August 7, 2012

Sample CFP® Certification Examination Questions

The following exam questions have appeared in previous administrations of the CFP® Certification Examination and meet the Job Task Domain blueprint requirements of the current exam. They are provided to help familiarize examinees with the format and cognitive level of questions on the exam. Answer keys and brief rationales are included to provide some explanation of the correct answer.

The sample questions do not represent an actual exam in length or content coverage. Examinees should not equate success or failure in answering these questions as a measure of readiness for the CFP® Certification Examination.

Job Task Domain
1.A - Identify the Client (e.g., individual, family, business, organization)

A client, Tom, informs a CFP® professional that his daughter, Susie, graduated from college last month and landed her first job. Tom wants to establish a Roth IRA for Susie. Tom wants to make a $5,000 contribution for Susie and explains that she does not know about investing and probably would not have the money to contribute. How could the CFP® professional best accomplish Tom's objective?

A  Open the account in Susie's name and then gift the assets to Susie.
B  Explain to Tom that he can contribute to an IRA for Susie.
C  Request Tom set up a joint meeting with Susie to complete the planning process with her.
D  Explain to Tom that Susie must complete a risk questionnaire before Tom can open the account.

Rationale
Susie will be the client and account owner and will need to be involved in the process and also "known" by the CFP® professional.
Job Task Domain
1.I.1 - Regulatory Disclosure

A CFP® professional is a Registered Investment Advisor, managing $120,000,000 in assets. One of the CFP® professional's clients sends a complaint letter to the CFP® professional, complaining that certain trades were not properly executed. During the investigation, it is discovered that the client never received the firm’s Form ADV. Which governing body has ultimate authority over lack of regulatory disclosure for this matter?

A  FINRA  
B  CFP Board  
C  The firm's compliance department  

Key  D  SEC

Rationale
The SEC regulates form ADV.
Job Task Domain
2.A.4 - Assess the Client’s Risk Exposures (e.g., longevity, economic, liability, health)

A young, single client approaches a CFP® professional with $5,000 stating that he would like to develop a financial plan and invest in the market. This is his first experience investing and he would like help choosing an appropriate account. What is the CFP® professional’s most appropriate course of action?

A  Open a brokerage account with margin
B  Open and fund a Roth IRA for the current year
Key C  Determine whether the client has any consumer debt
D  Determine whether the client has adequate life insurance

Rationale
Of the answer options provided, reviewing debt is the best fit. The CFP® professional needs additional information from the client before taking an action involving increasing client risk, such as opening a margin account. Reviewing life insurance may be appropriate for the client, but does not appear to be a goal of the client. The CFP® professional does not have enough information to determine if a Roth IRA is appropriate.
Ron and his wife Susan, both 61 years of age, ask a CFP® professional to provide a recommendation on whether or not Susan should start to draw Social Security benefits when she first becomes eligible at age 62. Which of the following would be the least important to obtain in order to provide a recommendation?

A  Family longevity and health history  
B  Social Security earning statement for each  
C  Other retirement assets or financial needs  
Key  D  Long-term disability coverage

Rationale
Requires consideration of multiple issues such as financial needs, health/life expectancy, survivor benefits, higher wage earner analysis. Disability coverage is not a factor.
Job Task Domain
3 - Analyzing and Evaluating the Client's Current Financial Status

A client has a $1,200,000 portfolio consisting of the following four stocks:

1. $300,000   ABC @ 1.1 beta
2. $225,000   RTR @ 0.7 beta
3. $405,000   XYZ @ 0.3 beta
4. $270,000   PDQ @ 1.3 beta

What is the beta of the portfolio as a whole?

Key
A 0.8
B 0.85
C 0.91
D 1.0

Rationale
Weighted average of beta of components.
Job Task Domain
4.B - Consider Alternatives to Meet the Client's Goals and Objectives

A 56-year-old client becomes unemployed due to disability. The client tells a CFP® professional that he hopes to go back to work eventually, but is not sure when that might be. Until then, he needs to generate replacement income. His only available asset is his traditional 401(k) plan. What is the best way for the client to replace his income?

Key
A  Directly from the 401(k) plan
B  From a rollover IRA, using Rule 72(t)
C  From a rollover annuity, using substantially equal payments
D  From a brokerage account, using net unrealized appreciation (NUA)

Rationale
The 401(k) plan is penalty-free and will not require continued payments if the client goes back to work.
Job Task Domain
5 - Communicating the Recommendation(s)

A CFP® professional meets a prospective client who is prepared to discuss his retirement accounts from a former employer. The client is concerned that those accounts are too aggressive, given his age and risk tolerance. He states that he and his wife would like to retire when he is 65 and that they have recently been leveraging themselves to support their adult son, who has ongoing issues. After further analysis, the CFP® professional determines that the client does not have the cash flow to retire when he is 65 while continuing to support his son. How should the CFP® professional proceed?

A Communicate to the client that his retirement goals are unrealistic, that he should plan to work until age 70, and that he should stop helping his son financially
B Help the client to review his goals and prioritize them before continuing into implementation
C Review the client’s current and potential income streams to identify ways to solve his immediate cash flow problem
D Recommend a conservative asset allocation to reduce the risk in his retirement accounts and suggest that he stop helping his son

Rationale
B is the correct answer because it is important to allow the client to reassess priorities before making specific recommendations. C is wrong because it assumes the client has established a new goal.
A CFP® professional meets with two new clients who would like advice about their mortgage. In the review, the CFP® professional finds that their essential expenses exceed their income. Mortgage rates have come down significantly and they intend to refinance their current 30-year mortgage to a 15-year mortgage. Their payments will be higher than their current payment. However, they will pay off the mortgage 5 years earlier than the current amortization schedule allows. What should the CFP® professional do?

A  Suggest they stay with their current mortgage, as the higher interest is tax deductible

B  Suggest they refinance to a 30-year fixed mortgage and begin funding savings

C  Suggest they refinance to the 15-year mortgage, which would reduce the amount of interest paid over the life of the loan

D  Suggest they meet with their mortgage broker

**Rationale**
The clients have a negative cash flow, and should reduce their payments as much as possible and establish a cash reserve.
Job Task Domain
7.B - Review the Performance and Progress of the Plan with the Client

During an annual review with Anna and Lawrence Harvey, a CFP® professional discusses their retirement objectives. Because of weak market performance over the past few years, it appears that they are no longer on track for retirement. How should the CFP® professional best direct discussion of this situation?

A  Tell the Harveys that they must increase their monthly savings
B  Recommend no changes since the market is likely to recover in the long term
Key C  Discuss alternatives currently available to increase their likelihood of success
D  Suggest that they postpone their retirement date until the economy recovers

Rationale
It is important to explore all available alternatives in order to revise their retirement expectations.
Job Task Domain
8 - Practicing within Professional and Regulatory Standards

A client is involved in a potentially litigious matter and asks to confide legally sensitive information to a CFP® professional under the protection of advisor-client privilege. This information may affect another one of the CFP® professional's clients, who happens to be a business partner of the first client. How should the CFP® professional respond to this situation?

A  Ensure that the client signs the required Privacy Policy before having any discussions
Key  B  Caution the client that there is no such thing as advisor-client privilege
C  Document the information and, as required by CFP Board's fiduciary standard, debrief the second client on the details that pertain to her
D  Document the information and, as required by CFP Board's Rule on Reciprocal Disclosure

Rationale
*Rules of Conduct 3.1* states “a certificant shall treat information as confidential except as required in response to proper legal process; as necessitated by obligations to a certificant’s employer or partners; as required to defend against charges of wrongdoing; in connection with a civil dispute; or as needed to perform the services.”
Set #1
Kevin, a 55-year-old corporate executive, wants advice as to when he can retire. His current salary is $240,000 and he receives an annual bonus of $300,000; he also has annual stock options and restricted stock awards valued at $100,000. His employer contributes to a cash balance pension plan as and matches his contributions to a 401(k). Kevin owns a whole life insurance policy with a $500,000 death benefit and is considering the purchase of a term policy with a $2,000,000 death benefit. He and his wife, Anne, also age 55, believe they can live on an after-tax income of $180,000. Assume a federal income tax rate of 35%.

Job Task Domain
4 - Developing the Recommendation(s)
Kevin is in the 42% marginal tax bracket (combined federal and state). Kevin wants to contribute $100,000 towards his child’s education in the next 3 years. Which of the following approaches minimizes his taxable gift?

Key A Paying the college directly
B Contributing the funds to a Section 529 Qualified Tuition plan
C Contributing to a Uniform Transfers to Minors Act (UTMA) account for the child
D Contributing to a Coverdell Education Savings Account plan

Rationale
A. Paying the school directly does not utilize any annual exclusion or credit equivalent.
B. Utilizes annual exclusions and possibly credit equivalent unless Anne agrees to gift split.
C. Uses both annual exclusion and credit equivalent, even with gift splitting.
D. Not eligible due to income.

Job Task Domain
6 - Implementing the Recommendation(s)
Kevin's non-qualified stock options are as follows:

2,000 shares, strike price $34
5,000 shares, strike price $30
Current stock price: $65
Kevin's tax bracket: 42% (federal and state)

Kevin has decided to exercise the above stock option awards which will expire in the next 2 years. Assuming he exercises them today, what is his tax liability?

A $35,550
B $68,250
C $91,660
Key D $99,540
Rationale
Non-qualified stock options are taxed on the “bargain element” (difference between the market price and the strike price) as ordinary income when exercised. \( \text{(Market Price} - \text{strike price)} \times \text{Number of Shares} \times \text{Tax Rate} = \text{Tax} \)

Therefore, on the first NQ grant of 2,000 shares the tax is:
\( (\$65 - \$34) \times 2,000 \text{ shares} = \$62,000 \text{ in ordinary income. At 42% tax rate the tax is } \$62,000 \times .42 = \$26,040.00 \)

And

On the second NQ grant of 5,000 shares the tax is:
\( (\$65 - \$30) \times 5,000 = \$175,000 \text{ in ordinary income. At 42% tax rate the tax is } \$175,000 \times .42 = \$73,500.00 \)

Total tax therefore is \$26,040.00 + \$73,500.00 = \$99,540.00 \)
Set #2
Harold and Mary Anne Miller are a married couple in their early 40s with three children, ages 7, 10, and 12. Harold earns $350,000 per year as General Counsel of a mid-sized IT firm and Mary Anne is a homemaker. They have major assets of $1,500,000 cash and $1,000,000 in stock options. They have done no estate planning. Harold has life insurance of two times his salary from his employer. Harold plans on working full-time until age 62. Harold has the potential to receive more options and restricted stock based on his company’s performance, but has requested that this not be included in his assets for now given the uncertainty. College planning is of great concern to the Millers, currently they have no plan in place. They estimate that they will need $150,000 for each child in current dollars to fund their education. The Millers have constructed a budget and have determined that their household expenses are currently $12,000 per month, after tax. Assume that the Millers are in the 35% federal tax bracket and 6% state tax bracket.

Job Task Domain
4 - Developing the Recommendation(s)

The Millers would like to set aside money to cover all of the required funding for their children’s education. They are not confident the children will be able to handle money by age 21. Which of the following is most appropriate for the Millers?

- A Uniform Transfers to Minors Act (UTMA) account in the name of each child
- B Coverdell Education Savings Account
- C Section 529 Qualified College Savings plan
- D Section 529 Prepaid Tuition plan

Rationale
529 plan allows for the family to save for all qualified costs, not just tuition. UTMA account causes loss of control at the age of majority. Education IRA would not be able to fully fund education given contribution limits. Prepaid Tuition plan only covers tuition.

Job Task Domain
6 - Implementing the Recommendation(s)

Given the facts above, what is the most important piece of the plan that the Millers should implement first?

- A Establish Wills with guardianship
- B Exercise stock options
- C Diversify cash investments
- D Establish an irrevocable life insurance trust (ILIT)

Rationale
Given the fact they have done no estate planning and are concerned about what would happen to their children, this should be addressed first. B and C are also important, but should be done afterwards. There are no facts in the case that justify D as an immediate need.
Set #3
Five years ago John and Barbara, who are in their mid 50s and have one adult child out of college, experienced a sharp increase in income (ten times) within a two year period. Their lifestyle and the complexity of their financial situation increased respectively. Their income statement's bottom line increased and their assets/liabilities expanded as well (third home, credit card debt, etc.). They had no retirement savings at age 50; after consulting their accountant, they implemented a 401(k) and defined benefit plan with the dual purpose of deferring taxes and saving for retirement. John and Barbara's increase in income was based upon Barbara's success at a new business venture. John is the business manager of the venture. Their financial assumptions were based on unrealistic sales assumptions and they were not prepared for the recent recession or their parent company's subsequent reorganization. Since the reorganization their income fell by 65%. As a result, they had a mortgage on a second home in Las Vegas (purchased at the peak of the real estate market), less than one month of emergency reserves, and six-figure credit card debt. They were unable to fund their pension obligation (to themselves) and closed the plan, while also taking the maximum loans from their 401(k)s to pay off their credit cards.

John and Barbara's objectives include: immediately establishing an emergency fund, determining how much income will be needed from investments to supplement Social Security and work in retirement, and preparing an exit strategy for real estate holdings.

Job Task Domain
5 - Communicating the Recommendation(s)
A CFP® professional observes that John and Barbara are constantly living a few steps ahead of their means. They assure the CFP® professional that they will reign in their spending, but their credit card balances continue to rise. All of the following are acceptable strategies EXCEPT

A  Terminate the relationship with the clients
B  Document their inability to take advice to guard the practice from risk
C  Counsel the clients on credit card balance transfer strategies
Key  D  Ask their son to talk to his parents about their spending habits and accumulated debt

Rationale
The CFP® professional cannot discuss sensitive information with another family member unless he/she has prior permission, can fire the client, document lack of follow thru, and counsel the client, so D is the most acceptable answer. This is an example of the type of situation a CFP® professional has likely encountered in post recession America. The clients (John and Barbara) are living above their means. This question requires the candidate to synthesize client spending, ethical principles, practice standards and communication skills to identify which answer is simply not acceptable.

Answer option A is certainly acceptable. The planner could terminate the relationship with a client. In the 100-1 series Practice Standard, a CFP® professional must define client and adviser responsibilities. By continuing to live above their means, the clients may be presenting a situation where the planner and client cannot meet obligations to one another (such as funding goals).
Options B and C are both possible outcomes a financial planner should take if he/she is going to continue a relationship with the client. While option B is not an optimal solution to the clients’ immediate problems; the process of documentation may lead to further discussion. Option B requires an understanding of the 400 series Practice Standards; overspending must be documented as a limitation when presenting the client with primary and alternative recommendations. If the clients will continue to overspend they will require flexibility in savings products. Option C holds to the ethical principles of competence and objectivity; the CFP® professional would need to address the client goal of managing debt by developing a debt management plan.

Option D, the correct answer choice (known as the Key) violates the ethical principle of confidence. A CFP® professional may not disclose client information (in this case spending habits, debt and behavior) directly to an adult child without legal compulsion or the clients’ direct involvement.

**Job Task Domain**
5 - Communicating the Recommendation(s)

Barbara feels that the economy is on the verge of a turn-around. She has an opportunity to expand her business, and, if she is right about the economy, this will substantially grow revenue. She will need an additional $50,000 for this expansion. What is the most suitable recommendation for Barbara and John as it pertains to business expansion?

A  Borrow $50,000 from a home equity line of credit  
B  Take a $50,000 loan from their 401(k)s  
Key C  Bring in a qualified partner who is able to commit the capital  
D  Use part of the cash reserve to fund a portion of the expansion

**Rationale**
They cannot afford to increase the debt load, 401(k) loan is too risky if unable to repay, and cash reserves should not be drawn down for a non-emergency. C is the most acceptable answer.

This item requires the candidate to exhibit an understanding of case facts. The client narrative expresses that the clients are indebted with a six digit credit card debt. The question asks the candidate to identify the most suitable recommendation. While all recommendations would provide Barbara with $50,000, the candidate must synthesize the risk of each option before making a decision. The client narrative provides the candidate with Barbara and John’s prior assumptions (like infinite growth) which may provide the basis for professional skepticism.

Answer options A and B bring additional debt exposure to the client. Additional debt exposure for a client heavily indebted will jeopardize financial safety and wellness, and if Barbara’s hunch is wrong, will hasten negative financial consequences.

Option D takes away from their remaining cash reserves - which have previously been reduced to one month of living expenses. While living expense ranges vary client to client; reducing one month by $50,000 is less suitable than the correct answer option, C. Bringing an outside partner into the venture may limit future income in the event Barbara’s hunch is correct but does not subject the clients to additional loss exposure. Of the solutions presented, C is the most suitable.