow analysis
5. All the following statements concerning financial planning are correct, EXCEPT:

A. It points out existing or potential financial problems.
B. It presents resources available to attain goals in an organized manner.
C. It expedites cash inflow.
D. It helps make choices and plans to attain financial goals.

6. According to the pyramid approach to financial planning, which of the following should be addressed first:

A. Retirement planning.
B. Planning to avoid taxes in the transfer of an estate.
C. Emergency fund accumulation.
D. Investment of funds toward goals.

7. Which of the following statements regarding behavioral biases are true?

(1) Confirmation bias occurs when someone fails to recognize factors that support their beliefs and decisions.
(2) Anchoring bias is the tendency to put too much emphasis on past information, usually the first piece of information you encounter on a topic.
(3) Familiarity bias occurs when a person favors what he or she already knows.
(4) Recency bias occurs when not enough weight is given to recent occurrences.

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

8. All the following statements concerning behavioral finance are correct, EXCEPT:

A. Bandwagon bias is the tendency to follow the crowd.
B. Anchoring bias affects only investment selection decisions.
C. The clustering illusion occurs when patterns are seen in random occurrences.
D. Recency bias occurs when a person believes a condition will always be the same as it has been recently, and overlooks the longer historical evidence.
Chapter 1

The Financial Planning Process

1. E is the answer. The first step is establishing the nature of the relationship between the two parties. This includes defining what will be expected of/owed to each of the two parties.

2. B is the answer. After establishing objectives, the financial planner and client should gather data, analyze information, develop the plan, and implement the plan.

3. B is the answer. Quantifying specific financial goals in dollar terms with definite time frames is important, but this action should occur at the earlier stage of establishing objectives.

4. B is the answer. Personal financial planning is defined, for purposes of this course, as involving the development and implementation of coordinated, comprehensive strategies to achieve personal financial objectives.

5. C is the answer. C is a nonsensical incorrect statement. Only indirectly (and very indirectly!) would financial planning do anything to expedite cash inflow. A, B, and D are correct statements.

6. C is the answer. The pyramid approach to financial planning begins with building a solid foundation, which includes accumulation of an emergency fund, acquiring appropriate levels of insurance, and implementation of important documents such as the will and power of attorney.

7. B is the answer. Confirmation bias is the tendency to recognize only factors that support one’s beliefs and decisions. Many decisions are affected by recency bias, when a person believes a condition will always be the same as it has been lately, and overlooks the longer historical evidence.

8. B is the answer. B is an incorrect statement. Anchoring bias is the tendency to put too much emphasis on past information, usually the first piece of information you encounter on a topic. This bias can affect investment decisions, but also affects other financial decisions. For example, it could affect the decision to purchase insurance, the decision to purchase a particular type of vehicle, decisions regarding employment, and numerous other financial decisions.