UNDER 5/AFTER 5 CHAPTER PROGRAM

PRACTICE DEVELOPMENT SERIES

Module 6

Analysis

Advocis®
The Financial Advisors Association of Canada

Learning Objectives

The initial interview and fact finding process will uncover a client's financial goals and priorities. The analysis and recommendation will differentiate you from other advisors in the marketplace. In this module, you will learn how to

- Prepare a financial plan and analysis
- Identify opportunities to improve a client's financial situation
- Prepare recommendations to address a client's needs.
- Give full and adequate disclosure of all assumptions made in the analysis
- Be aware of the life insurance policy replacement rules when making changes to current coverage

Preparing the Financial Plan & Analysis

Advisors approach financial planning from different directions. An advisor who has a background in life insurance may initially provide risk management services to their clients but may wish to expand their services into other areas. An advisor with an investment background may provide investment planning but also wish to expand in providing a broader range of services. Whatever the initial service provided, the transition to other services can be accommodated either by modular or comprehensive planning.

Advisors should always approach planning by offering the highest service, which often means preparing a comprehensive financial plan. An advisor who is trying to distinguish themselves and build lasting client relationships will incorporate comprehensive financial planning into their business.

With comprehensive financial planning, the initial fact finding interview will likely be longer, and require more than one touch point to gather all the information needed to complete the plan. It is critical to set a timeline and manage it. Examining the financial information and client goals together allows you present a solution that is unique and tailored to that client. All the goals and issues can be examined and prioritized based on cash flow, life stage and risk. Approaching the client's situation on a strategic basis using a comprehensive planning approach, often leads to more appropriate recommendations since the impact to all areas of the client's life is seen more clearly.

The client may not want a comprehensive financial plan at a particular time. They may also want to get to know you better before agreeing to a financial plan. That may mean providing the service you have introduced to the client or the service the client is looking for. In that case, the financial analysis will be modular rather than comprehensive. Keep in mind that the **Advocis Code of Professional Conduct** requires advisors to put the needs of the client first. When it is appropriate, a transition can be made to providing additional services to meet a client's changing needs.

Needs Analysis

A needs analysis is the process of identifying and quantifying a client's financial goals, then comparing those goals to any action that the client may be taking to achieve those goals.

The end result tells both you and the client whether or not the client is on track to achieve that particular goal, and if not, exactly what must be done in order to achieve it.

It's critical that the figures used in the needs analysis are those provided by the prospect, not the advisor. In this way, the analysis will be meaningful to the prospect since the numbers used are the prospect's. Regardless of the numbers used, the most important principle behind effective needs analysis is that it must be completed realistically.

A needs analysis can be conducted two ways;

- In a two interview approach, asking related questions (as illustrated on the following pages) during your fact finding interview, and presenting your findings as a part of a comprehensive financial plan
- On a single need basis during a discussion around one particular goal, prior to making a recommendation

Needs analysis is an integral part of delivering quality advice to clients for both investment and insurance goals. It's important to note that a needs analysis represents only one snap-shot of time, and as a result, it is recommended that all needs analysis are reviewed annually. The following section outlines the needs analysis process for both.

1. **Insurance Needs Analysis**

Life Insurance Needs Analysis

There are a number of methods that are available to calculate the amount of life insurance required:

1. *Multiple of earnings*. This method uses a multiple of annual earnings to arrive at an amount. For example, someone earning $50,000 per year may need 10 times earnings of protection. This would equate to $500,000 of life insurance required. There are a number of concerns for using this method including the fact that it does not take into account age (25 or 60) or responsibilities (single person versus married with children).

2. *Human Value*. The present value of the family's share of the breadwinner's future earnings is considered as human life value for purposes of life insurance. For example, the breadwinner, age 35, earning $50,000 per year is assumed to work for another 25 years until age 60. The present value of his/her future earnings would amount to over 1.2 million dollars at 3%.The concern with this method is that it does not take into consideration the current assets and liabilities of the person, the responsibilities he/she has, or his/her goals and objectives.

3. *Capital Needs Analysis*. This is the most common and most accurate method of determining life insurance needs. It takes into account the current assets and liabilities, government benefits, and the goals and objectives of the prospect.

For each need, it is strongly recommended that you research and understand what the costs are in your community.

Critical Illness Needs Analysis

The procedure used to calculate the amount of critical illness insurance to cover the costs of a critical illness is not as straight forward as at death. Whereas there is an element of certainty for the expenses (funeral, legal fees, probate, etc.) at death, the expenses at time of a critical illness are unknown.

Critical illness needs analysis tools may be used to determine an appropriate amount of coverage for the prospect; however, it should be communicated that the final dollar recommendation is based on the assumptions of the prospect. In other words, there is no guarantee that the amount of the recommendation will be sufficient to cover all expenses.

Similar to the Life Insurance Needs Analysis, it is imperative that the advisor understand the potential costs of a critical illness. It is also important for the advisor to understand the probability of having a critical illness and when each critical illness can occur.

For example, Multiple Sclerosis (MS) is a dread disease. Although there are 50,000 multiple sclerosis sufferers in Canada, the number of Canadians affected are many times that number since caregivers and family members (children) are very much affected.

For the vast majority of cases, MS is first diagnosed before the age of 40with sufferers having a life expectancy of only 10 years shorter than average. Those with MS may suffer from a variety of conditions, including severe fatigue, chronic pain, memory loss, blindness, and muscle loss required for walking, lifting, etc. There is no known cause and there is no known cure. MS strikes more women than men and is most common with people who lived in temperate climates during childhood.

Additional financial expenses for MS sufferers may include:

- mobility assist devices (wheelchairs, scooters, vehicle modifications, etc.);
- home modification (ramps, washrooms, elevators, door widenings to accommodate wheelchairs, etc.);
- medication and treatment (experimental drugs, out of country treatment);
- loss of income (for person with MS and for caregiver);
- additional child care expenses.

These additional financial expenses can add up to the hundreds of thousands of dollars for the lifetime of the person who has multiple sclerosis.

Knowledge to this depth of the critical illnesses covered by critical illness insurance will assist you in bringing the CI Needs Analysis to life. Using statistics alone will not tell the entire story.

Disability Needs Analysis

Unlike life insurance and critical illness insurance, the availability of disability income insurance is restricted. It may not be available to the prospect because of his/her age, income, occupation, understanding of English or French, current coverage, place of employment (at home or outside of home), or pattern of employment (full time versus part time).

Most disability needs analysis tools are based on the amount of income required for the family to maintain their lifestyle and financial planning goals, if the prospect is disabled. Sensitivity to the fact that additional disability income insurance may not be available, even if there is a need determined, should be expressed prior to presenting the recommendations from the analysis. Unless care is exercised in communicating this fact, your product recommendations for other needs may be jeopardized.

When conducting a needs analysis on a business owner, more complex variables need to be discussed, such as the source of income (salary, bonus, dividends), often financial information about the business, or corporation, overhead expenses as well as any potential unfunded obligations from buy/sell agreements that may be in place with business partners.

2. Investment Needs Analysis

Investment needs analysis differs from insurance needs analysis; it is far more segmented. It's important to analyze client investment goals separately, whether that is individual, corporate or business owner, and to consider the multiple strategies which could exist to support goal achievement i. (i.e. a client may want to save for their child's education, while also ensuring that their own retirement plans are on track; similarly, a business owner may have investment goals that are both personal and business related).

Doing this effectively, requires that you clearly identify several variables related to the underlying investment goal.

a) Capital Required: Identifying the capital required can be as simple as an arbitrary savings goal, such as a client wanting $10,000 in savings, to a much more specific capital goal, such as a buy-out of a business at a specified time at a specified price.

b) Time Horizon: Time horizon speaks to the length of time that the client has to achieve the savings goal, or in the case of income planning, the length of time a client needs the income for.

c) Payment: The payment represents either the amount of money a client is able to contribute towards a goal, or can also represent a specific payment a client would like to receive from an investment.

d) Target Rate of Return: Choosing a target rate of return is a critical variable that can impact the saving goal(s), so great care should be taken in the process in which you use to determine your assumptions. When determining a target rate of return, you should keep in mind the following constraints;

- Client's time horizon
- Client's risk tolerance
- Clients requirement for liquidity
- Client's investment knowledge and experience

Financial Planning Software

The financial planning process, requires a written report or analysis to present to a client. There are many different types of planning software available to help you prepare a professional analysis with recommendations. Some financial tools require minimal input to quickly present solutions, addressing only one goal or concern, such as future values, or monthly savings needed to reach various goals. Others are more complex and link multiple goals together while giving the option to run “what if” scenarios.

Whatever financial tools and software you will be using, you must know how to use it expertly and have full confidence in the calculations so they can be explained to a client. Not all software works the same way or uses the same assumptions. While financial planning tools may have many input fields, even the most sophisticated software will make a number of assumptions such as income tax rates and deductions, how compound growth is calculated and when dividends are paid, to name a few. Keep this in mind if you will be using tools from multiple sources, as the results may be inconsistent.

The Base Plan

To prepare an analysis of a client’s current situation, you will prepare what many planners refer to as a “base plan” which is the starting point for planning. It will contain the client’s current personal and financial information collected in the initial interview or from the client’s tax return and other statements. The base plan will also show current savings strategies such as RRSP contributions. It is important to prepare the base plan because it will be key in demonstrating what the client is doing now and whether they are on track to achieving their goals if they continue. It will allow you to analyze the current situation, identify opportunities to improve the client’s financial picture and make a client aware of them.

To minimize the risk of overlooking an important part of the plan, consider using a checklist of the most common financial issues a client might have.

Identifying Opportunities

When you are analyzing the base plan, you should focus on whether the current plan allows the client to achieve their goals and objectives. You should identify opportunities to improve the client's financial plan by modifying the current approach or by implementing new strategies not currently in the base plan.

Most people make the majority of their financial decisions on what could be referred to as a transactional basis. That is, they make decisions in each specific area of their financial world in total isolation. They fail to recognize that their whole financial world is inextricably connected, and that today's decisions decide tomorrow's financial destiny. For instance, an advisor may notice a situation where a client borrows to buy a car, when they have cash available in their savings or investment account. The client may not know that using the cash to buy the car and borrowing the money for investing, would be more tax efficient and may result in a lower interest rate on the loan.

In some cases, the client tells you they have a specific goal in mind, but when you conduct the fact finding interview, you uncover other planning opportunities.

For example, a client may say they are interested in education planning because they want to provide for their children's education, should anything happen to them. The client is clearly interested in education planning (a Registered Education Savings Program (RESP) or other savings vehicle) and will likely be open to a discussion about various savings options and investment products. However, the advisor may see the client's goal is broader than just saving for their children's education. Further probing may confirm that they want to make sure the children are taken care of should anything happen to them. An opportunity arises for the advisor to broaden the discussion and introduce insurance and other estate planning techniques to provide for their children's well-being in case of a death or disability of one or both parents.

Other opportunities the client may not have considered include using an RESP, Tax Free Savings Account (TFSA) or other vehicle to save for the children's education, which will lead to developing an investment plan. Another concept to introduce might be the use of trusts.

In the example, the client had one primary concern - they wanted a solution. As an advisor, you should always address the client's concerns first but also be looking for other financial strategies or gaps the client may not be aware of. Sometimes, you may not be able to address all of a client's needs at once. Financial issues and the solutions presented can be complex and will take time for a prospect or client to understand. To introduce too many options or issues at once may overwhelm the client and result in no action being taken because of all that you have introduced to them. Properly assessing their level of financial literacy in the initial interview is important and will help influence the advisor's approach.

A Holistic Approach Uncovers Opportunities

When preparing a financial plan, certain sections of the financial plan will uncover additional planning opportunities:

- Cash flow
- Asset management
- Taxation
- Estate distribution
- Preparing recommendations

Cash Flow

An analysis of a client's cash flow may seem like a simple exercise, but it is a critical first step in all planning activities. Unless they keep meticulous records, clients underestimate how much money they are spending and the cash flow statement and analysis is often shocking to them. Understanding where money is coming in from (employment, pensions, investments, rental income, annuity) and where it is going (lifestyle spending, income tax, debt repayment, investing) will help identify spending trade-offs that may need to be made to achieve financial goals and build wealth. For instance, clients that consistently use pay raises to increase lifestyle spending or borrow money annually to travel rather than saving towards that goal may not be aware of the long-term financial implications of those decisions. Less affluent clients may be uncertain as to whether they should invest or pay down debt. Depending on what debt they carry, often cash flow planning can help them to make the best decision for their situation.

Asset Management

Because investments are made at different times in a client's life, they tend to be sporadic and poorly managed and clients are often unaware of what they own. This is especially true when clients hold their assets with multiple financial institutions, and by analyzing all of their assets by goal together, you will provide exceptional, and often unique value to your client.

Investment risk is often misunderstood and you will need to explain to clients that risk is not just in their investment portfolios. Risk needs to be understood and managed – it cannot be fully eliminated. Even a GIC that appears to be risk-free to clients comes with purchasing power risk if the after-tax return does not keep up with inflation. Without a disciplined approach and an investment policy statement (IPS), investments may not be in line with their risk tolerance, time horizon, age, objectives and properly diversified. An IPS is the foundation for all investment strategies and recommendations. An advisor who will be making investment recommendations should require a client to have an IPS.

Taxation

Minimizing income tax is an integral part of building wealth. Tax rules are constantly changing and new products and strategies to help minimize tax continually evolve. Introducing clients to tax efficient investments; accounts such as the Tax Free Savings Account; strategies such as income splitting and tax loss selling, can create additional cash for clients to allocate towards their goals. Reducing taxes frees up cash, which can be directed to debt repayment, savings plans or other client goals.

Estate Distribution

Few people are aware of the tax consequences on death, which can significantly reduce the size of the estate for a surviving spouse or other beneficiaries. Examining a client's assets at an invented date of death can uncover an insurance need to help fund the cost of income taxes. It may also uncover opportunities to minimize income tax or probate fees by changing beneficiary designations, or creating testamentary trusts.

Preparing Recommendations

The recommendations should address any shortfalls in meeting a client's goals. They can be actions that can be taken immediately (rebalance portfolio, acquire life insurance, open RESP account, reduce spending and increase savings), those that are midterm (focus on RRSP contributions once the mortgage is paid off) and those that are long-term (delaying retirement date).

Every recommendation made by an advisor must consider whether they have put the client's best interest first. Does the recommendation take into consideration the client's goals, objectives dreams and fears? Has the client been presented alternative strategies to achieve the same result? How do the recommendations impact the client's current and future cash flow?

It is important that you are prepared to show a client more than one solution and to alter the solution based on the client discussion. Regardless of what you recommend, it may be necessary for the client to prioritize which recommendations they will act upon and when. The client's decision could be based on their available cash flow or other personal reasons. Using an action plan checklist will allow you to clearly identify all items to be addressed with a proposed timeline for doing so. The checklist can be part of the plan itself or it can be a separate document. The checklist need not be complex – a sample **Action Plan Checklist** can be found in the Forms & Templates section of the online BPM.

Full & Complete Disclosure

As you prepare the recommendations to present to a client, it is important not to overpromise.
Any projections or reports you show should help the client understand both the upside and downside risks of each of the recommendations. Before you present any recommendations to your clients review your presentation for the following:

- All reports should include consistent and realistic interest rates, rates of return or interest factors
- All reports should show the best and worst case scenarios and the impact on the client's goals, cash flow, income taxes and estate plan
- Terminology used must be plain, consumer-friendly language with limited use of industry jargon

- Guaranteed values or features must be clearly indicated reports or Illustrations should contain appropriate disclaimers and warnings and show all assumptions used in the calculations
- Advisors must disclose any conflict of interest, which would prevent the advisor from acting in the best interest of the client
- Advisors should be prepared to explain to the client how they will be paid for their services or products sold

Summary

You should now be able to:

- Prepare a financial plan and analysis
- Identify client opportunities and prepare recommendations to address their needs
- Fully disclose assumptions in the analysis process