**Chapter 1**

**Understanding the**

**Financial Planning Process**

**Chapter Outline**

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B. Spending Money Wisely

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C. Accumulating Wealth

\*Concept Check\*

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\*Concept Check\*

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\*Concept Check\*

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\*Concept Check\*

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#### **Major Topics**

Personal financial planning provides major benefits that help us to more effectively marshal and control our financial resources and thus gain an improved standard of living. Because the emphasis in this text is on planning—looking at the future—we must examine many areas to set and implement plans aimed at achieving financial goals. These areas are introduced in this chapter and examined in detail in later chapters. The major topics covered in this chapter include:

1. The benefits of personal financial planning techniques in managing finances, improving one’s standard of living, controlling consumption, and accumulating wealth.

2. Defining financial goals and understanding the personal financial planning process necessary to achieve them.

3. Financial planning as a lifetime activity that includes asset acquisition plans, liability and insurance plans, savings and investment plans, employee benefit plans, tax plans, and retirement and estate plans.

4. Special planning concerns, including managing two incomes, planning employee benefits, and adapting to other major life changes.

5. The use of professional financial planners in the financial planning process, the various types of financial planners, and choosing a financial planner.

6. The influence of government, business, and consumer actions and changing economic conditions on personal financial planning.

7. Age, marital status, education, geographic location, and career as important determinants of personal income levels.

8. The important relationship between career planning and personal financial planning.

# Key Concepts

To begin developing a personal financial plan, one must understand basic financial planning terminology, principles, and environmental factors. The following phrases represent the key concepts stressed in the chapter.

1. Standard of living

2. Consumption patterns

1. Wealth accumulation
2. The personal financial planning process
3. Financial goals
4. The role of money
5. The psychology of money
6. Money and relationships
7. Types of financial goals
8. The life cycle of financial plans
9. Plans to achieve financial goals
10. Technology in financial planning
11. The planning environment—players, economy, and price levels
12. Special planning concerns
13. Financial planners
14. Determinants of personal income
15. Career planning
16. Average propensity to consume
17. Financial assets, Tangible assets, and Liquid assets
18. Utility
19. Liability
20. Flexible benefit (cafeteria) plans
21. Commission-based versus fee-only planners
22. Factors of production
23. Fiscal policy
24. Monetary policy
25. Economic cycles (business cycles)
26. Expansion versus Contraction
27. Peak versus Trough
28. Inflation
29. Consumer price index and Purchasing power

## Answers to Concept Check Questions

1-1. *Standard of living,* which varies from person to person, represents the necessities, comforts, and luxuries enjoyed by a person. It is reflected in the material items a person owns, as well as the costs and types of expenditures normally made for goods and services.

Although many factors such as geographic location, public facilities, local costs of living, pollution, traffic, and population density affect one’s quality of life, the main determinant of quality of life is believed to be wealth.

1-2. Generally,consumption patternsare related to quality of life, which depends on a person’s socioeconomic strata. This implies that wealthy persons, who are likely to consume non-necessity items, quite often live higher quality lives than persons whose wealth permits only consumption of necessities.

1-3. The *average propensity to consume* is the percentage of each dollar of a person’s income that is spent (rather than saved), on average, for current needs rather than savings. Yes, it is quite possible to find two persons with significantly different incomes with the same average propensity to consume. Many people will increase their level of consumption as their incomes rise, i.e., buy a nicer home or a newer car. Thus, even though they may have more money, they may still consume the same percentage (or more) of their incomes as before.

1-4. An individual’s *wealth* is the accumulated value of all items he or she owns. People accumulate wealth as either financial assets or tangible assets. *Financial assets* areintangible assets such as savings accounts or securities, such as stocks, bonds and mutual funds. Financial assets are expected to provide the investor with interest, dividends, or appreciated value. *Tangible assets* are physical items, such as real estate, automobiles, artwork, and jewelry. Such items can be held for either consumption or investment purposes or both.

1-5. *Money* is the exchange medium used as the measure of value in our economy. Money provides the standard unit of exchange (in the case of the U.S., the dollar) by which specific personal financial plans—and progress with respect to these plans—can be measured. Money is therefore the key consideration in establishing financial plans. *Utility* refers to the amount of satisfaction derived from purchasing certain types or quantities of goods and services. Since money is used to purchase these goods and services, it is generally believed that greater wealth (money) permits the purchase of more and better goods and services that in turn result in greater utility (satisfaction).

1-6. Money is not only an *economic* concept; it is also a *psychological* one that is linked through emotion and personality. Each person has a unique personality and emotional makeup that determines the importance and role of money in his or her life, as well as one’s particular money management style. Personal values also affect one’s attitudes to money. Money is a primary motivator of personal behavior and has a strong impact on self-image. To some, money is of primary importance, and accumulation of wealth is a dominant goal. For others, money may be less important than lifestyle considerations. Therefore, every financial plan must be developed with a view towards the wants, needs, and financial resources of the individual and must also realistically consider his or her personality, values, and money emotions.

Money is frequently a source of conflict in *relationships*, often because the persons involved aren’t comfortable discussing this emotion-laden topic. Each person may have different financial goals and personal values, leading to different opinions on how to spend/save/invest the family’s money. To avoid arguments and resolve conflicts, it is essential to first become aware of each person’s attitude toward money and his or her money management style, keep the lines of communication open, and be willing to listen and to compromise. It is possible to accommodate various money management styles within a relationship or family by establishing personal financial plans that take individual needs into account. Some families are able to avoid conflict by establishing separate accounts, such as yours, mine and household, with a set amount allocated to each account each pay period. This way, no one feels deprived, and enough has been set aside to pay the bills and to meet common financial goals.

1-7. Realistic goals are set with a specific focus and a reasonable time frame to achieve results. It is important to set realistically attainable financial goals because they form the basis upon which our financial plans are established. If goals are little more than “pipe dreams,” then the integrity of the financial plans would be suspect as well

Students’ descriptions of the steps to achieve a specific goal will, of course, vary. They should follow the general guidelines in the chapter: define financial goals, develop financial plans and strategies to achieve goals, implement financial plans and strategies, periodically develop and implement budgets to monitor and control progress toward goals, use financial statements to evaluate results of plans and budgets, and redefine goals and revise plans as personal circumstances change.

1-8. Individual time horizons can vary, but in general individuals would expect to achieve their *short-term* financial goals in a year or less, *intermediate-term* goals in the next 2-5 years, and *long-term* financial goals in more than 5 years. Refer to Worksheet 1.1 on p. 14 of the text for examples of financial goals.

In making personal financial goals, individuals must first carefully consider their current financial situation and then give themselves a pathway to reach their future goals. People in the early stages of their financial planning life cycle may need more time to accomplish long-term goals than those who are already established in their careers and may also need to give themselves more flexibility with their goal dates.

1-9. Financial plans provide the roadmap for achieving your financial goals. The six-step financial planning process (introduced in Exhibit 1.3) results in separate yet interrelated components covering all the important financial elements in your life. Some elements deal with the more immediate aspects of money management, such as preparing a budget to help manage spending. Others focus on acquiring major assets, controlling borrowing, reducing financial risk, providing for emergency funds and future wealth accumulation, taking advantage of and managing employer-sponsored benefits, deferring and minimizing taxes, providing for financial security when you stop working, and ensuring an orderly and cost effective transfer of assets to your heirs.

1-10. Personal needs and goals change as you move through different *stages of your life*. So, too, do financial goals and plans, because they are directly influenced by personal needs. When your personal circumstances change, your goals must reflect the new situation. Factors such as job changes, a car accident, marriage, divorce, birth of children or the need to care for elderly relatives must be considered in revising financial plans.

1-11. The loss of *two percentage points* on investment returns is anything but inconsequential, particularly if the loss occurs annually over a period of several years. For example, if Chad had invested $1,000 at an 8 percent return and subsequently had invested all earnings from the initial investment at 8 percent, in 40 years he would have accumulated $21,725 from the initial $1,000 investment. If, on the other hand, he had earned a 10 percent return on the same investment, he would have accumulated $45,259 in 40 years—more than double his return at 8 percent! Clearly, two percentage points over time can make a significant difference! Calculate various rates of return on a $1,000 investment to see that for every 2 percent increase in return, your investment results will more than double over a 40-year period.

By carefully considering his investment and banking choices, it is likely that Chad would be able to get a 2 percent greater rate of return without taking on additional risk. This can be done both by choosing investments and bank accounts that hold down expenses, as well as by finding investments of the same type that have performed better.

1-12. *Employee benefits,* such as insurance (life, health, and disability) and pension and other types of retirement plans, will affect your personal financial planning. You must evaluate these benefits so that you have the necessary insurance protection and retirement funds. If your employer’s benefits fall short of your needs, you must supplement them. Therefore, employee benefits must be coordinated with and integrated into other insurance and retirement plans.

*Tax planning* involves looking at an individual’s current and projected earnings and developing strategies that will defer and/or minimize taxes. For income tax purposes, income may be classified as active income, passive income, or portfolio income. While most income is currently subject to income taxes, some may be tax free or tax deferred. Tax planning considers all these dimensions and more. Tax planning is an important element of financial planning because it guides the selection of investment vehicles and the form in which returns are to be received. This means that it is closely tied to investment plans and often dictates certain investment strategies.

1-13. This statement reflects a very limited and too often expressed point of view. Due to the inconsistencies and vagaries of our economic system—and of life itself!—the goals of and plans for retirement should be established early in life. If retirement goals are incorporated into an individual’s financial planning objectives, short- and long-term financial plans can be coordinated. Thus, financial plans can guide present actions not only to maximize current wealth and/or utility, but also to provide for the successful fulfillment of retirement goals. Furthermore, if retirement is desired earlier than anticipated, the plans may still permit the fulfillment of retirement goals.

1-14. Just like you, financial plans go through stages.

a) Being part of a dual income couple:

Couples should discuss their money attitudes and financial goals and decide how to manage joint financial affairs *before* they get married. Take an inventory of your financial assets and liabilities, including savings and checking accounts; credit card accounts and outstanding bills; auto, health, and life insurance policies; and investment portfolios. You may want to eliminate some credit cards. Too many cards can hurt your credit rating, and most people need only one or two. Each partner should have a card in his or her name to establish a credit record. Compare employee benefit plans to figure out the lowest-cost source of health insurance coverage, and coordinate other benefits. Change the beneficiary on your life insurance policies as desired. Adjust withholding amounts as necessary based on your new filing category.

b) Major life changes such as marriage and divorce:

*Marriage.* Finances must be merged and there may be a need for life insurance.

*Divorce.* Financial plans based on two incomes are no longer applicable. Revised plans must reflect any property settlements, alimony, and/or child support.

c) Death of a spouse:

The surviving spouse is typically faced with decisions on how to receive and invest life insurance proceeds and manage other assets. In families where the deceased made most of the financial decisions with little or no involvement of the surviving spouse, the survivor may be overwhelmed by the need to take on financial responsibilities. Advance planning can minimize many of these problems.

1-15. Unlike accounting and law, the field professional financial planning field is largely unregulated, and almost anyone can call themselves a *professional financial planner.* Most financial planners are honest and reputable, but there have been cases of fraudulent practice. So, it’s critical to thoroughly check out a potential financial advisor–preferably interview two or three.

Most financial planners fall into one of two categories based on how they are paid: commissions or fees. *Commission-based planners* earn commissions on the financial products they sell, whereas *fee-only planners* charge fees based on the complexity of the plan they prepare. Many financial planners take a hybrid approach and charge fees and collect commissions on products they sell, offering lower fees if you make product transactions through them.

The way a planner is paid—commissions, fees, or both—should be one of your major concerns. Obviously, you need to be aware of potential conflicts of interest when using a planner with ties to a brokerage firm, insurance company, or bank. Many planners now provide clients with disclosure forms outlining fees and commissions or various transaction costs.

1-16. Government, businesses, and consumers are the three major participants in the economic system. *Government* provides the structure within which businesses and consumers function. In addition, it provides a number of essential services that generally improve the quality of the society in which we live. To create this structure, various regulations are set forth, and to support its activities and provision of essential services, taxes are levied. These activities tend to constrain businesses and consumers.

*Businesses* provide goods and services for consumers and receive money payments in return. They also employ certain inputs in producing and selling goods and services. In exchange they pay wages, rents, interest, and profit. Businesses are a key component in the circular flow of income that sustains our economy. They create the competitive environment in which consumers select from many different types of goods and services. By understanding the role and actions of businesses on the cost and availability of goods and services, consumers can better function in the economic environment and, in turn, implement more efficient personal wealth maximizing financial plans.

*Consumers* are the focal point of the personal finance environment. Their choices ultimately determine the kinds of goods and services that businesses will provide. Also, consumer spending and saving decisions directly affect the present and future circular flows of income. Consumers must; however, operate in the financial environment created by the actions of government and business. Consumers may affect change in this environment through their elected officials, purchasing decisions and/or advocacy groups. Yet, basically, change occurs slowly and tediously, often with less than favorable results. Thus, consumers should attempt to optimize their financial plans within the existing financial environment.

1-17. The stages of the economic cycles are *expansion, peak, contraction*, and *trough.* Each of these stages relates to real gross domestic product (GDP), which is an important indicator of economic activity.The stronger the economy, the higher the levels of real GDP and employment*.* During an *expansion,* employment is high, the economy is active and growing, and prices tend to rise. During an expansion, real GDP increases until it hits a peak, which usually signals the end of the expansion and the beginning of a contraction. During a contraction, real GDP falls into a trough, which is the end of a contraction and the beginning of an expansion. An understanding of these four basic stages, coupled with knowledge of the stage in which the economy is presently operating, should permit individuals to adjust and implement financial actions in order to efficiently and successfully achieve their personal financial goals.

1-18. *Inflation* is a state of the economy in which the general price level is rising. It is important in financial planning because it affects what we pay for goods and services; it impacts how much we earn on our jobs; it directly affects interest rates and, therefore, it affects such things as mortgage and car loan payments. The most common measure of inflation is the *consumer price index,* which is based on the changes in the cost of a typical “market basket” of consumer goods and services. This can be used to compare changes in the cost of living over time for the typical family. Inflation is measured by the percentage change in the consumer price index from one time period to another, so that as the CPI rises, the cost of living also increases.

1-19. Disagree. Although higher levels of education may result in higher levels of income, this does not mean that everyone with a given level of education will achieve a specified level of income. Factors such as age, marital status, geographical location, and career choice also impact a person’s level of income. A number of other factors, such as the degree of personal motivation and the methods by which one utilizes his or her formal education, can also affect one’s income level.

1-20. *Career planning* is a critical part of the life cycle of the personal financial planning process. The choice of a career affects the amount you earn. By setting both short- and long-term career goals, you can incorporate them into your financial plans. For example, if you need additional education and/or other training for a particular job, you may include a savings plan to obtain the needed funds. You should reevaluate your career decision periodically to see if it still meets your personal and financial goals. Other important considerations with regard to a specific job (and company) include the earnings potential, advancement opportunities, and benefits, plus how well the job fits your lifestyle and values. In today’s rapidly changing job environment, you should expect to change careers several times. It is important to keep up with developments in your industry, acquire a broad base of experience, and continue to learn new skills, both general and technical.

Each student will, of course, have a different list of personal career goals based upon his or her career orientation and goals. However, responses should include discussion of personal financial planning and associated career planning goals and how a career choice would best fulfill quality of life, standard of living, and wealth maximization objectives. Goals might include getting a bachelor’s, master’s or other degree, working in a specific industry, owning one’s own business, finding a job in a different area of the country or overseas, achieving a desired salary and/or responsibility level by a certain age, or finding a job that meets lifestyle needs.

#### **Financial Planning Exercises**

1. Student answers will vary. In general, using personal financial planning tools help individuals to organize their finances, evaluate their current financial condition, and track changes in their financial condition through time to see if they are making progress toward their financial goals.
2. Student answers will vary depending on their personal situation. The purpose of this exercise is to encourage students to focus on how their personal goals and plans will change over their financial planning life cycle and also to help them be specific in setting their goals by designating dollar amounts and dates.
3. Student answers will vary. Suggestions may include the following:
4. Junior in college—pay off all credit card debt by graduation; pay off all student loans within 10 years of graduation; save $2,000 for a down payment on another vehicle during the next 2 years.
5. 30-year old computer programmer who plans to earn an MBA—pay off auto loan before beginning degree; find a cheaper place to live; set aside $5,000 for emergency use during school.
6. Couple in their thirties with two children, ages three and six—begin college fund for each child; fund Roth IRAs for both parents; max out employer-sponsored retirement plan, such as 401k, each year.
7. Divorced 42-year old man with a 16-year old child and a 72-year old father who is ill—engage the help of friends or family in carpooling teenager to school and activities; explore community or church programs which might provide assistance for the father, such as Meals on Wheels or a visitation program; help father with estate planning needs, hiring an attorney if needed.
8. Answers on economic trends will depend on current economic conditions. If the GDP is growing, the economy is expanding and general economic conditions are considered favorable. Unemployment is probably low, and jobs are available. If the GDP is slowing, the economy may not be doing well, and jobs may be scarce. Changes in the CPI indicate the level of inflation. If inflation is rising, purchasing power is declining, and you will need more money to achieve your financial goals. In periods of high inflation, interest rates rise making it more difficult to afford big-ticket items.
9. Possible steps to “repackage” yourself might include:

* Analyzing skills and experience to identify transferable skills
* Looking for companies in related fields and industries
* Considering your own interests to see if other career paths make sense
* Networking extensively
* Researching fields that use your skills
* Developing functional resume focusing on skills rather than job titles

**Solutions** **to Critical Thinking Cases**

* 1. **Tom’s Need to Know: Personal Finance or Golf?**

1. Personal financial planning is a process through which financial plans are developed and implemented to achieve personal financial goals. An individual can develop these goals in a fashion consistent with his or her emotional needs and preferences. As a process, personal financial planning is dynamic and prospective as well as immediate and retrospective. Furthermore, it can be adjusted to changes in goals, emotional orientation, available resources, and the economic environment.

2. Personal financial planning covers the key elements of one’s financial affairs and provides a plan to achieve financial goals. Income level is one input in the process but does not dictate its importance. An efficient, well-developed personal financial plan can help to maximize an individual’s wealth and quality of life given his or her income and goals. If desired goals cannot be met with a given level of income, financial planning will help evaluate what is really important and establish realistic and attainable goals. Thus, financial planning is important regardless of one’s income.

3. The personal financial planning environment is made up of three key groups, all of which Tom will contact directly or indirectly. *Government* establishes an intangible structure in which an economy or society must function. It levies taxes to fund its operations and institutes regulations which direct and control the actions of the participants in the economic environment. *Businesses* produce goods and services, employ labor, and use land and capital. They receive money as payment for their goods and services and pay wages, rents, interest, and profit. Businesses are a key part of the circular flow of income supporting our economy. Businesses establish the price and availability of goods and services in our economy through competitive interaction with each other and interfacing with government and consumers. Finally, the *consumer* is the focal point of the financial planning environment. Consumer choices determine the types of products and services businesses provide. Because consumers are net providers of funds to government and businesses, their decisions to spend or save have a major effect on the planning environment. However, government and businesses place a number of constraints on the environment, and consumers must therefore function within those limits.

The economy is a dynamic mechanism that reacts to numerous inputs. Economic fluctuations can cause significant changes in one’s wealth, thereby affecting financial plans. Changes in price levels result from increases in inflation, which can directly affect an individual’s present and future consumption patterns, level of wealth, standard of living, and quality of life. Changes in economic conditions also affect nearly all aspects of one’s financial life, from career choices to retirement. Thus, the state of the economy and its fluctuations are important factors defining the financial planning environment and affecting how one implements a financial plan.

4. Although beginning golf would probably provide a great deal of personal satisfaction, personal finance would, in the long run, provide more benefits. The personal finance course will help Tom better understand the financial environment, thereby allowing him to establish a realistic quality of life and personal financial goals. He could then develop a plan to achieve his goals and a methodology for monitoring the ongoing effectiveness of that plan. With an understanding of the personal finance environment, the financial planning process, and goal setting techniques, Tom can optimize the use of his assets, provide for a secure financial future, and acquire the resources to realize his quality of life goals. Finally, the rewards achieved from using these financial planning techniques could, in the future, allow Tom to take not only beginning golf but also intermediate golf and possibly join a golf club.

**1.2** **Zack’s Dilemma: Finding a New Job**

This case asks students to consider the long-range implications of career and financial planning. In today’s business world, changes in the economy and in corporate strategies often result in workforce downsizing. Many students may be faced with the loss of a job during their working years. They may find themselves in Zack’s position, overqualified for some jobs and underqualified for others. Knowing what steps to take to avoid this situation is an important aspect of career and financial planning.

There are many correct answers to these questions; some possibilities are given below.

1. Important career factors for Zack to consider when looking for a new job include salary, opportunity for advancement, his transferable skills that could apply to a field other than retailing, availability of benefits, available training programs, types of industries and companies (size, work environment, etc.) that interest him, and tuition reimbursement policies so he can finish his degree.

2. Personal factors that Zack should take into account as he investigates job opportunities include location/need to relocate (his children live in the area), personal lifestyle needs (is he willing to travel, work overtime, commute further?), type of work situation most suitable for him (managing others, part of a team, level of public contact, etc.), and any personal interests that could open doors to a new career. (There is some overlap between career and personal factors.)

3. Zack should consider a lower-paying job on a short-term basis and at the same time look for a managerial job in another field. He cannot afford to wait out the recession; his funds will run out in a few months. This two-pronged approach is therefore preferable to one or the other. A job at a lower salary, particularly one with good benefits and a tuition reimbursement policy, would allow him to finish his degree or obtain other job training to qualify for a better position. Because he has no dependents, he should be able to cover his living expenses, although he may have to cut back on some discretionary expenses. He should look in several fields and not limit himself to retailing, particularly if he does not wish to relocate to another area of the country away from his grown children. If he is committed to staying in retailing, he probably will have to move. He needs to determine his personal priorities to make these decisions. We do not have enough information to know what they would be. He may want to participate in some career workshops or get some career counseling to work out some of these issues.

4. There are many strategies today’s workers can employ to avoid being placed in Zack’s position. Staying with one employer and one basic type of work for 28 years, as Zack did, will be the exception rather than the rule. Job changes, whether voluntary or involuntary, should be made with certain objectives in mind, such as broadening your base of experience and learning new skills—for example, computer skills and management responsibility. Keeping up with industry trends and overall economic conditions is very important. This can alert you to the skills needed for future success and provide advance warning of possible downsizings. Don’t allow yourself to be “pigeonholed” into one very specific type of job for too long; look for opportunities to transfer within your company or to another firm to get more diverse experience. Think of your capabilities in terms of general skills that can be applied to other jobs, companies, and industries. Develop and maintain a network of professional contacts in firms and industries that appeal to you, and be willing to share your knowledge with others who need your help.