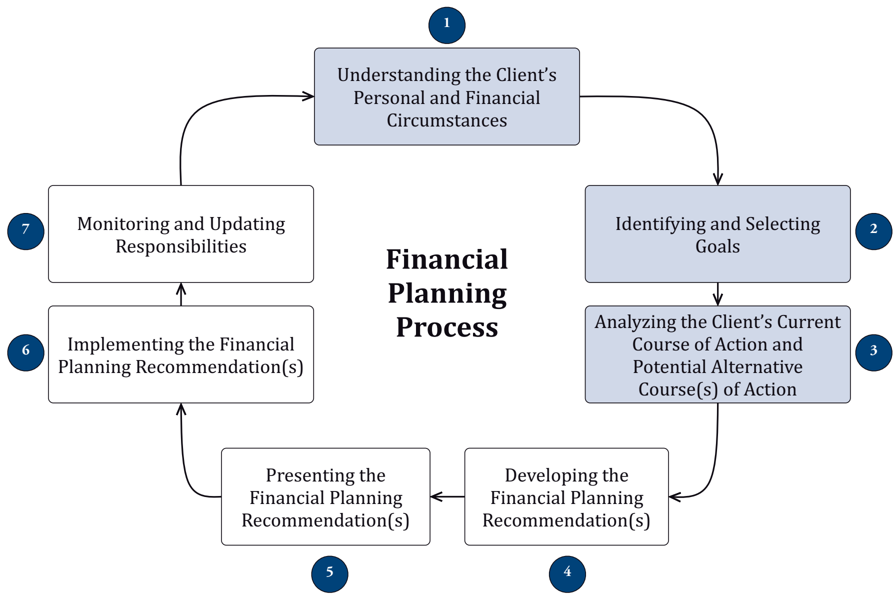
Exhibit 3.1 | Financial Planning Process[1]



The purpose of the analysis is to identify any weaknesses in the plan and make recommendations that will assist the client in achieving their goals.

THE APPROACHES TO FINANCIAL PLANNING ANALYSIS AND RECOMMENDATIONS

There are a wide array of possible approaches to analyzing, evaluating, and developing recommendations in the financial planning process. Each approach individually is useful and provides the planner and client with a slightly different perspective of the collected data. These approaches are identified and the benefits of each approach are briefly described below with further explanation later in the chapter.

- The **life cycle approach** - Data collection is quick, simple, and relatively nonthreatening to the client. It provides the planner with a brief overview of the client's financial profile permitting the planner to have a relatively focused initial conversation with the client. It is generally used very early in the engagement and is generally high level as opposed to detailed.
- The **pie chart approach** - This approach provides a visual representation of how the client allocates financial resources. It provides a broad perspective on the client's financial status and it is generally used after the collection of internal data and the preparation of financial statements. For example, the balance sheet pie chart illustrates the relative size of liabilities and net worth in comparison to total assets, the relative size of cash/cash equivalents, investment assets to total assets, and personal use assets in comparison to total assets. If a benchmark comparison pie chart from the metrics approach (discussed below) is added, it is often revealing for the client to discover the sources and uses of money and how much is used for debt service.

1. Abbreviated from the CFP Board's Financial Planning Practice Standards.

- The **financial statement and ratio analysis approach** - This approach helps to establish a financial snapshot of the client as of today. The ratio analysis provides an opportunity to assess the client's strengths, weaknesses, and deficiencies by comparing the client's ratios to the benchmark metrics. The ratio approach usually follows the pie chart approach and provides the planner with the actual financial ratios with which to compare the benchmarks in the metrics approach.
- The **two-step/three-panel approach** - A step-by-step approach in which the client's actual financial situation is compared against benchmark criteria. This approach is relatively thorough and presents a manageable approach to the client. It stresses the management of risk, seeks to avoid financial dependence, and promotes savings and investing to achieve financial independence.
- The **present value of goals approach** - This approach considers each short-term, intermediate-term, and long-term goal, determines their respective present value, then sums all of these together and treats the sum as an obligation (liability) that can then be reduced by current resources of investment assets, cash, and cash equivalents. The resultant is the net future obligation that will need to be retired over the remaining work life expectancy by savings at the expected rate of investment return using an ordinary annuity. This calculated annuity requirement (in dollars) is then compared to the current annual savings amount after any implemented risk management, other immediate recommendations, and a tax analysis to determine whether the current savings amount is adequate to fund all goals. As part of determining the ability to save, a pre- and post-recommendations tax analysis must be performed to determine whether the client is properly, over- or under-withheld on income taxes.
- The **metrics approach** - This approach uses quantitative benchmarks that provide rules of thumb for a measurement of where a client's financial profile should be. When combined with the two-step/three-panel approach, metrics help establish objectives that are dollar and percentage measurable compared to ratio analysis.
- The **cash flow approach** - This approach takes an income statement approach to recommendations. It uses the three-panel approach and uses a pro forma approach (as if) "to purchase" the suggested recommendations. This approach has the effect of driving down the discretionary cash flow. Next, positive cash flows or the sale of assets are identified and used to finance the recommendations.
- The **strategic approach** - This approach uses a mission, goal, and objective approach considering the internal and external environment and may be used with other approaches.

Key Concepts

1. List assumptions that the financial planner and client need to consider when developing a comprehensive financial plan.
2. Identify the eight approaches to financial planning analysis and recommendations.
3. Describe the types of information the financial planner gathers and analyzes using the life cycle approach.
4. Identify the three phases of the life cycle approach along with each phase's likely risks and goals.

Using any single approach described above is not likely to be adequate to develop a comprehensive financial plan. Employing all of the approaches simultaneously will create some redundancy, but considered together, will probably produce a comprehensive financial plan that is effective for the client. While a beginner planner may want to use all of the approaches, an experienced financial planner will find it sufficient to use a combination of a select few. For example, it is usually essential in any comprehensive plan to use the cash flow approach because it requires the client to prioritize and monetize each recommendation and determine the overall financial impact of each recommendation on the financial statements. Also, the cash flow approach clarifies the current and future resources to be used and whether or not they are sufficient to implement all of the recommendations or whether some recommendations will have to be deferred until additional resources are available. Experienced financial planners will combine approaches depending on the preferences of the planner and the needs of the client.

Exhibit 3.2 portrays examples of common financial and risk characteristics, by age group, of individuals with typical financial risks and goals. Financial planners should be familiar with these typical characteristics so that their particular client's financial wants, needs, and goals can be anticipated. This is not to say that everyone will have the same characteristics. Rather, that many people similarly situated will have the same or similar goals and risks.

Exhibit 3.2 | Examples of Common Client Profiles and Their Typical Life Cycle Factors, Financial Risks, and Goals

(These are selected and not intended to be exhaustive)

Life Cycle Factors							
Age	**22-30**	**25-35**	**25-35**	**35-45**	**45-55**	**55-65**	**65-75**
Marital Status	Single	Married**	Married	Married	Married	Married	Married
Children* **	No	No	Yes	Yes	Yes	Yes	Yes
Grandchildren* **	No	No	No	No	No	Yes	Yes
Income	$35-$75k	$35-$75k	$45-$100k	$50-$150k	$75-$200k	$100-$200k	$50-$200k
Net Worth	$10-$20k	$10-$20k	$15-$25k	$20-$40k	$50-$100k	$500-$1,200k	$400-$1,500k
Self Employed	No	No	No	No	Yes	Maybe	No
Typical Risks/Insurance Coverage Needs							
Life Insurance	No	Maybe	Yes	Yes	Yes	Yes	No
Disability	Yes	Yes	Yes	Yes	Yes	Yes	No
Health	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Long-Term Care*	No	No	No	No	No	Maybe Yes	Maybe Yes
Property	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Liability	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Typical Goals							
Retirement Security	Yes	Yes	Yes	Yes	Yes	Yes	In Retirement
Education Funding	No	No	Yes	Yes	Yes	No	No
Gifting	No	No	No	No	No	Yes	Yes
Lump-Sum Expenses	Yes	Yes	Yes	Yes	Yes	Yes	No
Legacy	No	No	No	No	No	Maybe	Maybe

** While younger clients will not typically require long-term care insurance, in some circumstances long-term care may be appropriate.*
*** Married could be married, divorced, or widow(er).*
**** Children and grandchildren are always yes, no, or maybe.*

THE LIFE CYCLE APPROACH

Using this approach, the planner gathers and analyzes the following information:

- the ages of the client and spouse/partner
- the client's marital status
- the number and ages of children and grandchildren
- the family income by each contributor
- the family net worth
- whether the client is employed, unemployed, self-employed, or retired

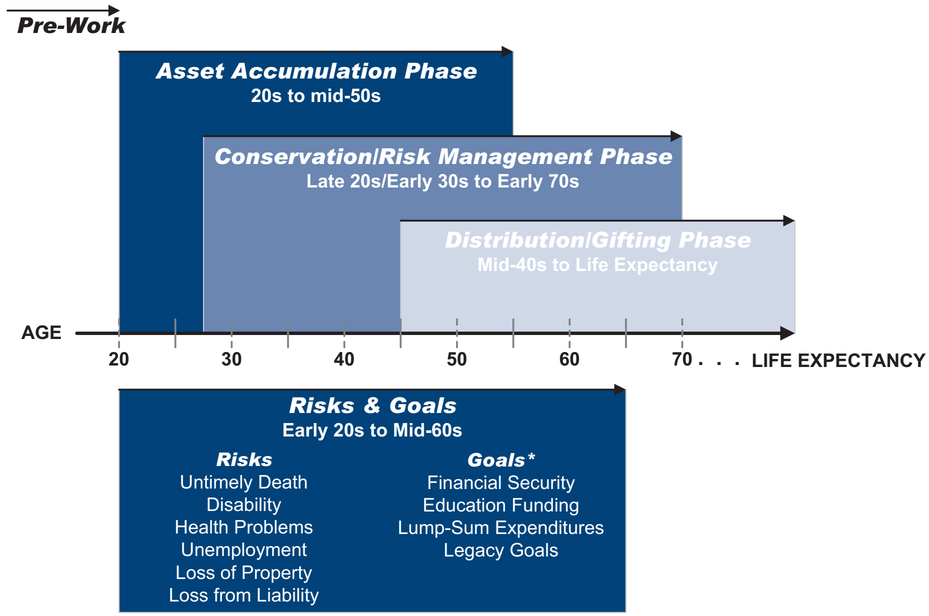
The life cycle approach is a broad overview of the client financial profile and is best employed to provide general information with which to focus an initial financial discussion with the client when the financial planner only has partial information. For example, a married couple with small children will probably have a goal to save for the college education of their children. Meanwhile they should be concerned about certain other risks such as their untimely death or disability. The life cycle approach serves as a foundation for a dialog with the client and gives the planner a 60-75 percent perspective of the risks the client is likely to be concerned about, as well as their likely financial goals.

It should be emphasized that there are no absolutes in personal financial planning. Each client is unique. Having said that, many clients fit into similar profiles (see **Exhibit 3.2**). The ages of the spouses may provide an indication as to what phase of life the client is in, as defined below.

- The **asset accumulation phase** usually begins in the early 20s and lasts to mid 50s when discretionary cash flow for investing is low and the debt-to-net worth ratio is high.
- The **conservation (risk management) phase** usually begins in the late 20s and lasts to the early 70s, where cash flow, assets, and net worth have increased and debts have decreased somewhat. In addition, risk management of events like unemployment, disability due to illness or accident, and untimely death become a priority.
- The **distribution (gifting) phase** usually begins in the mid 40s or early 50s and continues to the end of life. It is characterized by the individual having high cash flow, low debt, and high net worth.

Knowing the client's life cycle phase helps the planner to understand the client's likely risks and goals. It is entirely possible for a given client to be in two or even all three of these phases simultaneously. When special circumstances occur, such as the untimely death of a spouse, the conservation phase may even come before the asset accumulation phase.

Exhibit 3.3 | Life Cycles



*Financial security means retirement with adequate income to maintain lifestyle.

If the client is married, the couple typically files a joint income tax return and relies on both incomes for the payment of family expenses (such as a home mortgage, auto loans, etc.). This financial dependency creates a life insurance and disability insurance need for each spouse. The fact that a client has young children signals a need for both life and disability insurance, regardless of the parent's marital status. Young children may also indicate a client's need, or at least desire, for college education funding. If a client has grandchildren, gifts, tuition payment plans, and other transfers during life (gifts) or at death (bequests) to or for grandchildren may be a consideration. Older clients may also be thinking about estate planning needs.

The planner should conduct a comprehensive review of the complete insurance portfolio for all clients (especially for those in the risk management phase). This review should include an analysis of the need for and the use of life insurance, health insurance, disability insurance, long-term care insurance, property insurance, and liability insurance.

Other client profile characteristics that provide insight into the client's needs include:

- Any client that is simultaneously in the accumulation and conservation phase has financial security (retirement) as a long-term goal.
- Generally, the higher a client's net worth and the greater a client's income, the more interest that client has in income tax minimization.
- If a client is self-employed, it creates opportunities to use employer-sponsored retirement plans to assist that client in accomplishing long-term financial security goals.

Analyzing client data to achieve long-term financial goals takes time. Achieving those financial goals takes persistent savings and good investment returns. Unfortunately, risks that are insured against, such as untimely death, disability, health issues, and loss of property or personal liability, are unexpected events that can occur at any time. An uninsured loss can destroy even the best conceived savings and investment plan. Therefore, clients need to make having an appropriate risk management portfolio their highest priority goal. A great retirement investment plan with a time horizon of 30 years that relies on persistent savings and investment returns can be abruptly derailed if the client becomes disabled before retirement and has no disability insurance benefits.

The life cycle approach provides financial planners with a broad overview of the client's probable risks and likely goals. It is a good place to start, but it lacks the specifics to direct the planner in analyzing internal and external data and in developing a detailed, comprehensive financial plan.

THE PIE CHART APPROACH

A pie chart focuses the client on the relative size of financial variables. People can only spend 100 percent of what they have, and visualizing where the money goes is often a sobering, but helpful exercise. The pie chart approach is an effective analytical and illustrative tool for financial planning clients.

The pie chart approach provides the planner and the client with separate pictorial representations of the balance sheet and the statement of income and expenses. These financial statements are discussed in detail in Chapter 4.

The financial statements are prepared first and then depicted in pie charts. One set of pie charts is for the statement of income and expenses (income statement) and the other set is for the balance sheet (statement of financial position). Note that the statement of income and expenses (income statement) is also referred to as the cash flow statement. For purposes of this textbook, it is not referred to as the cash flow statement because not all cash flows are included in the statement (such as inheritance of cash). The pie chart approach generally uses percentages of the whole, but can use a dollar approach. The percentage approach is usually more effective for comparison purposes.

Key Concepts

1. Identify the financial planning usefulness of the income statement pie chart.
2. Understand the questions that the balance sheet pie chart should answer and illustrate.
3. Identify the reason for creating benchmark pie charts.

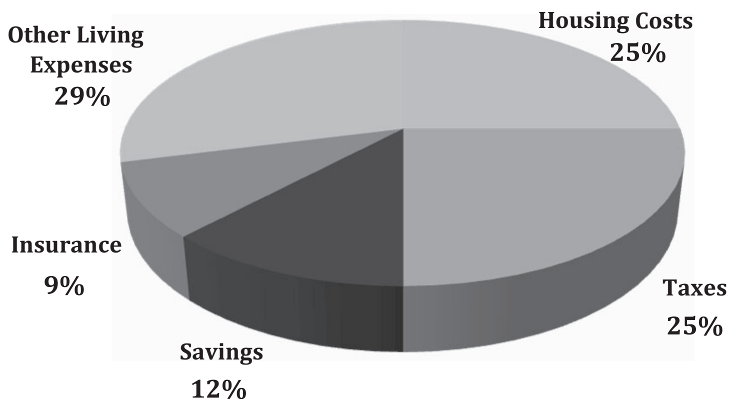
Income Statement Pie Chart

The questions that the pie chart approach addresses are:

- What percentage of gross pay is the client paying in taxes (income and Social Security)?
- What percentage of the client's gross pay are they saving?
- What percentage of the client's gross pay goes to protection (insurance)?
- What percentage of the client's gross pay is spent on basic housing costs (principal, interest, tax, and insurance or rent plus insurance)?
- What percentage of the client's gross pay is spent on debt repayments both excluding housing costs and including housing costs?
- What percentage of the client's gross pay is left to live on?

For example, the following sample income statement pie chart reflects total living expenses of 54 percent (housing costs 25% plus other living expenses). This is useful information for the planner to analyze considering a client's other characteristics (e.g., age, gross pay, risks, etc.). To build the pie chart, the planner calculates the client's expenses from the income statement as a proportion of the client's gross pay and portrays them in the income statement pie chart.

Exhibit 3.4 | Income Statement Pie Chart



There are many flexible and creative ways to make a pie chart. One useful way is total income arrayed by percentage of:

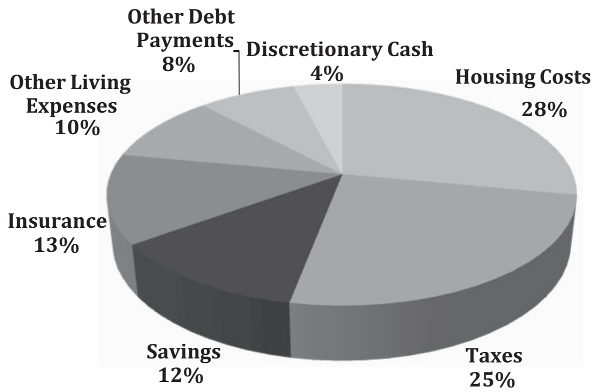
- savings
- housing costs
- other debt payments (ODP)
- insurance other than property insurance
- all other living costs (OLC)
- taxes other than property taxes
- net discretionary cash flows (DCF), presuming that they are positive

The pie chart approach has some shortcomings, including that it is difficult to depict negative cash flows in pie charts and it does not lend itself to detailed analysis and recommendation. It is, however, a useful depiction of where the client is at the moment.

Example 3.1

Assume a client has gross pay of $100,000 and expenses as listed in the table below. The data can be reflected in an income statement pie chart, allowing the client to visualize his financial situation as pertains to income and expenses.

Example Income = $100,000



	Amount	*Percentage*
Gross Income	$100,000	100%
Taxes	$25,000	25%
Savings	$12,000	12%
Insurance	$13,000	13%
Housing Costs	$28,000	28%
Other Debt Payments (ODP)	$8,000	8%
Other Living Costs (OLC)	$10,000	10%
Discretionary Cash Flow (DCF)	$4,000	4%

The data is easy to depict on an income statement pie chart with the percentages that a client is paying for taxes, saving for the future, and paying insurance premiums (25% + 12% + 13% = 50%) to protect the client's assets that have or will be accumulated. That leaves approximately 50 percent of the income for current living expenses, 10-28 percent of which is typically allocated to housing or shelter costs. **Exhibit 3.5** provides targeted example benchmarks for various income statement items.

The pie chart approach assists the planner and client by illustrating if the client is spending too much on debt repayment or too much on housing, either of which may result in undersaving or being underinsured. The financial planner can then present benchmark pie charts that illustrate where a client should be in order to meet typical goals and objectives.