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Achieving financial security for your retirement years: A Speech for CPAs to deliver to general audiences

American Institute of Certified Public Accountants. Communications Division

ACHIEVING FINANCIAL SECURITY FOR YOUR RETIREMENT YEARS

A SPEECH FOR CPAs TO DELIVER TO GENERAL AUDIENCES

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PREPARED BY:

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Most of us have an uncanny knack for postponing the inevitable. We know we have to save money for our retirement, but we simply don't want to begin saving until tomorrow, or next week, or next year.

Ideally, planning and saving for retirement should be a lifelong endeavor. Yet the majority of Americans postpone saving until the last moment. Starting early will give you the advantage of compounding interest. For example, if you contributed $2,000 a year to an IRA starting at age 17 and stopped funding it at age 20, your total contribution of $8,000 -- assuming an 8 percent interest rate -- will grow to $288,000 by the time you are 65. Now let's say you procrastinate until you are age 36 and then contribute $2,000 per year for the next 30 years until you are 65. Using the same 8 percent rate, the value of the IRA will be $227,000 and you will have contributed a total of $60,000. The amazing thing to note here is that if you had started saving younger -- in just four years of contributing, compared to 30 -- you would have accumulated $61,000 *more* at retirement, while contributing $52,000 *less*.

Unfortunately many of us never get to experience this incredible power of compounding interest. Perhaps we avoid saving for retirement because we think we can't afford to -- but the fact is we can't afford <u>not</u> to. And like it or not, old age creeps up on us before we realize it. Then, we must suddenly face what we put off 20 or 30 years ago -- and those who are not prepared indeed have reason to worry.

Maybe these statistics will make you think twice about postponing retirement planning: The American Association of Retired Persons reports that one-fifth of the older population was poor or near-poor in 1991 -- older women having a poverty rate double that of older men. In addition, the Social Security Administration suggests that Social Security benefits and pensions combined account for only 38 percent of an annual retirement income of $28,714. The balance of that income -- about another 62 percent -- will have to come from investments, earnings, and other sources.

These statistics show the absolute necessity of early planning if you want to maintain your independence and lifestyle during retirement.

Those of you born during the baby boom era have even more cause for concern. The 75 million Americans born between the years 1946 and 1964 will have much fewer working counterparts than those retired today. When the first generation of baby boomers retires in the year 2010, there will be about 10 million more retired persons than there are today. When the last generation of boomers retires in 2030, there will be about 35 million more retirees than there are today. With more than one-fifth of the population retired at the same time, your Social Security benefits could be significantly reduced.

Nevertheless, you can reduce your personal risk by early retirement planning. Today, we will explore just what retirement planning means. We'll take a look at the various factors which influence your decision on when to retire. Then, we will discuss how much money you may need for your retirement years. Finally, we'll take a detailed look at the different sources of retirement income.

The first step in planning for retirement is deciding when you want to retire. Many different factors -- personal, legal, and financial -- will influence your decision. One consideration is life expectancy. Currently, the average life expectancy is 76. However, a man age 65 can expect to live another 15 years -- to age 80, and a woman who is 65 may live another 19 years -- to age 84. Moreover, because of advanced medical technology, the Census Bureau expects the percentages of those age 85 or older to double within about 40 years. This dramatic increase means that many more people will need retirement income for periods stretching out to 20 years and beyond.

Your decision on when to retire may also be influenced by eligibility for Social Security benefits. There are three retirement option dates available to those who were born in or before the year 1937. These options are also available to those born after 1937, but with certain adjustments in dates and percentages.

- One -- you can retire between 62 and 65 on a reduced benefit.
- Two -- you can retire at 65 on a full benefit.
- Three -- you can delay retirement and get a bonus of 1 to 6.5 percent, depending on your birth date, for each year you delay retirement after your 65th birthday, up to age 70.

The law was changed in the mid-80s to gradually raise the age at which workers can retire to 67 years. Thus, if you were born between 1938 and 1959, the age at which you can retire with full benefits increases on a sliding scale from age 65 to 67. Those born in 1960 or later can retire with full Social Security benefits at age 67.

Another factor that will influence your decision on when to retire, as well as whether or not to change jobs, is your employer's pension plan. The important thing to keep in mind is that your pension may be significantly reduced, or completely eliminated, if you are not with the company long enough to be fully vested. So, if your employer's pension plan specifies that you must be with the company seven years before you become fully vested, and you've worked there only five years, it may be wise to sit tight for another two years. And don't forget that your benefit will hinge partly on your final salary.

After deciding when to retire, you can begin estimating how much money you'll need in each year of retirement. This amount depends on three factors -- namely, the number of years you expect to be retired . . . the lifestyle you desire during those years . . . and the rate of inflation between now and continuing throughout retirement.

How much you'll need for retirement is much easier to estimate if you're close to retirement, but it's important to develop a rough estimate even if you're 20 or 30 years away. Generally, anywhere from two-thirds to as much as three-quarters of your income before retirement may be required. This rule of thumb will vary depending on personal values, health, housing, and planned activities as a retiree.

A good approach to working up an estimate of required income is to assume that you are presently at retirement age. Using your current budget as a starting point, write down those expenses that will continue during retirement. Then determine how these expenses will change with retirement. For example:

- Hopefully, your mortgage will be paid off. If so, your housing costs should be lower.
- Work-related expenses -- clothing, commuting, eating out, and any other unreimbursed job expenses you can think of -- will be eliminated.
- Taxes may be less, but don't count on it. Social Security income is now taxed more heavily than in the past, and income tax rates could be higher than at present. Furthermore, your total taxable income may be larger than you think. The time-honored belief that a retiree will be in a lower tax bracket may become a myth from the past.
- Senior citizen discounts can add up. A variety of goods and services may be offered at reduced prices to those 62 and over, including travel. It often pays to ask.

You may, however, incur additional costs for health care due to loss of your present medical insurance and its replacement with Medicare, and physical problems may increase. A medigap policy supplementing Medicare may be advisable. Also, since you will have more free time, you may need more money to pursue a hobby, travel, or entertain family and friends. And don't forget possible relocation expenses.

Whether your discretionary lifestyle expenses go up or down during retirement is up to you. At any rate, it is crucial to forecast all of your expenditures as realistically and as accurately as possible, and to review them periodically. The absence of a retirement budget, or a haphazardly prepared budget, could very well lead to shortfalls and crisis situations that could have been avoided through planning.

A few points should be made regarding inflation. Anyone living on a fixed income must give serious thought to the never-ending increase in prices and consequent decrease in the value of the dollar. Financial planners recommend that in adjusting for inflation, an assumed rate of 4 to 7 percent be used. Economists feel this is a reasonable estimate for the next 10 to 20 years. In any case, it is advisable to periodically recalculate how much you will need as you get closer to retirement. Updated estimates will be more reliable and a more accurate investment scenario, including interest rates, may be factored in.

Now you know what's involved in figuring out how much money you will need during retirement. The next step is to calculate what your income during retirement will be and how much you will have saved by then. This requires that you list and total the sources of retirement income for both you and your spouse, and that you understand the characteristics of these sources as well. The four main sources of retirement income are:

- One -- Social Security.
- Two -- employer pension plans.
- Three -- retirement savings plans for individuals and business owners.
- Four -- personal investments.

Let's start with Social Security, or the deduction that appears on your paycheck as "FICA." Social Security is a compulsory federal government insurance program that provides basic financial support for you and your family during retirement or disability, and for your survivors following your death. The system was never intended to provide for financial independence at retirement by itself. Rather, it serves as a foundation for a comprehensive retirement plan -- as a supplement to other sources of income.

Basically, Social Security operates by taxing those currently working to fund the benefits of those currently retired. Your benefits are based on the average lifetime earnings on which you paid Social Security taxes. The computation of monthly benefits is complicated. Earnings in earlier years are restated to bring them into line with current wage levels. Also, earnings in low income years may be excluded from the calculation. Generally, it is safe to say that the more you have earned, the more you collect.

The amount of your monthly check also depends on how old you are when you apply for benefits. For example, the benefits of those who retire at age 62 are reduced, whereas those who retire at the normal retirement age of 65 to 67 receive regular benefits, and those who delay retirement beyond that age enjoy increased benefits. But in any case, Social Security income is limited. The maximum benefit payable in 1993 to a person who retires at 65 is $13,536; the average benefit is just $7,836. For married couples, both receiving benefits, the maximum amount is $20,304 and the average is $13,272.

If you continue to work beyond retirement, be aware that your Social Security benefits will be reduced when you reach a certain income threshold -- many retirees go back to work often overlooking this fact. For example, for those age 62 through 64, in 1993, for every $2 in earnings above $7,680, $1 in benefits is taken away. For retirees age 65 through 69, $1 in benefits is taken away for every $3 in earnings above $10,560. If you are 70 or older, there is no restriction on your outside earnings.

Also keep in mind that Social Security benefits are subject to income tax if your provisional income exceeds certain levels. Effective January 1, 1994, those levels are $34,000 for a single person; $44,000 for married couples filing jointly. Provisional income is your adjusted gross income, plus nontaxable interest, plus one-half of your Social Security benefits. The percentage of benefits included in taxable income ranges from 0 to 85 percent. This range was extended from 50 to 85 percent as a result of tax legislation enacted in August 1993.

The Social Security Administration maintains a file on every person who has a Social Security number. This record contains the maximum yearly earnings covered by Social Security, earnings taxed, and taxes paid. For planning purposes, contact the Social Security Administration once every three years and ask for the form used to request "A Personal Earnings and Benefit Estimate Statement." You should review this statement very carefully, especially the credits to your account for earnings and taxes paid. If you find that some of your earnings have not been credited to you, contact your Social Security office at once. You can correct mistakes regardless of when they were made. However, it will be far easier to identify and correct errors earlier rather than later.

For those of you who outlive your spouse, you may be able to count on survivors benefits to supplement your retirement income. To be eligible for survivors benefits, you must be a widow or widower who is age 60 or older; age 50 and disabled; or any age and caring for a child who is under 16, or disabled. If you are divorced, you may still be eligible for survivors, or retirement benefits, as long as you were married to the deceased for 10 years or more.

Another key source of retirement income is your employer's pension plan. You should be aware of the rules for pension plan vesting, that is, your entitlement to pension rights whether or not you remain with a firm. Beginning after December 1, 1988, plans must have adopted either a five-year "cliff" vesting schedule, or a seven-year "graduated" vesting schedule. With the "cliff" plan, you become 100 percent vested in five years.

With the "graduated" plan, you become 20 percent vested in three years, and then gradually become fully vested by the end of the seventh year of service.

One characteristic that qualified pension plans have in common is that they are "tax-advantaged." This means you don't have to pay income taxes on either the contributions, or the income earned on contributions, until retirement. At that time, withdrawals are taxed at ordinary rates. This tax-deferral feature enables interest to compound tax-free, resulting in bigger payouts at retirement.

The tax-advantaged nature of qualified retirement plans is counter-balanced, however, by the law applying to early withdrawals. Simply put, withdrawals before age 59 1/2 are usually hit with a penalty of 10 percent, plus income tax at regular rates. There are few exceptions to the 10-percent penalty law.

Pension income is typically limited and, of course, there are some who will not receive any pension. Therefore, it becomes absolutely essential to pick up the ball and develop a personal retirement savings and investment strategy for supplementing Social Security and pension income.

Personal retirement accounts include the popular Individual Retirement Account, or IRA. IRAs are tax-advantaged savings vehicles in which investors control the selection of custodian and type of investments. However, there are rules regarding who can open an

IRA, the source of money invested, amounts which may be contributed, and the timing of withdrawals. Withdrawals may be made at any time, but those you make before the age of 59 1/2 are subject to the 10-percent penalty, plus income tax at ordinary rates.

One requirement for an IRA is that you must have earned income from wages or self-employment. If you do, you may make deductible IRA contributions of up to $2,000 per year. This amount increases to $2,250 if you have a nonworking spouse and file jointly, or up to $4,000 with two spouses working. Earnings on your IRA account are tax-deferred . . . meaning you don't pay taxes until retirement.

If neither you nor your spouse are active or eligible participants in an employer-sponsored retirement plan, your IRA contributions are fully tax deductible. If you or your spouse are eligible for an employer-sponsored plan, you still may be able to deduct your contributions, depending on your adjusted gross income, or AGI. A married couple who files jointly, and whose AGI does not exceed $40,000, gets a full deduction. A single person gets the full deduction if AGI does not exceed $25,000.

A partial deduction is allowed for a married couple who files jointly with an AGI between $40,000 and $50,000, and for a single taxpayer with an AGI between $25,000 and $35,000. However, even if you can't take a deduction, IRAs still may be advantageous because of the tax-deferral benefit on the earnings.

The 401(k) plan is another popular personal retirement account. If your company offers one, and thousands of both large and small companies have added them, you should probably sign up. Your elective contributions to a 401(k) represent deferred compensation, and therefore are not subject to income tax. For example, if you earned $50,000 in 1993 and contributed $5,000 to a 401(k), only $45,000 of your salary would be taxed. In effect, you would receive a tax deduction of $5,000. The maximum allowable contribution is adjusted annually for inflation; in 1993, the maximum contribution to a 401(k) is $8,994.

Other positive features of 401(k) plans may include employer contributions that match all or part of your contribution. In addition, your employer chooses an investment firm to manage the accounts and a range of investment options may be offered, such as a fixed-interest security known as a guaranteed investment contract -- something like a CD; a smorgasbord of mutual funds reflecting different investment objectives; and, perhaps, company stock. But be wary of this option -- your company's fortunes could change.

As is typically the case with tax-advantaged retirement vehicles, investment earnings are tax-deferred, and early withdrawals are penalized. You may also be able to borrow on your 401(k) account, if the plan provides for this, and you will also receive special tax treatment of lump-sum distributions. If you leave your employer, you can roll your 401(k) savings over to an IRA account so you won't be taxed on the withdrawal.

There are two additional qualified retirement plans available to virtually anyone who has a business, whether it be full- or part-time. They are the Simplified Employee Pension plan or SEP, and the Keogh plan. Contributions to each are tax-deductible, and the individual accounts grow on a tax-deferred basis. However, again, early withdrawals are penalized.

First, let's talk about the SEP -- technically, the SEP-IRA. The IRA is the deposit vehicle for this employer-sponsored and funded retirement plan. The SEP is ideal for those who are starting a business, and is available to proprietorships, partnerships, and corporations, with or without employees. SEPs are easy to set up and administer. The employer contracts with a financial institution, but each participant maintains his or her own account.

Effective January 1, 1994, the contribution to a SEP by a business owner on his or her own account and for each employee, if any, can be anywhere from zero to 15 percent of self-employment income or salary, or $22,500, whichever is less. Annual contributions are not required, but when the employer makes a contribution on his or her own behalf, contributions must be made at the same rate for all eligible employees. The rate may be changed from year to year to reflect business conditions. Paperwork is minimal; a simple tax form -- 5305-SEP -- must be filed with the IRS when the plan is set up, but there are no reporting requirements thereafter, except for notifying employees of amounts contributed.

If you earn self-employment income from a full-time or a sideline business, consider setting up a Keogh to lower your tax liability. Partnerships may also set up Keoghs for their partners. Limits to contributions on a Keogh are much higher than those for an IRA and higher than those for a SEP. In addition, the Keogh can have a powerful effect in attracting and retaining a strong work force. As with other retirement plans we've talked about, contributions are deductible and funds grow tax-deferred.

A Keogh must be formally established in writing by the end of the calendar year in which you want the plan to be effective. However, you don't have to contribute to the plan at set-up time. As long as the plan is established by December 31, you have until the due date of your tax return, including extensions, to make contributions.

You can set up a Keogh at almost any type of financial institution -- a bank, brokerage firm, life insurance company, or mutual fund company. Most financial services companies offer master or prototype Keogh plans that are already approved by the IRS. Establishing a plan with such an institution results in less paperwork and lower administrative costs. If you choose to work with a lawyer or pension plan expert in preparing a personalized plan, you will have to submit your plan to the IRS for approval.

Once again, withdrawals before age 59 1/2 are subject to a 10-percent penalty tax. Note, however, that withdrawals from a Keogh after age 59 1/2, taken in a lump sum, may qualify for favored 5- or 10-year averaging -- a special tax computation resulting in a smaller tax because the lump sum is effectively treated as if received in installments over a number of years.

There are a few drawbacks to Keoghs. Let me mention three of them. First, the rules, recordkeeping, and filing requirements are more complicated than for IRAs or SEPs. For example, an annual report must be filed with the IRS. The only exception is a firm without employees whose assets in the Keogh are under $100,000. Second, if you have employees, Uncle Sam requires that you include them if they are eligible, and that you make contributions which are proportional to yours. By the way, this is true of some other retirement plans as well. Third, one type of Keogh requires a preset, fixed contribution by the employer each year, whether or not the business shows a profit.

Last but not least as a major source of retirement income is your personal portfolio of savings and investments. You will have more flexibility and control over this portion of your retirement assets. Since there are many investment products available, care should be taken to screen out the hype and to read the small print. Your age and tolerance of risk should be considered -- the young can afford to be more aggressive, and probably should be. In addition, diversification is critical.

Before we discuss actual investment options, I'd like to take a moment to stress to you the importance of investing. Inflation erodes the value of money. Therefore, holding a cash portfolio is very unwise. As inflation increases, the value of cash as measured by its purchasing power decreases. For example, a cash portfolio of $100,000 in an inflationary environment of 5 percent annually, will be worth only $95,000 in purchasing power by the year's end. In fact, at an annual inflation rate of only 4 percent, money will lose half of its value in 18 years. This suggests the wisdom of putting money where it will grow faster than the rate at which it loses value due to inflation, rather than under the proverbial mattress.

Investment options we will discuss include tax-advantaged investments such as marketable U.S. Treasury securities and nonmarketable U.S. Savings Bonds; municipal bonds; and annuities. Other options, while not tax-advantaged, should be considered on other merits. This latter group includes certificates of deposit, corporate bonds, stocks, and mutual funds.

First, the tax-advantaged. U.S. Treasuries, as they are called, are the safest securities around. They are backed by the "full faith and credit" of the United States, so the credit risk is practically nil. But these investments are not safe from the effects of inflation. In fact, long-term studies have shown that Treasury yields have a tendency to track inflation with the result that the real, inflation-adjusted returns are close to zero. Nevertheless, Treasury securities are considered to be a key component of a well-rounded portfolio.

Treasuries may be purchased directly from Federal Reserve Banks or the U.S. Treasury, or indirectly through a mutual fund. Maturities range from 13 weeks to 30 years. U.S.

Savings Bonds, Series EE, are registered and nontransferable, that is, they may not be sold by the owner. They may be purchased in small denominations at banks and, perhaps, where you work under the payroll savings plan. Accrued interest may be reported each year, or you may elect to report it all when the bonds are cashed in. Yields fluctuate with market rates, but there is a protective floor -- a guaranteed minimum rate of 4 percent for EE Bonds held 5 years or more. The income from both Treasuries and Savings Bonds is exempt from state income taxes.

Municipal bonds may also be purchased directly or through a mutual fund. These bonds are issued by states and cities. Interest is exempt from federal tax and also from state tax in the state of issue. Municipal bond interest rates must be converted to tax-equivalent yields in order to make valid comparisons with a comparable taxable bond. The new and higher federal income tax rates of 36 percent and 39.6 percent, retroactive to January 1, 1993, make munis especially attractive. Remember -- bonds, including both Treasuries and municipals, are subject to interest rate risk, that is, bond values go down when interest rates go up. However, the prices of bonds maturing over the short-term, say one to three years, are far less sensitive to fluctuations in rates.

Annuities are investment contracts sold by insurance companies. They are tax-advantaged because the government sees them as a safe and convenient way of building up retirement savings which will benefit the retiree and contribute to a more stable and secure society in the process. The income earned on underlying investments escapes taxes until the annuity is paid out, whether in a lump sum or in installments. Premiums paid for annuities are not deductible, but the good news is that contributions are not limited to a set amount. A joint-and-survivor annuity may be purchased to provide a guaranteed retirement income to a married couple for as long as either spouse lives. Watch out for front-end and back-end charges though, especially back-end charges on early redemptions which can cut sharply into your total return.

Now let's jump from the tax-advantaged to the taxable investment. Such investments should be included as a component of your personal retirement assets for several reasons. Some types of taxable investments may carry the prospect of larger after-tax returns with, of course, a commensurate increase in risk. In addition, you will have a greater degree of control in buying, monitoring, adjusting, and selling securities, which may often be accomplished by making a toll-free telephone call. And lastly, there are no early withdrawal penalties, should withdrawals be necessary.

An in-depth discussion of taxable investments is beyond the scope of this talk. However, mention of a few of the more promising investment types and some of their characteristics may serve to motivate you to investigate . . . always investigate before you invest! Let's briefly discuss some investments worth considering.

Certificates of deposit, or CDs, are fixed-income investments with higher interest rates than savings accounts. CDs are available in maturities ranging from 30 days to several years. They are insured, so risk is minimal. However, because interest rates are unpredictable, putting $5,000 in a five-year CD at 7 percent would turn out to be a good move if interest rates fall, or a bad move if they rise. A better strategy may be to buy a one-year CD once every six months so you can rotate your money and reinvest it at whatever rate is prevalent at the time.

Corporate bonds also generate a fixed income. Standard & Poor's rates such bonds from AAA -- the best, to D -- those in default. Returns tend to exceed those of CDs, but with more risk. The value of bonds fluctuates inversely with interest rates. When interest rates are rising, keeping bond maturities short will minimize loss in value.

Corporate stock may provide both income in the form of dividends and share price appreciation. I say may, because dividends are not legally required, and stock prices can fall as well as rise. But generally, stocks offer the greatest hope of significant returns over the long haul. However, if you want a relatively risk-free portfolio, you should not purchase common stock. When you buy common stock, you're buying part-ownership in a business enterprise, whose success is not guaranteed. Of course, you can lessen your risk by diversifying your holdings.

For many investors, the best way to invest in the stock market is through a mutual fund, in which your investment is pooled with others to buy a variety of securities. Since your money is invested in many stocks, you have spread your risk. Professional management and diversification are the hallmarks of the funds, not to mention liquidity and convenience. The fund's objectives and past performance should be carefully examined. But be forewarned -- past performance may not be indicative of future results.

. . . To sum up, the key to a successful retirement planning strategy is to calculate how much income will be necessary to live in retirement with the degree of comfort that you desire. Get an estimate of what Social Security benefits will be, as well as pension benefits. Once you have an estimate of these figures, it will be easier to determine how much savings and investment return will be needed to meet your personal retirement goals. You will want to periodically review this information and adjust it in light of your present and projected future financial status, earning power and family situation.

Let me conclude by urging you to set retirement goals and begin planning now. Start thinking about what you want to do during retirement. What lifestyle would you like to enjoy? Do you wish to continue working, or relax and enjoy hobbies and travel? I realize it is difficult to look down the road, and perhaps uncomfortable to do so. Nevertheless, planning is essential. So regardless of your age, get started. The golden years, in spite of the challenges, can be a satisfying and happy time of your life -- your best years. However, you must plan and follow through to make it happen. The younger people in the audience have the advantage of time, but for the older among you, it's never too late. Plan for a wonderful retirement -- thank you -- and I welcome your questions.

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