PFIN 7th edition Billingsley Solutions Manual

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Chapter 1

Understanding the Financial Planning Process

HOW WITH THIS AFFECT ME?

The heart of financial planning is making sure your values line up with how you spend and save. That means knowing where you are financially and planning on how to get where you want to be in the future no matter what life throws at you. For example, how should your plan handle the projection that Social Security costs may exceed revenues by 2034? And what if the government decides to raise marginal tax rates to help cover the federal deficit? An informed financial plan should reflect such uncertainties and more.

This chapter describes the financial planning process and explains its context. Topics include how financial plans change to accommodate your current stage in life and the role that financial planners can play in helping you achieve your objectives. After reading this chapter you will have a good perspective on how to organize your overall personal financial plan.

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:

1-1 Identify the benefits of using personal financial planning techniques to manage your finances.

The benefits of personal financial planning techniques include managing finances, improving one's standard of living, controlling consumption, and accumulating wealth. See Exhibit 1.1. Financial Plans results in Financial Actions that ends with Financial Results. 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

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estate plans. The importance of the rate of return on investments and the length of time the funds are invested **cannot** be understated.

1-2 Describe the personal financial planning process and define your goals.

See Exhibit 1.3 for the six-step financial planning process. Defining financial goals and understanding the personal financial planning process necessary to achieve them will lead to attaining the financial goals you set. Most Americans believe that money gives them freedom to soar like an eagle. Money is an important motivator of personal behavior because it has a strong effect on self-image. Money can be one of the most emotional issues in any relationship.

Types of financial goals include controlling living expenses, meeting requirement needs, maintaining investment programs, minimizing taxes, sending kids to college, and buying a house, furniture, and cars. Financial goals should be specific [not save some money, but set aside 10% of take-home pay each period], they should be written done [putting goals on paper or in a word file, helps to formulate your goals], and they should be for a specific time period [short term goals for six months and one year; long-term goals of five years and thirty years]. See Worksheet 1.1 for an approach to writing down your goals.

1-3 Explain the life cycle of financial plans, their role in achieving your financial goals, how to deal with special planning concerns, and the use of professional financial planners.

From goals you determine plans to achieve the goal. It is not a one and done process, but a lifetime of developing plans, comparing to actual results, and modifying plans in order to finally achieve goals.

Exhibit 1.4 graphically displays the financial planning life cycle.

Exhibit 1.5 shows the importance of rate of return and time of an investment. The students need to understand this exhibit. If they are going to get a tattoo it should be this exhibit.

The use of professional financial planners in the financial planning process, the various types of financial planners, and choosing a financial planner should be discussed. Having a financial planner is like having a personal trainer. Of course, you can do it yourself, but it helps to have someone looking over your shoulder and pointing out your failure to follow your plan.

1-4 Examine the economic environment's influence on personal financial planning.

The influence of government, business, and consumer actions and changing economic conditions on personal financial planning must be understood. Events outside of your control happen. Your financial plan must include the ability to react to these external factors.

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1-5 Evaluate the impact of age, education, and geographic location on personal income.

Exhibit 1.8 points out that the more education you have the greater your earning capacity. But education is no guarantee. A PhD in French Literature does not have the earning capacity of a PhD in Engineering or Finance.

1-6 Understand the importance of career choices and their relationship to personal financial planning.

Exhibit 1.8 shows that it does matter what you major in for your college degree. The discipline you choose for your life works will impact your financial wealth.

The Chapter Review Cards at the end of the textbook are very useful in summarizing the major topics in the chapter. It would be good to point out to students.

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Financial Facts or Fantasies?

These may be used as a quiz or as a pre-test to get the students interested.

1. True False Your income level depends on your age, education, and career choice

2. True False Over the long run, gaining only an extra percent or two on an investment makes little difference in the amount of earnings generated

3. True False Personal financial planning involves translating personal financial goals into specific plans and arrangements that put these plans into action.

4. True False A savings account is an example of a tangible asset because it represents something on deposit at a bank or other financial institution.

5. True False An improved standard of living is one of the payoffs of sound personal financial planning.

Answers:
1. True 2. False 3. True 4. False 5. True

FINANCIAL IMPACT OF PERSONAL CHOICES

Jacob Cuts Back on Lunch Out and Lattes

Jacob buys lunch out most days and buys a latte every morning. He believes he could cut back a bit and save $5 a day, which is $35 a week and $140 a month. What is the impact of this seemingly modest cutback?

If Jacob invests his $35 savings a week every month at 5 percent, he will have the following in the future:
- 20 years: $57,545
- 30 years: $116,516
- 40 years: $213,643

The seemingly small act of investing only $5 a day would have a dramatic long-term effect on Jacob's future accumulated wealth

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Financial Planning Exercises

The following are solutions to problems at the end of the PFIN 7 textbook chapter.

1. Benefits of Personal financial Planning: How can using personal financial planning tools help you improve your financial situation? Describe changes you can make in at least three areas.

Students' answers will vary. In general, using personal financial planning tools helps 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. Note the example, "Ethan Cuts Back on Lunch Out and Lattes". Personal Choices impact your financial plan.

2. Personal Financial Goals and the Life cycle: Fill out Worksheet 1.1, "Summary of Personal Financial Goals," with goals reflecting your current situation and your expected life situation in 5 and 10 years. Discuss the reasons for the changes in your goals and how you'll need to adapt your financial plans as a result.

Students' 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. The example Worksheet 1.1 in the chapter can be used as an example for class discussion.

3. Personal Financial Goals: Recommend three financial goals and related activities for someone in each of the following circumstances:

a. A junior in college

b. A 28-year-old computer programmer who plans to earn an MBA degree

c. A couple in their 30s with two children, ages 5 and 9

d. A divorced, 52-year-old man with a 16-year-old child and a 78-year-old father who is ill

Students' answers will vary. Suggestions may include the following:
a. Junior in college—pay off all credit card debt by graduation; pay off all student loans within 10 years of graduation; save $4,000 for a down payment on another vehicle during the next four years; review selection of major.

b. 28-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.

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c. Couple in their 30s with two children, ages five and nine—begin college fund for each child; fund Roth IRAs for both parents; max out employer-sponsored retirement plan, such as 401k, each year.

d. Divorced 52-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; establish or continue college fund; 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.

4. Life Cycle of Financial Plans: ***Explain the life cycle of financial plans and their role in achieving your financial goals.***

> As you move through life and your income patterns change, you'll typically have to pursue a variety of financial plans. By having gone through the planning process, you are better able to adjust your plans to your changing situation. As we pass from one stage of maturation to the next, this life cycle of financial plans reflects our patterns of income, home ownership, and debt changes. The role of these plans is important in achieving our financial goals which can range from short-term goals, such as saving for a new sound system, to long-term goals, such as saving enough to start your own business. Reaching your particular goals requires different types of financial planning.

5. Impact of Economic Environment on Financial Planning: ***Summarize current and projected trends in the economy with regard to GDP growth, unemployment, and inflation. How should you use this information to make personal financial and career planning decisions?***

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. Inflation is of vital concern to financial planning. Changing economic conditions requires that you review your financial plans at least annually.

Common indices include the Dow Jones Industrial Average [the Dow] and the Standard & Poor's index [the S&P]. Chapter 12 discusses these indices and others.

6. Effects of Inflation: How does inflation affect interest rates, security prices, and financial planning?

Inflation is a state of the economy in which the general price level is rising. The inflation rate is one of the important factors that impacts the interest rates and security prices in the market and will in turn impact the financial planning of an individual. High rates of inflation lead to

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high interest rates as the lenders demand more money to compensate their decreasing purchasing power. High rates of inflation also have a harmful effect on the prices of stocks and bonds. The rate of inflation not only affects what an individual pays for the goods and services, but also affects what an individual earns in his/her job. High inflation rates decrease the purchasing power of an individual and he/she needs more money to achieve the financial goals. Thus, inflation affects the financial planning of an individual.

7. Effect of Age and Geography on Income: Evaluate the impact of age, and geographic location on personal income.

Age, education, and geographic location all impact personal income. For example, the amount of money you earn is closely tied to your age and education. Generally, the closer you are to middle age (45–65) and the more education you have, the greater your income will be. Heads of households who have more formal education earn higher annual incomes than do those with lesser degrees. Geographic factors can also affect your earning power. Salaries vary regionally, tending to be higher in the Northeast and West than in the South. Typically, salaries will also be higher if you live in a large metropolitan area rather than a small town or rural area. Of course, these higher wages reflect the higher cost of living in these locations. Note Exhibit 1-8 for examples of the impact of age and education.

8. Career choices and Financial Planning: Assume you graduated from college with a major in marketing and took a job with a large, consumer-products company. After three years, you are laid off when the company downsizes. Describe the steps you'd take to "repackage" yourself for another field.

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 focusing on the careers that are in high demand.
- Developing functional resume focusing on skills rather than job titles

9. Career Planning: Leo Johnson, a 52-year-old retail store manager earning $90,000 a year, worked for the same company during his entire 25-year career. Tom was laid off and is still unemployed 10 months later, and his severance pay and unemployment compensation have run out. Because he adopted careful financial planning practices, he now has sufficient savings and investments to carry him through several months of unemployment. Leo is actively seeking work but finds that he is overqualified for available, lower-paying jobs and underqualified for higher-paying, more desirable positions. There are no openings for positions equivalent to the manager's job he lost. He lost his wife several years earlier and is very close to his two grown children, who live in the same city.

Tom has these options:

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● ***Keep looking for a new job.***

● ***Move to another area of the country where store manager positions are more plentiful.***

● ***Accept a lower-paying job for two or three years and then go back to school evenings to finish his college degree and qualify for a better position.***

● ***Consider other types of jobs that could benefit from his managerial skills.***

a. What important career factors should Leo consider when evaluating his options?

b. What important personal factors should he consider when deciding among his career options?

c. What recommendations would you give him in light of both the career and personal dimensions of his options noted above?

d. What career strategies should today's workers use in order to avoid Leo's dilemma?

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 Leo'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.

Important career factors for Leo 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.

a. Leo should consider his age and his geographical location when deciding about his career options. He is 50 years old and it is difficult for him to start a new career now. He should also think if he is ready to relocate to other part of the country in order to get better career opportunities. The fact that he has followed a financial plan and has funds to support himself means that he is able to put greater weight on his family than what job he has.

b. Considering the age, educational qualification, and geographical factors of Leo, he should consider looking out for other types of jobs that could benefit from his managerial skills which he gained during his 25-year career. Management skills are transferrable to other industries including non-profit organizations.

c. Today's workers plan their careers carefully to improve their work situation and to gain personal and professional satisfaction. They should identify their skills and interests and based on this should create short-term and long-term goals. They should also develop a

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career plan that helps in achieving their career goals. They should frequently review and revise the career plans as and when their career situation changes. Their financial plan should consider an interruption in their income stream due to job loss. Having financial resources to cover the time you are out of work will prevent you from making sub-optimal decisions.

d. The average American starting a career today can expect to have at least 10 jobs with five or more employers. You need to revise your resume on a yearly basis and evaluate yourself as if you are considering hiring a person like you. Keep your skills current by maintaining a program of continuing education. Adding proficiency in technology or languages puts you ahead of the pack in dealing with changing workplace requirements. Keep yourself valuable to your company and you will be able to stay where you are or move to another company if you desire or are forced to move. You will be in control of your career.

10. Income and Education: Using Exhibit 1.8, discuss the relationship between annual income and the highest level of education completed. Provide specific examples of the difference between having no high school diploma and having a bachelor's degree, and between having a bachelor's degree and a professional degree.

In an individual's career, the annual income earned is directly proportional to the level of education completed by the individual. The individuals with highest level of education earn higher income, whereas individuals with lowest level of education earn lower income. An individual with a bachelor's degree will earn approximately $34,000 more income from his job on an average compared to an individual with no high school diploma. Similarly, an individual having a professional degree will earn approximately $35,000 more income on average when compared to an individual having only a bachelor's degree. Exhibit 1.9 reports that Business majors are the third highest paid careers. Of course, there are exceptions to all general rules, but when selecting a major, certainly one factor is how the average graduate from that major competes in the job market.

Answers to Test Yourself Questions

The following are questions and solutions are part of legacy questions that have been in previous editions. You could use them as class discussion questions, exam questions or additional homework.

1-1 What is a *standard of living?* What factors affect the quality of life?

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.

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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 Are consumption patterns related to quality of life? Explain.

Generally, consumption patterns are 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 What is *average propensity to consume?* Is it possible for two people with very different incomes to have the same average propensity to consume? Why?

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 Discuss the various forms in which wealth can be accumulated.

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* are intangible 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 What is the role of money in setting financial goals? What is the relationship of money to utility?

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).

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1-6 Explain why financial plans must be psychologically as well as economically sound. What is the best way to resolve money disputes in a relationship?

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 Explain why it is important to set realistically attainable financial goals. Select one of your personal financial goals and develop a brief financial plan for achieving it.

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 Distinguish between long-term, intermediate, and short-term financial goals. Give examples of each.

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

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years, and *long-term* financial goals in more than 5 years. Refer to Worksheet 1.1 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 What types of financial planning concerns does a complete set of financial plans cover?

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 Discuss the relationship of life-cycle considerations to personal financial planning. What are some factors to consider when revising financial plans to reflect changes in the life cycle?

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 Chad Jackson's investments over the past several years have not lived up to his full return expectations. He is not particularly concerned, however, because his return is only about 2 percentage points below his expectations. Do you have any advice for Chad?

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

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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 **Describe employee benefit and tax planning. How do they fit into the financial planning framework?**

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 "There's no sense in worrying about retirement until you reach middle age." Discuss this point of view.

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 Discuss briefly how the following situations affect personal financial planning:
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

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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 or divorce

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 What is a *professional financial planner?* Does it make any difference whether the financial planner earns money from commissions made on products sold as opposed to the fees he or she charges?

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

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now provide clients with disclosure forms outlining fees and commissions or various transaction costs.

1-16 Discuss the following statement: "The interactions among government, business, and consumers determine the environment in which personal financial plans must be made."

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 What are the stages of an economic cycle? Explain their significance for your personal finances.

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

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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 What is *inflation*, and why should it be a concern in financial planning?

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. "All people who have equivalent formal education earn similar incomes." Do you agree or disagree with this statement? Explain your position.

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 Discuss the need for career planning throughout the life cycle and its relationship to financial planning. What are some of your own personal career goals?

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

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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.

Solutions to Critical Thinking Cases

The following are questions and solutions to "Critical Thinking Cases" that you may use for additional homework or class discussion. These are legacy questions from prior editions.

1.1 Jim's Need to Know: Personal Finance or Golf?

During the Christmas break of his final year at the University of Maryland (UMD), Jim Curtis plans to put together his résumé in order to seek full-time employment as a software engineer during the spring semester. To help Jim prepare for the job interview process, his older brother has arranged for him to meet with a friend, Lisa Bancroft, who has worked as a software engineer since her graduation from UMD two years earlier. Lisa gives him numerous pointers on résumé preparation, the interview process, and possible job opportunities. After answering Jim's many questions, Lisa asks Jim to update her on UMD. As they discuss courses, Lisa indicates that of all the electives she took, the personal financial planning course was most useful. Jim says that, although he had considered personal financial planning for his last elective, he's currently leaning toward a beginning golf course. He feels that the course will be fun because some of his friends are taking it. He points out that he doesn't expect to get rich and already knows how to balance his checkbook. Lisa tells him that personal financial planning involves much more than balancing a checkbook, and that the course is highly relevant regardless of income level. She strongly believes that the personal financial planning course will benefit Jim more than beginning golf—a course that she also took while at UMD.

Critical Thinking Questions

1. Describe to Jim the goals and rewards of the personal financial planning process.
2. Explain to Jim what is meant by the term *financial planning* and why it is important regardless of income.
3. Describe the financial planning environment to Jim. Explain the role of the consumer and the impact of economic conditions on financial planning.
4. What arguments would you present to convince Jim that the personal financial planning course would benefit him more than beginning golf?

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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 Jim 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 Jim 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, Jim can optimize the use of his assets, provide for a secure financial future,

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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 Jim to take not only beginning golf but also intermediate golf and possibly join a golf club.

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1.2 Brad's Dilemma: Finding a New Job

Brad Smitham, a 53-year-old retail store manager earning $75,000 a year, has worked for the same company during his entire 28-year career. Brad was recently laid off and is still unemployed 10 months later, and his 10 months' severance pay and 6 months' unemployment compensation have run out. Because he has consistently observed careful financial planning practices, he now has sufficient savings and investments to carry him through several more months of unemployment. Brad is actively seeking work but finds that he is overqualified for available lower-paying jobs and underqualified for higher-paying, more desirable positions. There are no openings for positions equivalent to the manager's job he lost. He lost his wife several years earlier and is very close to his two grown children, who live in the same city.

Brad has these options:

- **Wait out the recession until another retail store manager position opens up.**
- **Move to another area of the country where store manager positions are more plentiful.**
- **Accept a lower-paying job for two or three years and then go back to school evenings to finish his college degree and qualify for a better position.**
- **Consider other types of jobs that could benefit from his managerial skills.**

Critical Thinking Questions

1. What important career factors should Brad consider when evaluating his options?
2. What important personal factors should Brad consider when deciding among his career options?
3. What recommendations would you give Brad in light of both the career and personal dimensions of his options noted in Questions 1 and 2?
4. What career strategies should today's workers employ in order to avoid Brad's dilemma?

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 Brad'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 Brad 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.

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2. Personal factors that Brad 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. Brad 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 Brad's position. Staying with one employer and one basic type of work for 28 years, as Brad 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.

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Key Terms

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

average propensity to consume	The percentage of each dollar of income, on average, that a person spends for current needs rather than savings.
consumer price index (CPI)	A measure of inflation based on changes in the cost of consumer goods and services.
Contraction	The phase of the economic cycle when real GDP falls.
expansion	The phase of the economic cycle when levels of employment and production are high and the economy is growing, generally accompanied by rising prices for goods and services.
financial assets	Intangible assets, such as savings accounts and securities, that are acquired for some promised future return.
financial goals	Results that an individual wants to attain, such as buying a home, building a college fund, or achieving financial independence.
flexible-benefit (cafeteria) plan	A type of employee benefit plan wherein the employer allocates a certain amount of money and then the employee "spends" that money for benefits selected from a menu covering everything from child care to health and life insurance to retirement benefits.
gross domestic product (GDP)	The total of all goods and services produced in a country; used to monitor economic growth.
goal dates	Target dates in the future when certain financial objectives are expected to be completed.
Inflation	A state of the economy in which the general price level is increasing.
money	The medium of exchange used as a measure of value in financial transactions.
peak	The phase of the economic cycle when an expansion ends and a contraction begins.

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personal financial planning A systematic process that considers important elements of an individual's financial affairs in order to fulfill financial goals.

professional financial planner An individual or firm that helps clients establish financial goals and develop and implement financial plans to achieve those goals.

purchasing power The amount of goods and services that each dollar buys at a given time.

standard of living The necessities, comforts, and luxuries enjoyed or desired by an individual or family.

tangible assets Physical assets, such as real estate and automobiles, that can be held for either consumption or investment purposes.

trough The phase of the economic cycle when a contraction ends and an expansion begins.

utility The amount of satisfaction received from purchasing certain types or quantities of goods and services.

wealth The total value of all items owned by an individual such as savings accounts, stocks, bonds, home, and automobiles.

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Chapter Outline

I. The Rewards of Sound Financial Planning
- A. Organizational Planning Model:
  Financial Plans → Financial Actions → Financial Results
- B. Improving Your Standard of Living
- C. Spending Money Wisely
  1. Current Needs
  2. Future Needs
- D. Accumulating Wealth

II. The Personal Financial Planning Process
- A. Steps in the Financial Planning Process [Exhibit 1.3]
- B. Defining Your Financial Goals
  1. The Role of Money
  2. The Psychology of Money
- C. Money and Relationships
- D. Types of Financial Goals [Worksheet 1.1]
- E. Putting Target Dates on Financial Goals
  1. Long-term Goals
  2. Short-term Goals and Intermediate Goals

III. From Goals to Plans: A Lifetime of Planning
- A. The Life Cycle of Financial Plans [Exhibit 1.4]
- B. Plans to Achieve Your Financial Goals
  1. Asset Acquisition Planning
  2. Liability and Insurance Planning
  3. Savings and Investment Planning
     a. Importance of rate of return
     b. Importance of time
  4. Employee Benefit Planning
  5. Tax Planning
  6. Retirement and Estate Planning
- C. Special Planning Concerns
  1. Managing Two Incomes
  2. Managing Employee Benefits
  3. Managing Your Finances in Tough Economic Times
- D. Using Professional Financial Planners

IV. The Planning Environment
- A. The Players
  1. Government
  2. Business
  3. Consumers
- B. The Economy

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1. Economic Cycles
2. Inflation, Prices, and Planning

V. What Determines Your Personal Income?

A. Where You Live
B. Your Career
C. Planning Your Career

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