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**Personal financial specialist candidates handbook: a guide to
accreditation for the CPA financial planner, fourth edition, revised**

American Institute of Certified Public Accountants. Personal Financial Planning Division

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PFS

CANDIDATES HANDBOOK

A Guide to Accreditation
for the CPA Financial Planner

Fourth Edition, Revised

AICPA

American
Institute of
Certified
Public
Accountants

NOTICE TO CANDIDATES

This fourth revised edition of the Personal Financial Specialist Candidates Handbook (previously entitled Accredited Personal Financial Specialist Candidates Handbook) was prepared by the AICPA Personal Financial Planning Division. The PFS Subcommittee of the Specialization Accreditation Board is responsible for monitoring the preparation of the PFS Examination. The AICPA Examinations Division is responsible for supervising the grading.

This booklet contains answers to illustrative examples of multiple-choice, objective-format other-than-multiple-choice, and case-study questions. These answers were reviewed by James A. Shambo, past chairman of the PFS Subcommittee, and Charles A. Rhuda, assistant director in the AICPA Examinations Division. The answers do not purport to be the official positions of the American Institute of Certified Public Accountants.

Personal Financial Specialist

CANDIDATES HANDBOOK

A Guide to Accreditation
for the CPA Financial Planner

Fourth Edition, Revised



American Institute of Certified Public Accountants

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PREFACE

This fourth revised edition of the booklet was prepared by the Personal Financial Planning Division to provide information about the Personal Financial Specialist (PFS) designation program and the examination for PFS candidates. (The previous edition was entitled *Accredited Personal Financial Specialist Candidates Handbook*.) The booklet gives suggestions for preparing to take the examination. It also includes illustrative examples of multiple-choice, objective-format other-than-multiple-choice, and case-study questions. After reading this booklet, PFS candidates should have a better understanding of the PFS requirements and what to expect on the examination.

We encourage all CPA financial planners to become Personal Financial Specialists. PFS is a new designation that is gaining recognition for competence and integrity in the financial planning field.

We would like to acknowledge the cooperation and assistance of Isabelle V. Curtiss, Michael A. Seda, James A. Shambo, and Bernice Sobel, who provided and reviewed the information presented in this booklet.

Phyllis J. Bernstein
Director—
Personal Financial Planning Division

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PERSONAL FINANCIAL SPECIALIST CANDIDATES HANDBOOK

Purpose

This booklet provides information on the Personal Financial Specialist (PFS) designation program, and on its application and examination processes.

The Need for Specialization

A number of factors have generated a need for specialization in the accounting profession, including a rapidly changing business environment, advancements in computer technology, increasingly complex accounting and auditing standards, new tax laws and government regulations, and increased public expectations. Although CPAs already specialize in various areas of accounting, auditing, taxation, and management consulting services, the profession questioned whether it is necessary to evaluate and accredit members who practice as specialists in the functional fields of public accounting. For two decades, the AICPA and state societies have researched and debated this matter.

Creation of the Specialization Accreditation Board

In 1986, the AICPA Task Force on Specialization issued a report to the AICPA Board of Directors recommending action by Council

to recognize and accredit specialties. This recommendation received a favorable vote by Council. As a result, the voluntary AICPA program for accreditation of CPAs as specialists was created and the Specialization Accreditation Board (SAB) was established. The SAB, a senior committee of the AICPA, is responsible for establishing standards for the accreditation of specialties. The SAB is also responsible for implementing and monitoring the specialty programs to assure consistent application of and adherence to the accreditation standards. To date, the SAB has established one specialty program and is in the process of establishing several others.

The accredited specialist designation program is voluntary. A CPA can practice in any specialty area without participating in the program.

The PFS Designation Program

Personal financial planning is the first practice area recognized as a specialty. This specialty program is called the PFS designation program and is monitored by the PFS Subcommittee—a subcommittee of the SAB—all of whose members hold the PFS designation. With the input provided by the Personal Financial Planning (PFP) Executive Committee, the PFS Subcommittee is responsible for developing the PFS Examination, as well as for monitoring the PFS program to assure the consistent application of and adherence to the standards established by the SAB.

Benefits of Having the PFS Designation

There are several reasons why a CPA providing personal financial planning services should consider obtaining the PFS designation. They include—

- Protecting the public by assuring that the providers of personal financial planning services are competent.
- Improving skills and expertise in personal financial planning, which results in increased professional competency.

- Providing the opportunity for specialists to keep up-to-date in a profession currently experiencing information overload.
- Facilitating client referrals among practitioners.
- Creating the opportunity for smaller firms to become more competitive in specialty areas of practice.
- Encouraging closer ties within the profession as members with similar interests are brought together.
- Improving communication between the accounting profession and the public.
- Developing uniform standards to be used in evaluating claimed expertise.

Initial Requirements for the PFS Designation

To qualify for the PFS designation, a candidate must—

1. Be a member in good standing of the AICPA.
2. Hold a valid and unrevoked CPA certificate issued by a legally constituted state authority.
3. Have at least 250 hours of experience per year in personal financial planning activities for the three years immediately preceding the application. This experience must include—
 - Personal financial planning process.
 - Personal income-tax planning.
 - Risk-management planning.
 - Investment planning.
 - Retirement planning.
 - Estate planning.
4. Submit a written statement of intent to comply with all the requirements for reaccreditation.
5. Pass the PFS Examination.
6. Submit six references to substantiate working experience in personal financial planning.

The first four requirements must be met at the time of the application to sit for the examination. References are required only after the candidate has been notified of successful completion of the examination. Candidates have six months to submit their references. Candidates failing to submit their references within the prescribed time period will have their examination score invalidated. Thus, they will have to retake and pass the examination if they wish to be a Personal Financial Specialist.

Applications are due fifteen days prior to the examination date. Candidates will be notified about the status of their application. If an application is denied or withdrawn, the candidate will receive a refund of the application fee less a nonrefundable processing fee of \$25.

Candidates who are unable to sit for the examination will automatically be signed up for the next available examination at no additional cost.

All requests for refund of application fees must be in writing. A nonrefundable processing fee of \$25 will be deducted from the application fee.



Future Dates and Testing Sites

The examination is given semiannually. In general, the test dates fall on the last Friday in September and the day immediately preceding the PFP Division's Technical Conference, unless those days fall on national or religious holidays. The number and location of the testing sites depends on the number of candidates taking each examination. A list of testing sites will be published in the PFP Division's newsletter, *Planner*, and supplied by mail to candidates.



Content of the Examination

A content specification outline of the examination is presented in appendix A. In consultation with the PFP Executive Committee, the PFS Subcommittee developed this outline based on the content specification outline that the National Accreditation Board for CPA Specialists, Inc. (formerly part of the Colorado State

Society of CPAs), whose program was integrated with the AICPA's PFS designation program in 1987, used for its accreditation of financial planning specialists. It served as a useful guide in developing the PFS Content Specification Outline adopted by the SAB. To help PFS candidates prepare for the examination, the outline specifies the scope of the examination and the weight that each area will be given.

Format of the Examination

The examination tests for professional competency in personal financial planning. It is a six-hour examination, 50 percent of which is composed of multiple-choice questions, 25 percent of objective-format other-than-multiple-choice questions, and 25 percent of a case-study question. The morning session presents approximately 100 multiple-choice questions. The afternoon session presents several objective-format other-than-multiple-choice questions and a case study, which tests a candidate's ability to apply specific technical skills and professional judgment to a planning problem.

Multiple-Choice Questions

A multiple-choice question consists of a stem that includes factual data, or describes a situation, and four options—the answer and three incorrect choices. The following illustrates a multiple-choice question:

1. Which of the following areas included in the PFS Examination is weighted at 20 percent?
 - a. Personal financial planning process
 - b. Personal income-tax planning
 - c. Risk-management planning
 - d. Investment planning

Answer Sheet

1. a b c d

Candidates are not penalized for incorrect responses on multiple-choice questions. Therefore, candidates are likely to get a higher score if they answer all questions, even if they are uncertain of the answer.

Objective-Format Other-Than-Multiple-Choice Questions

The objective-format other-than-multiple-choice questions present a factual setting to which the candidate is asked to apply his or her knowledge of planning techniques. The answers to the questions, however, are in objective formats. The following illustrates one of the formats that will be used:

The PFS Content Specification Outline specifies the scope of the examination and the weight that each area will be given.

1. Which of the following areas included in the PFS Examination are weighted at 15 percent?
 - a. Personal financial planning process
 - b. Personal income-tax planning
 - c. Risk-management planning
 - d. Investment planning
 - e. Retirement planning
2. Which of the following topics are included in the professional responsibilities area of the PFS Content Specification Outline?
 - a. General concepts of state regulation
 - b. Code of Professional Conduct
 - c. Defining engagement objectives
 - d. Quantifying risk and return

Answer Sheet

1. a **b** **c** **d** **e**
2. **a** **b** c d

Case-Study Question

The case-study question presents a factual setting to which the candidate is asked to apply his or her knowledge of planning techniques. A case-study question is designed so that the candidate exercises professional judgment while exploring alternatives, which includes identifying the significant planning issues, assisting in setting goals, discussing alternative courses of action, and developing a plan of action.

Illustrative examples of multiple-choice questions, objective-format other-than-multiple-choice questions, and a case-study question are presented in appendix B. These examples should familiarize candidates with the general types of questions that they will find on the examination.

Preparation of the Examination

The examination is prepared under tight security by the PFS Subcommittee. The subcommittee determines that the questions are technically appropriate and that the examination tests from the content specification outline in accordance with the weights assigned to each area.

Unlike the CPA Examination, the answers to the PFS Examination are not published, and candidates are not permitted to remove the examination booklets from the testing site.

Grading the Examination

The AICPA establishes grading procedures to assure that all examination papers are fairly and uniformly graded. This is achieved by using grading keys for the case-study questions and statistical controls for all questions. A grading key lists the concepts tested by the case-study question and specifies under what conditions credit will be awarded. The grading key is simultaneously developed with the case-study question. The grading keys provide uniform standards to which the graders must adhere throughout the grading process. Furthermore, the candidates' anonymity is preserved throughout the grading process. The only information about candidates available to the graders is their candidate numbers.

The multiple-choice questions and the objective-format other-than-multiple-choice question are graded by an optical scanning machine, and candidates' explanations of their answers are not considered. Therefore, candidates should only answer them by filling in the circle.

The case-study question is graded using a grading key. Candidates are not expected to compose perfect solutions under examination conditions and can receive full credit for a less-than-perfect solution.

A score of 75 has been set as the passing score for the examination. All examination papers that are close to the passing score after the first grading are regraded a second time. The results of the examination are mailed within four months of the examination.

Preparing for the Examination

The key to passing the examination is the candidate's broad working experience in financial planning. For that reason, the 750-hour experience requirement is a prerequisite to sitting for the examination. It is through experience that candidates apply their knowledge, as well as gain new knowledge about personal financial planning. Candidates may need to study those planning areas in which they have less experience. Past PFS candidates who passed the examination used the content specification outline to become familiar with the topics that the examination covered and to identify the areas of weakness that need further study.

Studying the AICPA PFP Division's *Manual* and at least one of the other sources cited therein has generally proven to be adequate preparation for the examination. However, each candidate should individually determine the level of preparation necessary to be successful. The following are examples of reference materials used:

- The AICPA PFP Division's *Manual*
- Practitioners Publishing Company's *Guide to Personal Financial Planning*
- Bureau of National Affairs' *Tax Management Financial Planning*
- Commerce Clearing House's *Financial and Estate Planning*

- Materials used in the AICPA Certificate of Educational Achievement (CEA) Personal Financial Planning Process Program (PFPP)
- National Underwriter's *Tools and Techniques of Financial Planning* and *The Tools and Techniques of Estate Planning*
- The American College's *Financial Services Professional's Guide to the State of the Art*

In addition to PFP services, professional journals and newsletters, including the AICPA PFP Division's newsletter *Planner*, are a good source for techniques that financial planners are currently using to service their clients. Additionally, new publications are produced frequently and should be considered when available.

Taking the Examination

Knowledge of the subject matter is essential for success on the examination. However, there are some examination-taking techniques that could improve performance. Candidates should remember and use these techniques when preparing for and taking the examination. Following are some suggested techniques:

Be punctual. Plan to arrive at the examination room well in advance of the starting time. Allow time for any unforeseen delays. Be seated and accustomed to the surroundings by the time the examination begins.

Bring an adequate supply of pencils and erasers. A pencil with No. 2 lead should be used to mark the answer sheets for the multiple-choice questions and the objective-format other-than-multiple-choice questions. To maintain uniform examination conditions, rulers, slide rules, and calculators **are prohibited**.

Do **not** bring any paper or printed material to the examination table.

Budget time. A schedule of the points for each question is printed on the cover of the examination booklet. These points should be used as a guide in budgeting the time to spend on each question.

Multiple-choice and objective-format other-than-multiple-choice answers. All multiple-choice questions and objective-format other-than-multiple-choice questions should be answered because there is no penalty for incorrect answers, and grades are based solely on the total number of correct answers. Because these questions are computer-graded, no consideration is given to comments and calculations pertaining to them. Therefore, comments and calculations should not be submitted.

Read the case-study question. Carefully read the entire case-study question to get a general idea of the subject matter being tested, and then reread the question and underscore the pertinent facts and data. Some candidates approach a case-study question by reading the requirements first and then by reading the situation for the information it contains. This procedure may enable candidates to identify the data more rapidly and to classify the information for pertinence.

Respond to the question. The PFS Examination case-study question is intended to be straightforward. Assumptions rarely are necessary. However, when a candidate feels that an assumption must be made, the assumption for the case-study question should be stated, together with the reasons for it. An example of when an assumption must be made is when the answer to the estate-planning portion of a case-study question would be different in the cases of common-law and community-property states.

Answers should respond directly to the specific question asked and not be broad expositions on the subject of the case-study question. Do not identify the general subject matter and then state everything known about the subject without regard to the specific question.

Answers should not contain contradictions within themselves. In some cases, when a discussion of both sides of a question is required, make it clear that differing views or opposing arguments are presented.

Use examples freely to illustrate the statements made, but be certain that the examples provide logical support or present reasonable applications. Providing well-chosen examples often is a short and easy way of expressing an idea or supporting a conclusion. On the other hand, inapplicable examples can cast doubt on the candidate's comprehension of the subject matter.

Select the efficient approach. Selecting an inefficient—though not necessarily incorrect—approach to a question can waste precious time. Before writing the answer, devote some time to determine what approach will be used, and then to think through the answer to its conclusion. This is a logical use of time that will ensure maximum credit for both knowledge of the subject matter and professional skill in recognizing and completing the significant part of the answer first.

If it appears that there is not enough time to complete a question, work until the last few minutes of the time budgeted for the question, and then state briefly how the answer should be completed. Remember, however, that resorting to explanations rather than completing the answers for a number of questions would probably lead to the conclusion that the candidate was not fully prepared.

Organize answers. After clearly understanding the requirements of the question and analyzing the data, organize answers so that they respond directly to the requirements. These requirements are phrased carefully to elicit specific knowledge. Organizing answers carefully before beginning to write them in final form will save time, avoid false starts, and aid in writing coherently. Rough outlines may assist in organizing answers.

Each principal idea should be the subject of a separate paragraph. Follow the rules of good grammatical construction, and state the principal idea of the paragraph in the first sentence. Subsequent sentences should present subordinate or supporting concepts or illustrative examples. Generally, knowledge is best expressed by employing short paragraphs composed of short sentences. Moreover, short paragraphs, each limited to one principal idea, can better emphasize the main points in the answer.

Prepare adequate, concise answers. Answer the question completely. Comprehensive answers using proper language need

not be lengthy. Adopting this practice will improve answers. However, guard against the extremely brief answer that is likely to omit important points. Quality and quantity of ideas are desired, not quantity of words. Do not repeat the question; this wastes valuable time.

Be specific. Be specific so that there can be no doubt about the meaning or reasoning set forth in the answer. The grader cannot make any assumptions about the candidate's knowledge.

Give reasons. The reasons offered for conclusions may be as important as the conclusions themselves. Citing authorities, rather than giving the underlying reasons or supporting logic, is a common error.

Write legibly. Answers to the case-study question should be legible and neat in appearance. Answers need not be either printed or artistically attractive. Extensive underscoring for emphasis of major points is unnecessary.

Turn in the examination booklet. This is a secure examination. All examination booklets must be turned in at the completion of the test.

Study the instructions for the PFS Examination. These instructions are presented in appendix C.



After Passing the Examination

The results of the examination will be mailed within four months of the examination. After passing the examination, a candidate will be asked to submit within six months six references to substantiate his or her experience in personal financial planning activities. Three references must be from clients and three from other professionals, including CPAs, with whom the applicant has previously worked. Only one of the latter references can be from a CPA within the applicant's own firm. If a question about a candidate's references arises, the person submitting the questioned reference will be contacted directly to resolve the issue. Candidates should allow their references to prepare the requested

comments. It is not acceptable for a candidate to prepare comments that are presented to a reference for signature.

After the references are reviewed and accepted, the candidate will receive a PFS certificate and lapel pin, as well as be eligible to use the PFS designation in compliance with the rules of the state in which the candidate practices. The candidate's state society also will be notified that the candidate has been designated as a Personal Financial Specialist.

A candidate who fails to submit his or her references within the six-month period will have his or her examination score invalidated. This means that the candidate will have to retake and pass the examination if he or she wants to be a Personal Financial Specialist.



Reaccreditation Requirements

The PFS practitioner must pay an annual reaccreditation fee and recertify his or her accreditation every three years. To do so, he or she must—

- Be a member in good standing of the AICPA.
- Have a valid and unrevoked CPA certificate issued by a legally constituted state authority.
- Have at least 750 hours of experience in personal financial planning over the preceding three years. Experience must be in each of the following areas:
 - Personal financial planning process
 - Personal income-tax planning
 - Risk-management planning
 - Investment planning
 - Retirement planning
 - Estate planning
- Have taken at least seventy-two hours of financial planning courses in prescribed disciplines every three years. Self-study courses are limited to 33 1/3 percent of the total hours.

- Submit a written statement of intent to continue to comply with all the requirements for reaccreditation.
- Submit a completed internal practice review questionnaire (IPRQ), as amended from time to time. The questionnaire asks the PFS practitioner to provide information to determine whether he or she has met the reaccreditation requirements. The PFS practitioner agrees to submit supporting data, including work papers, for external review of personal financial planning activities upon request.

If reaccreditation requirements are not met, accreditation ceases and all initial requirements, including examination, must again be met to regain accreditation. A waiver may be requested and will be granted if, in the sole judgment of the AICPA SAB, there is justification because of extreme hardship or extraordinary circumstances.



Further Information

Information packages about the PFS program and applications for the examination are available from the AICPA Personal Financial Planning Division by calling 1-800 862-4272, submenu #5 or writing AICPA, Personal Financial Planning Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

Appendix A

**PERSONAL
FINANCIAL SPECIALIST
EXAMINATION CONTENT
SPECIFICATION OUTLINE ***

- I. Professional responsibilities (5%)
 - A. Regulatory
 1. Securities Act of 1933 and the Securities Exchange Act of 1934
 2. Investment Advisers Act of 1940
 3. General concepts of state regulation
 - B. Professional standards—AICPA
 1. Authoritative
 - a. Code of Professional Conduct
 - b. Statements on Standards for Accounting and Review Services (Statements 1–7)
 - c. *Personal Financial Statements* guide
 - d. *Guide for Prospective Financial Statements*
 - e. Statement on Standards for Consulting Services

*The PFS Content Specification Outline is revised on occasion. It was last revised in May 1993. Please contact the Personal Financial Planning Division at (800) 862-4272 to obtain a copy of the latest outline.

Studying the AICPA PFP Division's *Manual* and at least one of the other sources cited therein has generally proven to be adequate preparation for the examination. However, each candidate should individually determine the level of preparation necessary to be successful.

2. Nonauthoritative
 - a. Statements on Responsibilities in Tax Practice (Statements 1–8)
 - b. Statement on Responsibilities in Personal Financial Planning
- II. Personal financial planning process (20%)
- A. The financial planner as a generalist
 - B. Levels of PFP service
 1. Consultations
 2. Segmented planning
 3. Comprehensive planning
 - C. Elements of the process
 1. Defining engagement objectives
 2. Planning the engagement
 3. Performing analyses to develop and support recommendations and planning decisions
 4. Documenting the planning process
 5. Reporting of recommendations and advice
 6. Coordinating the implementation of the client's financial planning decisions
 7. Monitoring the client's progress in achieving goals
 8. Assisting the client to revise planning decisions
 - D. Time value of money calculations
 - E. Practice management, including engagement letters
 - F. Establishing financial objectives and identifying constraints
 1. Qualitative issues
 - a. Client goals
 - b. Life-cycle considerations
 - c. Client's personality, health and preferences
 - d. Time horizon
 - e. Other
 2. Quantitative issues

- a. Financial statement analysis
- b. Cash flow planning and budgeting
- c. Business considerations
- d. Financial independence, including retirement
- e. Current income and spending patterns
- f. Other income or cash flow sources

III. Personal income-tax planning (15%)

A. Fundamental rules

1. Filing status
2. Dependency exemptions
3. Nontaxable and partially taxable income
4. Deductible and nondeductible expenses
5. Tax credits
6. Other, such as taxation of social security and children under fourteen
7. Alternative minimum tax

B. Income splitting

1. Incorporating
 - a. Subchapter C corporations
 - b. Subchapter S corporations
2. Interest-free loans
3. Private annuities
4. Employing spouse or children and FICA taxes
5. Family partnerships
6. Installment sales to heirs
7. Gifts and trusts
8. Assignments of income rules

C. Employee fringe-benefits planning

D. Retirement tax planning

1. Deferred compensation
2. Stock options
3. Qualified plans, including Keoghs and SEPs
4. IRAs
5. Distributions and rollovers

- E. Charitable contributions
 - 1. Limitations
 - 2. Property donations
 - 3. Charitable trusts
 - 4. Bargain sales to charities
 - F. Income and deduction timing
 - 1. Capital gains and losses
 - 2. Original issue discount
 - 3. Net operating losses
 - 4. Passive income and losses
 - 5. Interest expense classification
 - 6. Itemized deduction limitations
 - G. Divorce considerations
 - 1. Property settlement rules
 - 2. Alimony, child support, and property payments
 - 3. Dependency exemption
 - 4. Retirement-plan asset division
 - H. Bankruptcy or insolvency
- IV. Risk-management planning (15%)
- A. Methods of handling risk
 - B. Needs analysis
 - C. Life insurance
 - 1. Types
 - 2. Uses
 - a. Life-insurance trust
 - b. Key-man insurance
 - c. Buy-sell agreement funding
 - d. Split-dollar arrangements
 - e. Minimum deposit issues
 - f. Charitable giving
 - g. Other, such as cash fund, education fund, and estate-clearance fund
 - 3. Beneficiary designations

- D. Annuities
 - 1. Immediate vs. deferred annuities
 - 2. Flexible annuities
 - 3. Rollovers, withdrawals, and distributions
 - E. Disability insurance
 - 1. Policy definitions
 - 2. Exclusions
 - 3. Waiting periods and duration of benefits
 - 4. Partial disability benefits and qualification periods
 - F. Property and casualty insurance
 - 1. Homeowner's insurance
 - 2. Automobile insurance
 - 3. Other property insurance
 - 4. Umbrella insurance
 - G. Health insurance
 - 1. Basic, major-medical, and comprehensive insurance
 - 2. Medicare
 - 3. Health maintenance organizations (HMOs) and preferred provider organizations (PPOs)
 - 4. Long-term health care
 - 5. Other types
 - H. Professional liability insurance
 - I. Interrelationship of business and personal risks
 - J. Tax implications of insurance
- V. Investment planning (15%)
- A. General considerations about clients
 - 1. Risk tolerance
 - 2. Liquidity
 - 3. Cash flows to and from investment
 - 4. Tax implications
 - 5. Maturity

6. Diversification
 7. Collateralization
 8. Growth
 9. Need for income
 10. Marital and family status
 11. Life cycle
 12. Time horizon
 13. Monitoring
- B. Investment considerations
1. Investment risk
 - a. Systematic risk
 - b. Unsystematic risk
 - c. Quantifying risk and return
 2. Investment preferences
 - a. Safety of principal
 - b. Growth
 - c. Cash flow (income)
 - d. Total return
 - e. Tax benefits
 3. Asset allocation
 - a. Asset categories and mix
 - b. Economic considerations
 4. Investment strategies
 - a. Diversification
 - b. Buy and hold
 - c. Dollar cost averaging
 - d. Market timing
 - e. Value averaging
 - f. Leveraging
 - g. Hedging
 - h. Index funds
 - i. Maturity selection
 5. Forms of ownership
 6. Tax implications
- C. Record-keeping requirements

- D. Cash and cash equivalents
 - 1. Money-market instruments
 - 2. Passbook savings accounts
 - 3. Certificates of deposit
 - 4. Other
- E. Fixed income
 - 1. U.S. government securities
 - a. Treasury bills, notes, and bonds
 - b. Zero-coupon bonds
 - c. Other
 - 2. Bonds
 - a. Municipal bonds
 - b. Corporate bonds
 - c. Bond funds
 - d. Zero-coupon bonds
 - e. Other, such as savings bonds and commercial paper
 - 3. Mortgage-backed securities and REMICs
- F. Equity investments
 - 1. Common stock
 - 2. Preferred stock
 - 3. Stock options
 - 4. Commodity futures
 - 5. Stock-index futures
 - 6. Foreign equities
 - 7. Warrants
 - 8. Convertible securities
- G. Mutual funds
- H. Real estate
 - 1. Commercial real estate
 - 2. Residential real estate
 - 3. Real estate investment trusts
- I. Other types of investments
 - 1. Equipment leasing

2. Research and development
3. Energy
4. Limited partnerships and investment trusts
5. Insurance products
6. Others
 - a. Precious metals
 - b. Options
 - c. Futures
 - d. Collectibles and physical assets

VI. Retirement planning (15%)

- A. Determining cash needed
- B. Retirement plans
 1. Types
 - a. IRAs
 - b. Qualified plans
 - c. Nonqualified plans
 - d. Pension versus profit-sharing
 - e. Social security
 2. Limits on contributions and benefits
 3. Methods of distribution and their taxation
 4. Qualified plan investments
 5. Beneficiary designations
 6. Plan loan provisions
- C. Tax and economic considerations
 1. Tax-advantaged funding
 2. Creating and protecting retirement assets
 3. Identifying present asset base
 4. Insurance, including supplemental medical coverage
 5. State income and death taxes
- D. Noneconomic considerations
 1. Relocation
 2. Second career, training
 3. Activities
 4. Life expectancy
 5. Other

- VII. Estate planning (15%)
 - A. Property ownership and the titling of assets
 - 1. Split-income property ownership
 - 2. Pros and cons of jointly held assets
 - B. Determining cash needed
 - 1. Federal estate-tax calculations
 - 2. State death taxes
 - 3. Other liquidity needs
 - C. Probate estate
 - 1. Advantages
 - 2. Disadvantages
 - D. Tools and techniques
 - 1. Wills
 - 2. Intestacy
 - 3. Instruction letters
 - 4. Gifts
 - a. Annual exclusion unified credits
 - b. Present versus future interests
 - c. Generation-skipping tax
 - d. Gifts to dependents
 - e. Gifts to charities
 - 5. Trusts
 - a. Intervivos and testamentary
 - b. Revocable and irrevocable
 - c. Charitable
 - d. Life insurance
 - e. Q-TIP
 - f. Qualified domestic
 - 6. Life insurance
 - 7. Marital deduction
 - 8. Living wills and durable powers of attorney
 - 9. Other, such as beneficiaries and alternatives
 - E. Disclaimers and responsibility to inform on a timely basis
 - F. Closely-held business issues

1. Valuation issues
2. Family succession planning
3. Active vs nonactive owners
4. Equitable vs equal distribution
5. Buy-sell agreements
6. Estate-freeze techniques

Appendix B

**ILLUSTRATIVE EXAMPLES
OF MULTIPLE-CHOICE
QUESTIONS, OBJECTIVE-
FORMAT OTHER-THAN-
MULTIPLE-CHOICE
QUESTIONS, AND A
CASE-STUDY QUESTION**

**Illustrative Examples of
Multiple-Choice Questions**

Note: Part I of the PFS Examination will consist of approximately 100 multiple-choice questions and will be worth 100 points. Because Part I is 50 percent of the total grade for the PFS Examination, each of the following examples of a multiple-choice question would be 0.5 percent of the total grade for the PFS Examination.

1. Which of the following statements regarding the performance of personal financial planning services by a CPA is (are) correct?
 - I. Exercise due professional care in the performance of professional services.
 - II. Adequately plan and supervise the performance of professional services.
- a. I only.
- b. II only.

- c. Both I and II.
 - d. Neither I nor II.
2. Barriers that make it difficult for a client to formulate personal financial plans include which of the following?
- I. Psychological makeup of client.
 - II. Variety and complexity of client needs.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.
3. Which of the following statements concerning personal financial planning is correct?
- a. It is a process that is limited to focusing on clients' quantitative circumstances.
 - b. It is a nonthreatening, nonstressful experience for clients to identify and prioritize their objectives.
 - c. It avoids involving clients in the decision-making process that affects their financial well-being.
 - d. It requires time spent in educating and counseling clients as to available courses of action.
4. Winston owns a home with a fair market value of \$250,000. Winston's acquisition indebtedness is \$190,000. What amount of new home equity indebtedness can Winston incur and have all of the home equity interest be deductible?
- a. \$60,000
 - b. \$100,000
 - c. \$187,000
 - d. \$190,000
5. Which of the following types of property used in a like-kind exchange will result in the deferral of long-term gains?
- I. Business inventory.
 - II. Professional sports franchise.
- a. I only.
 - b. II only.

- c. Both I and II.
 - d. Neither I nor II.
6. A client has an unendorsed homeowners HO-3 policy and a personal auto insurance policy. Which of the following circumstances would cause you to recommend that the client consider modifying the insurance coverage?
- a. The client's six-year-old child throws a stone through a neighbor's window.
 - b. The client purchases a thirty-foot sailboat.
 - c. The client's detached garage is damaged when a tree limb falls on the roof.
 - d. The client borrows your automobile to drive to the bank to cash a check.
7. A client is considering the purchase of a listed stock. The stock sells for \$28 per share on an organized exchange but the client wants to place a buy order at \$25. The client is placing a—
- a. Limit order.
 - b. Stop-loss order.
 - c. Market order.
 - d. Call order.
8. Which of the following actions will minimize the possibility that the IRS will consider a controlling shareholder to be in constructive receipt of compensation under a deferred-compensation arrangement?
- a. Use an independent plan trustee.
 - b. Provide for the forfeiture of benefits on termination prior to retirement.
 - c. Name the shareholder as annuitant if an annuity is used to fund the plan.
 - d. Name the shareholder as beneficiary if life insurance is used to fund the plan.
9. Which of the following statements concerning the tax on excess distributions from a pension plan is (are) correct?
- I. Early withdrawals from individual retirement accounts (IRAs) may have the effect of minimizing the excess-

- distributions tax since the period over which the distributions will be received is lengthened.
- II. When applied to a lump-sum distribution from a pension plan, the excess-distributions tax is assessed against the total amount of the distribution.
 - a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.
10. A client desires to write a codicil that would establish a pourover trust provision to the client's will. For this to be an effective planning procedure, the client must also—
- a. Revoke all prior wills and have a new will prepared.
 - b. Have an inter-vivos trust in place prior to executing the codicil.
 - c. Use the same witnesses to the codicil as were used for the original will.
 - d. Obtain the written consent of beneficiaries of the current will.

The difficulty level of the preceding multiple-choice questions should not be construed to represent the difficulty level of the PFS Examination.

The answer to each of the preceding multiple-choice questions and the area of the Content Specification Outline that is being tested are as follows:

1. c (Area I—Professional Responsibilities)
2. c (Area II—Personal Financial Planning Process)
3. d (Area II—Personal Financial Planning Process)
4. a (Area III—Personal Income-Tax Planning)
5. b (Area III—Personal Income-Tax Planning)
6. b (Area IV—Risk-Management Planning)
7. a (Area V—Investment Planning)
8. b (Area VI—Retirement Planning)
9. d (Area VI—Retirement Planning)
10. b (Area VII—Estate Planning)

Illustrative Example of an Objective-Format Other-Than-Multiple-Choice Question

Note: *In Part II of the PFS Examination, there will be several objective-format other-than-multiple-choice questions, which will be worth approximately 50 points. Since this portion of Part II is approximately 25 percent of the total grade for the PFS Examination, the following example of an objective-format other-than-multiple-choice question, which is worth eight points, would be 4 percent of the total grade for the PFS Examination.*

You have been performing the general and tax accounting for Patti and Eric Winner. They now need some personal and business-related financial planning advice and have learned that you provide these services as part of your public accounting practice. Although the Winners seem unsure of exactly what personal financial planning encompasses, they have confidence in your professional abilities for the services you have provided in the past and are willing to share personal matters with you.

Eric, aged sixty, has been employed by the same firm for the past twenty-eight years. Patti, aged thirty-six, owns and operates a franchise computer store, which she acquired four years ago. They have two children, aged eight and ten, whom they expect will attend college.

The Winners have the following assets:

	<u>Market Value</u>	<u>Cost Basis</u>	<u>Encumbrance</u>
Personal Residence	\$175,000	\$100,000	\$ 75,000
Summer Home	90,000	85,000	60,000
Stock Portfolio	250,000	200,000	90,000
Bond Portfolio	70,000	65,000	25,000
30-Foot Sailboat	35,000	40,000	10,000
Personal Checking Account	5,000	5,000	none
Computer Store	200,000	125,000	100,000

Additional information is as follows:

- During a preliminary meeting with the Winners, you frequently referred to the need for clients to have a well-defined set of objectives.
 - Eric suffered a mild heart attack two years ago. He is eligible for early retirement and would like your advice. If retirement is elected prior to age sixty-five, Eric's pension plan does not allow a lump-sum distribution.
1. Which of the following are financial objectives that clients typically have?
 - a. To maintain their standard of living.
 - b. To begin capital accumulation.
 - c. To provide for estate distribution.
 - d. To create an entertainment fund.
 - e. To spend a week in Paris every year.
 2. To be operational, a client's set of financial objectives must—
 - a. Be quantifiable.
 - b. Have a time frame for completion.
 - c. Reduce estate taxes to the minimum.
 - d. Be prioritized.
 - e. Be based on hypothetical goals.
 3. Which of the following factors should be considered when advising Eric about early retirement?
 - a. His health.
 - b. The difference in age between Eric and his wife Patti.
 - c. The additional available time for recreation.
 - d. His desire to move to a warm climate.
 4. If Eric retired early and selected a single life annuity with a ten-year-period certain option instead of a joint and survivorship annuity option—
 - a. Eric would have greater cash flow.
 - b. Patti would receive greater cash flow when she reaches retirement age.
 - c. Patti must consent in writing to this option.

The difficulty level of the preceding illustrative question should not be construed to represent the difficulty level of the PFS

Examination. Also, the number of questions in the preceding illustrative example that were developed from the information in the factual setting should not be construed to represent the number of questions that would be developed from a similar factual setting on the PFS Examination.

The answer to each of the items in the above objective-format other-than-multiple-choice question and the area of the Content Specification Outline that is being tested are as follows:

1.
 - a. Yes (Area II—Personal Financial Planning Process)
 - b. Yes (Area II—Personal Financial Planning Process)
 - c. Yes (Area II—Personal Financial Planning Process)
 - d. No (Area II—Personal Financial Planning Process)
 - e. No (Area II—Personal Financial Planning Process)
2.
 - a. Yes (Area II—Personal Financial Planning Process)
 - b. Yes (Area II—Personal Financial Planning Process)
 - c. No (Area II—Personal Financial Planning Process)
 - d. Yes (Area II—Personal Financial Planning Process)
 - e. No (Area II—Personal Financial Planning Process)
3.
 - a. Yes (Area VI—Retirement Planning)
 - b. Yes (Area VI—Retirement Planning)
 - c. No (Area VI—Retirement Planning)
 - d. No (Area VI—Retirement Planning)
4.
 - a. Yes (Area VI—Retirement Planning)
 - b. No (Area VI—Retirement Planning)
 - c. Yes (Area VI—Retirement Planning)

Illustrative Example of a Case Study

Note: *In Part II of the PFS Examination, there will be a case study that will be worth approximately 50 points. Because this portion of Part II is approximately 25 percent of the total grade for the PFS Examination, the following example of a case study, which is worth 50 points, would be 25 percent of the total grade for the PFS Examination. Using the 50 points as a guide in*

budgeting the time for the example of a case study, a candidate should spend approximately one and one-half hours to answer this case study.

The case study on the PFS Examination tests more than one area of the Content Specification Outline. The following example of a case study tests from the following areas: Area II—Personal Financial Planning Process, Area III—Personal Income-Tax Planning, Area IV—Risk-Management Planning, Area V—Investment Planning, Area VI—Retirement Planning, and Area VII—Estate Planning.

You have been performing the general and tax accounting for Patti and Eric Winner. They now need some personal and business-related financial-planning advice and have learned that you provide these services as part of your public accounting practice. Although the Winners seem unsure of exactly what personal financial planning encompasses, they have confidence in your professional abilities for the services you have provided in the past and are willing to share personal matters with you.

Eric, aged sixty, has been employed by the same firm for the past twenty-eight years. Patti, aged thirty-six, owns and operates a franchise computer store which she acquired four years ago. They have two children, aged eight and ten, whom they expect will attend college.

The computer store markets several brands of PCs, related equipment, and supplies. Patti purchased the franchise with money inherited from her parents. Including the franchise cost, inventory, display fixtures, and delivery vehicle, Patti's investment in the venture exceeds \$125,000. The franchise contract stipulates that upon death, disability, or her outright sale of the business, Patti must first offer the business to the franchisor. The terms of any such sale would be: her original purchase price for the franchise plus one and one-half times her average annual profit over the last two years of operation plus any inventory at time of sale at her cost less 10 percent. Annual payments would be made over a fifteen-year period and would include interest on the unpaid balance at a rate equal to the U.S. Treasury bill rate.

In addition to the investment in the computer store, the Winners have the following assets:

	<i>Market Value</i>	<i>Cost Basis</i>	<i>Encumbrance</i>
Personal Residence	\$175,000	\$100,000	\$75,000
Summer Home	90,000	85,000	60,000
Stock Portfolio	250,000	200,000	90,000
Bond Portfolio	70,000	65,000	25,000
30-Foot Sailboat	35,000	40,000	10,000
Personal Checking Account	5,000	5,000	none

Questions on the Winner Case

The 50 points are allocated as follows:

	<u>Points</u>		<u>Points</u>
1. a.	4	4. a.	4
b.	4	b.	5
2. a.	4	5. a.	4
b.	4	b.	3
3. a.	5	6. a.	4
b.	4	b.	5

1. During a preliminary meeting with the Winners, you frequently referred to the need for clients to have a well-defined set of objectives.
 - a. Identify the financial objectives that clients typically have and explain how they usually are established.
 - b. To be operational, a client's set of objectives must possess certain characteristics. Describe these characteristics.

2. Eric suffered a mild heart attack two years ago. He is eligible for early retirement and would like your advice on selecting between two options available to him if he did retire now. Under his employer's pension plan, the normal retirement benefit is a joint and survivorship annuity. Eric was told that his monthly pension benefit would be much higher if he selected a single life annuity with a ten-year period certain. The pension plan does not allow lump-sum distributions if retirement is elected prior to age sixty-five.

- a. What factors should be considered when advising Eric about his pension options? Explain.
 - b. What specific action must be taken if Eric elects the single life annuity as the retirement option? Explain.
3. Now that the computer business is showing excellent growth, Patti is giving consideration to establishing some form of retirement plan for her own benefit. She would prefer to have a plan that would not include employees of the business.
- a. She is considering establishing an individual retirement account (IRA). For what reasons would you recommend that Patti establish an IRA?
 - b. Patti asks whether it would be appropriate to set up a self-employment Keogh plan for her retirement program. What is your recommendation?
4. The Winners want to ensure that finances will not be a factor that would prevent their children from attending college. At this time, they plan to set aside \$30,000 from the bond portfolio specifically for this purpose.
- a. They have heard that a single premium whole life (SPWL) insurance policy is an excellent investment vehicle because earnings on the \$30,000 premium would accumulate free of income taxation. Because Eric is uninsurable, they have asked your advice on purchasing an SPWL policy on Patti's life to fund the children's college education.
What is your recommendation concerning the use of an SPWL policy to achieve this objective? Support your position.
 - b. The Winners have also heard that buying a term life insurance policy on an annual premium basis and investing an amount comparable to the SPWL premium might be a more practical solution to their education funding needs. They also heard that the investment money should be given to their children under the provisions of the Uniform Gifts to Minors Act of their state of residence. Describe the potential problems of this approach.

5. Since starting to manage their portfolio several years ago, the Winners feel they have been successful by following a strategy for investing in common stocks that have relatively high betas. Their security trading provided some of the money used to purchase the bond portfolio and their summer home. They feel their recent security trading performance has become less than satisfactory now that Patti spends so much of her time with the computer store.
 - a. All marketable investment instruments (or portfolios) are subject to various investment risks. Describe three such risks.
 - b. Based on all information contained in this case, do you think a high-beta portfolio is appropriate for the Winners? Support your position.
6. Because of Eric's age and his lack of experience in the retail computer business, the Winners believe the buy-back provisions with the franchisor are advantageous to them.
 - a. Assume that Patti were to die, that her estate qualified for a Section 6166 fifteen-year payout, and that her executor elected this option. What would be the tax consequences to her estate of this election? Explain.
 - b. Assume that Patti were to become disabled and that she sold the business to the franchisor under the terms described in this case. How would the proceeds of the sale be taxed to the Winners for federal income-tax purposes? Explain.

Note: *The following information is provided to aid candidates in their preparation for the PFS Examination. Candidates should keep in mind that they are not expected to compose perfect solutions under examination conditions and can receive full credit for a less-than-perfect solution.*

The Overall Objective for each question is provided to give candidates a general idea of the subject matter being tested.

The Example of the Answer to each question is provided to give candidates an idea of what an answer that would receive full credit would look like. Also

included, in some instances, are discussions of additional answers, alternative answers, and other approaches to an answer that would receive credit.

Overall Objective for Question 1. The focus of this question is to discuss what constitutes objectives that enable the planner to effectively work with the client for goal achievement and to develop benchmarks so that progress can be measured and corrective action, if needed, can be taken.

Example of the Answer to Question 1

a. The financial objectives typically sought by individuals are as follows:

- Standard of living The current and future living standards are intertwined. Devoting exceptionally large portions of current income during the working years to this objective leaves little to be set aside for future years when income from employment is reduced or nonexistent.
- Protection Clients require protection against uncertainties including the risks of illness and death, as well as property loss and liability exposure.
- Retirement (financial independence) Through either a business plan, an individual plan, or both, clients desire to be financially independent during their retirement years.
- Capital accumulation For many varied purposes, such as education funding for children, down payments on residences, vacation homes, and sheer acquisition of assets to be wealthy, clients have this as an objective.
- Estate distribution Typically, most clients who have amassed a sizable estate desire to

have it distributed both as they would prefer and with a minimum of shrinkage due to administrative expenses and taxes.

A somewhat different list of items would be acceptable, provided it included several distinct categories of financial objectives.

- b. Objectives require some degree of specificity for the client and the planner to effectively establish programs of action for objective achievement. These characteristics are as follows:
 - 1. First and foremost, the objective must be quantified, that is, have some numerical target. Thus, “accumulate money for a college education for the children” is not sufficient, but “accumulate \$25,000 of education funds for each of the two children” provides the needed quantification.
 - 2. Next, the objective must have a target date or time frame for completion. Obviously, for education funding, that time is when each child will start college. However, must the entire amount be available at that time or can some of the expenses be paid from income during the college years? The target time must so specify the duration of the funding period.
 - 3. The last criterion is that the various objectives be prioritized according to which are the most important, are the least deferrable, and, hence, should have the greatest emphasis in short-term goal achievement.

Overall Objective for Question 2. The focus of this question is to discuss the factors that should be considered when advising a client about his or her retirement options. These factors include the client’s objectives, health, age, and survivorship option percentage.

Example of the Answer to Question 2

- a. There are several factors that should be considered when advising Eric on the selection of a retirement option. The

first is a review of the Winners' objectives. These may suggest which retirement option is most appropriate. For example, if one objective is to maximize cash flow or current income, the single life annuity plan would be the preferred option.

A second factor to consider is Eric's health. Because of the recent heart attack, there is an obvious need to be concerned about possible future medical costs, including potential institutional care if Patti is unable to care for Eric. Finally, Eric's health should place him on the short side of the life expectancy range for individuals his age.

The difference in age between Eric and Patti is another factor that could influence the decision between retirement options. The reduction in the benefit amount for the survivorship option increases as the age difference between the annuitants increases. Because of the age difference in this case, the benefit amount for the survivorship option could be considerably below the benefit level for the single life annuity. Eric should ask for the benefit amount under each option.

The age difference has a second effect on the option decision. Although there might be an objective to maximize income now, consideration should be given to future income needs. Under either option, Eric's retirement income might be satisfactory when added to Patti's income from the store and their unearned income. However, when Patti retires, how much income will be needed? It is probably safe to say that Eric will not be alive when Patti reaches retirement age. Planning ahead, would the survivor annuity from Eric's plan be a welcome supplement to Patti's retirement plan (should she establish one), her social security, and other income?

Several other factors might be considered in the election process. For example, what is the survivorship option percentage—50, 75, or 100? Each affects the benefit level. It could also be suggested that the difference in benefit level between the options would be used to purchase life insurance that might provide a greater benefit than the survivorship annuity option (this option is not viable in this case because of Eric's uninsurability). It could also be stated that inflation expectations would influence a decision on which retirement option to select.

A full answer to this question should include a discussion of objectives, Eric's health, and differences in ages as factors in the decision process. Credit would be earned for other factors.

- b. Qualified pension plans include a requirement that retirement benefits be paid in the form of a joint and survivor annuity, unless waived by the participant with the consent of his or her spouse. Therefore, if Eric elects the single life annuity, Patti must consent (in writing) to this election.

Overall Objective for Question 3. The focus of this question is to discuss what the advantages of an IRA are for a self-employed client, how they outweigh the disadvantages, and how an IRA compares with a Keogh plan.

Example of the Answer to Question 3

- a. The maximum contribution to an IRA is the lesser of \$2,000 or 100 percent of compensation. The level of income for the Winners is not stated in the case, but it can be assumed that Patti's income exceeds \$2,000. Therefore, her maximum contribution to the IRA will be limited to \$2,000 (\$2,250 on a spousal basis).

Since Eric is still an active participant in a qualified pension plan, some or all of Patti's IRA contribution would be considered nondeductible from income for tax purposes. However, when Eric does retire, the entire \$2,000 will be deductible.

Several reasons can be advanced to recommend that Patti establish an IRA.

1. The contribution can be deductible from income for tax purposes (up to the limit allowed).
2. The internal buildup is tax-deferred. Even if the entire \$2,000 is not deductible for tax purposes, Patti might establish two IRAs (deductible contribution—nondeductible contribution) because of this advantage.
3. Patti can exercise some control over the investment vehicle for the IRA (mutual funds, CDs, trust accounts, insurance annuities, etc.).

4. At retirement, funds can be withdrawn as a lump sum or as installment payments.
5. Distributions are taxed as ordinary income (at presumably lower rates at retirement).
6. Contribution can vary from year to year (subject to a maximum contribution).

In addition, the answer to this question could include features such as the unpaid amount of the IRA account going to a selected beneficiary at death of the annuitant, or the possible rollover facility from one IRA to another or from other distributions of funds.

A comment could be made about the 10 percent penalty for early withdrawal before age 59½ (except for certain distributions). This is a limitation rather than a reason to support the purchase of an IRA. However, it could be argued that the early withdrawal penalty might be a positive influence on a participant to leave funds intact to accomplish the objective of retirement funding.

Finally, it might be argued that \$2,000 is a rather small token contribution to a pension plan. However, at Patti's current age, a \$2,000 annual contribution over the next twenty-nine years at an interest rate such as 8 percent will grow to \$207,932.

- b. Keogh plans are now basically subject to the same requirements as qualified corporate retirement plans. One of these requirements is the inclusion of employees in the plan. Since Patti has stated that she does not want to include employees in a retirement plan at this time, a Keogh plan cannot be established. However, when it is pointed out to Patti that with a Keogh plan she can—depending on the structure of the plan and the amount of her income—contribute up to \$30,000 annually and that the generally high turnover of retail employees often leads to forfeitures, there is the possibility that she would change her mind about employee coverage. If she were to change her mind on the inclusion of employees, Keogh plans (or other pension plans) could be recommended. One reason, for example, would be the ability to contribute more than \$2,000 on Patti's behalf.

Overall Objective for Question 4. The focus of this question is to discuss whether a single-premium whole life insurance policy is an appropriate investment vehicle to fund the clients' children's college education. Also, the candidate is asked to discuss the potential problems with the investment strategy of buying a term life insurance policy on an annual premium basis and investing an amount comparable to the single-premium whole life policy. The problems are in the areas of estate planning, personal income-tax planning, risk-management planning, and investment planning.

Example of the Answer to Question 4

- a. The recommendation is that the SPWL policy not be purchased on Patti's life.

An SPWL fails to meet the seven-pay test and therefore becomes a modified endowment contract (MEC). Policies that are classified as MECs do not enjoy certain tax-related advantages associated with cash-value life insurance policies.

Although investment earnings in an MEC accumulate income tax free, withdrawals may be subject to taxation. This includes policy loans as well as policy surrenders. Because the Winners will need the education funds beginning in about eight years, they could consider a policy loan. The loan would be taxable income to the extent the policy cash value exceeds the policy basis. As an alternative, the Winners could surrender the policy and receive the total cash-value accumulation (basis and accumulated interest). The amount above basis would be considered taxable income.

Although this taxation might be acceptable to the Winners, the law also extracts a 10 percent penalty for amounts (above basis) withdrawn prior to age 59½. Since Patti would be in the forty-four-to-fifty age bracket when education funds are needed, the impact of the penalty should be considered.

Finally, SPWL policies tend to include a surrender charge if the policy is surrendered during the early years (within ten to fifteen years). The Winners could expect a surrender charge in their situation.

It could be argued that an SPWL policy is an acceptable vehicle for the Winners' education funding. This argument would include that (1) the principal (\$30,000 in this case) is guaranteed, (2) there is a guaranteed minimum interest rate, and there could be a competitive current interest rate (with deferred taxation), and (3) the death benefit (not stated in the case) would provide more than adequate funds for college expenses if Patti were to die.

- b. Some of the problems that this strategy would raise are as follows:
 1. Term insurance is temporary protection. However, if the Winners view the education funding objective as needing protection should Patti die during the next few years, then the use of term insurance for this purpose is not a problem.
 2. Who will be the custodian of the assets? Whenever a parent (Patti or Eric) is custodian and subsequently dies before the assets are distributed to the children, and despite the fact that completed and perhaps taxable gifts were made under the UGMA provisions, the accumulated funds will be included in the parent's estate. Because the assets belong to the child (children), the assets do not qualify for the marital deduction and hence are part of the estate for estate-tax purposes.
 3. The income earned would be investment income and therefore subject to the "kiddie tax" provisions of the tax code as long as the children are under fourteen years of age. This means that, after a modest exclusion, the income earned would be taxed at the Winners' marginal tax rate.
 4. Removing \$30,000 of the bond portfolio could, if interest rates rise and the value of the bond portfolio declines, subject the Winners to a maintenance margin call since the bond portfolio is leveraged.
 5. There is a potential problem of investment-fund management. Will the Winners match the maturity dates with the need for the funds so that bonds need

not be sold at a discount if interest rates are high when funds are needed for college education?

6. There is a potential gift tax problem if \$15,000 is given to each child in one year unless Eric and Patti make joint gifts to the children.
7. Some states restrict the type of assets that can be used to make qualified gifts to minors. The Winners must obtain legal advice on this matter.

This question requires some integration of issues from estate planning, taxation, insurance, and investment planning to develop the particular problems associated with this particular strategy.

Overall Objective for Question 5. The focus of this question is to discuss the different types of investment risks and how diversification can eliminate the effect of most investment risks except market risk, which is nondiversifiable. Furthermore, the candidate is asked to discuss the need to establish some objective criteria in order to determine whether the investments are performing as expected and some guidelines for evaluating how realistic the expected rate of return is. Last, the candidate is asked to determine what the client's risk-taking propensity is and whether it is appropriate.

Example of the Answer to Question 5

- a. The various risks associated with a marketable investment instrument (or portfolio) can be described as follows:
 - Business risk This is the risk that the venture might fail for operating reasons such as poor management or products, actions of rivals, and changes in consumer preferences.
 - Financial risk This occurs if the firm uses too high a degree of financial leverage (borrowing) and, despite its operating profitability, is unable to service its debt obligations.
 - Inflation risk Sometimes known as purchasing-power risk, this risk is concerned with

the manner in which both the annual income and the value of the principal (capital invested) increases with increases in the rate of inflation.

- **Interest-rate risk** This is a two-part risk. First, how does the market price of the investment change with changes in the interest rate? For many investments, the relationship is negative; that is, the investment's market price and interest rates move in opposite directions. Second, fixed-duration investments mature, and the proceeds must be reinvested. If current rates are at or near all-time lows, the investor will not be able to obtain the same return as was realized on the surrendered investments.
- **Market risk** Whenever the market as a whole is depressed for a particular investment, such as stocks in mid-October 1987, then the value of the investment falls.
- **Liquidity risk** This is an inability to sell the investment quickly and at the current market price should an emergency need for funds arise. A more stringent description would also include "and not at a loss"; that is, the sale will not generate any appreciable capital loss.
- **Tax risk** Congress can alter the taxation of some element associated with the investment that will result in making the investment more (or less) attractive.
- **Event risk** This is a new concept that has emerged with the recent rash of leveraged buy-outs. Owners of previously issued bonds of the acquisition target suffer a reduction in bond values as the market assesses these bonds to be junk bonds in the same category as those that will

be issued to raise the funds to purchase the targeted firm.

The above risks are appropriate for both individual investments such as stocks, bonds, and real estate as well as for portfolios consisting of one form of investment instrument (i.e., stocks) or a mixture of several instruments (stocks, bonds, futures, real estate, etc.).

Modern portfolio theory is based on the covariance of the performance of several stocks contained in a portfolio. If the covariances are properly selected, a portfolio of about twenty properly diversified stocks is needed to eliminate the effect of most of the investment risks except market risk, which is nondiversifiable. Thus an approach to this question might distinguish between diversifiable (sometimes called nonsystematic) risk and nondiversifiable (sometimes called systematic or market) risk. If the diversifiable risk were explained to include the potential for business, financial, or tax risks, as well as an explanation of the nondiversifiable risk, the candidate would have responded to the question.

- b. Although the Winners' risk-taking propensity is not explicitly stated in the facts, an impression, based on the nature of their assets and the financing thereof as well as the nature of the business, is that they have some tolerance for risk-taking activities. However, at this time, some advice concerning the risk structure of their total situation and some words of caution seem appropriate, at least until such time as they decide upon and arrange for some of their future financial concerns. Therefore, this discussion suggests that the portfolio could be considered as being inappropriate.

First, they appear to use a high degree of leverage in the acquisition of their assets. Although they do possess equity in their assets, each asset does have some debt associated with it. When Eric retires, their income will most likely decline, and interest and debt-reduction payments could become burdensome.

Patti's ownership of the computer store can be perceived by some as a high-risk venture. The survival rate for small businesses is low—less than half remain in business more than a few years. In addition, rapid growth characterized the personal computer market during the recent past, and the

retail market for these products has been relatively easy to enter. Thus competition for both the consumer and business dollar has risen and could lead to severe price cutting if a “hard fall” rather than a “soft landing” recession occurs in the near future. Because of the previously described risks inherent in Patti’s business, consideration should be given to insulating the Winners from the potential liabilities: possibly through incorporation.

A third consideration is that although Eric seems to have recovered from his heart attack, a second one could occur. If the joint and survivor pension option were elected, there would be a significant reduction in income should a second heart attack be fatal. If the single life option were elected, all income from his pension would cease upon his death (except for the contractual payments certain).

Lastly, the Winners have not yet decided on a funding scheme for their children’s education. Although they own \$320,000 of securities, many of the stocks are of a high-risk nature. Many advisers suggest that the sooner the funds are needed, the lower the assumed investment risk should be. With education expenses commencing within eight years, a depressed stock market such as that experienced in the mid-1970s to the early 1980s could seriously affect the value of these securities. Therefore, until college education funding is somewhat assured, a less risky portfolio should at least be considered.

This question requires the examination of the total situation and a conclusion based on the information provided. Obviously not all the needed data can be provided within a short fact pattern, but sufficient clues can be contained therein to recommend, with reasons, one course of action or another. The above answer suggests an element of caution as the appropriate action for the Winners.

An alternate answer, suggesting that they reduce some of the outstanding indebtedness; provide for the education funding for the two children; determine an appropriate pension distribution; and ascertain whether Eric is going to work in the store (or elsewhere), that the consequences of the portfolio risk are made clear to them, and that the risk is in line with their risk tolerances, and, hence, that the port-

folio's risk level is satisfactory, would also be acceptable provided there were reasoning for the course of action.

Overall Objective for Question 6. The focus of this question is to discuss the estate-tax consequences if Section 6166 is elected and the individual tax consequences if the franchise is sold back to the franchisor.

Example of the Answer to Question 6

- a. The tax consequences to Patti's estate would be as follows:
 - The full value of the business would be included in her estate.
 - Taxes on the value of the business could be deferred.
 - For the first five years, interest would only be paid on the deferred portion of the taxes.
 - During the following ten years the taxes due would be amortized and interest would be paid on the deferred, unpaid tax balance.
- b. Because Patti owns her business as a sole proprietor, the proceeds on the sale of the business would be taxed to the Winners as follows:
 - The business would be divided into its component parts and a pro-rata fair-market value allocation of the sales price made to each part.
 - The ordinary-income components sold at a gain would yield ordinary income.
 - The capital-gain components, after a recovery of basis, would yield capital gain (any built-in recapture income would be treated as ordinary income, includable in income in the year of sale).
 - Each annual installment is to be allocated between return of basis (not taxable), ordinary income, capital gain, and interest income.

Appendix C

INSTRUCTIONS FOR CANDIDATES FOR THE PFS EXAMINATION

1. When you arrive at the examination site, you must—
 - Sign the roster sheet.
 - Show the letter we sent you with your Candidate Number on it to the proctor. Compare the Candidate Number with the one on the roster sheet. If there is a discrepancy, the proctor will change the roster sheet.
 - Provide the proctor with a photo ID, such as your driver's license, passport, etc.
2. Before you sit down at the examination table, you must place attache cases, bags, books, and writing paper that you have brought with you in the space in the examination room designated for storing these items.
3. The only aids you are allowed to take to the examination table are pens, pencils, and erasers. Rulers, slide rules, and calculators are prohibited.

Personal items, such as purses, snacks, beverages, timers, etc., are allowed at the examination table; but must be placed on the table so that they are visible to the proctor(s).
4. The following materials will be distributed to you shortly before the examination begins:
 - Examination booklet
 - Printed answer sheet (Part I only)
 - Answer book (Part II only)

5. Before the examination begins, you may do the following:
 - Put your *Candidate Number* on the cover page of the examination booklet, the printed answer sheet, and the cover page of the answer book (Part II only).
 - Put your *Examination Site Number* on the printed answer sheet.
 - Put the *Examination Booklet Number* in the space provided on the printed answer sheet.
6. You are not permitted to open the examination booklet until the starting signal is given.
7. The PFS Examination consists of two separate booklets.
 - Part I is scheduled for three hours from 9:00 AM to 12 noon.
Part I consists of multiple-choice questions (50 percent of grade).
 - Part II is scheduled for three hours from 1:00 PM to 4:00 PM.
Part II consists of objective-format other-than-multiple-choice questions (25 percent of grade) and a case-study question (25 percent of grade).
8. You must observe the fixed time for each examination. Be ready when the starting signal is given and stop writing when told to do so.
9. During the examination, any reference to books or other materials or the exchange of information with other candidates shall be considered misconduct sufficient to bar you from further participation in the examination.
10. Do not write your name anywhere in the examination materials.
11. Answer **all** multiple-choice items on Part I of the examination and **all** objective-format other-than-multiple-choice items on Part II of the examination on the printed answer sheet provided for that purpose.

Use a No. 2 pencil only. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments associated with them are not considered. Be certain that you have entered your answers on the printed answer sheet before the examination time is up.

12. Answer the case-study question in the answer book provided. Write on one side of the paper only. Additional answer books will be available if you need them.
13. You are not permitted to take the examination booklet, printed answer sheet, or answer book with you when you leave your table temporarily. You are responsible for protecting your examination materials at all times and should turn them face down when temporarily leaving for any reason.
14. Penalties will be imposed on any candidate who is caught cheating. These penalties may include expulsion from the examination and ineligibility to apply to sit for future PFS examinations.
15. You cannot leave the examination site before 11:30 AM for Part I of the examination and 3:30 PM for Part II of the examination.
16. You must turn in the examination booklet with your answers (printed answer sheet and answer book[s]). You must not take the examination booklet with you.

Any questions regarding the PFS Designation Program or Examination may be addressed to the following:

**Personal Financial Planning Division
American Institute of Certified
Public Accountants**

**Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881
1-800-862-4272, submenu #5**