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COMMENTS - APRIL, 2001

ACCOUNTING AND AUDITING

Research by three accounting professors at Southern Methodist University reveals, where a merger among publicly held companies is not concluded within 90 days after the announcement, the value of the targeted company begins to erode. More specifically, the target's profitability declined between 1% and 2% on an annualized basis and sales revenue fell by 8%. The declining numbers are attributed to: (1) competitors scrambling to lure nervous customers from the target company and (2) indifference by the target's managers, who are job-hunting rather than continuing business planning and management. The conclusion of the research is in order to avoid erosion of the value of a targeted company, it is essential for the acquirer to provide concrete incentives to key managers and to conclude the merger in the shortest possible time.

ADMINISTRATION, SYSTEMS AND EDP

The Association of Fraud Examiners reports the typical U.S. business loses $9 per day per employee through fraud and theft, and the situation has deteriorated over the past 5 years. Executives who were questioned admitted to inadequate fraud detection resources in their companies. Furthermore, smaller, rapidly growing businesses were most prone to employee fraud and theft. Among the reasons:

1. Preoccupation with growth which results in a relaxed attitude about establishment and adherence to internal controls.
2. Inability to develop internal controls quickly enough to keep up with explosive growth.
3. Company policies and incentive pay systems which may induce employees to issue false reports about making budgets and meeting goals.
4. Extreme pressure from investors which encourages the issuance of "fudged" data in order to meet investment community projections or to obtain additional capital.

As the founder and manager of a rapidly growing small business, you need to be particularly concerned your policies and procedures do not encourage dishonest activity by your employees and there has been implementation and ongoing surveillance of sound systems of internal control to protect assets from theft and management information from being compromised.

Proponents believe use of biometrics to replace user passwords will significantly tighten security over business information systems while significantly lowering overall information technology cost. One biometric security system which may soon be coming to your airport counter relies on iris recognition. Here, passengers register for the system by taking a digital picture at the airport lounge. Then 512 bytes of data are extracted and stored. When the passenger checks in at the counter, another camera takes a second picture, and the iris patterns are compared

with the stored images. If they conform, the passenger can proceed. The technology takes advantage of the fact no two human iris patterns are alike. Incidentally the technology is not purely theoretical, but was actually tested and successfully used at the German pavilion during the last Olympics.

FEDERAL REGULATIONS

Rules issued by the Federal Communications Commission last October, prevent a landlord or another service provider in multi-tenant office buildings from restricting access to the building by competing providers. The rules are designed to suspend the practice of allowing landlords to make deals with a particular service provider to restrict access to other service providers or to prevent the tenant from setting up its own antennas for data or Internet services. The new regulations essentially comprise four elements which provide building tenants with a greater choice for obtaining data and Internet service. Thus, they:

1. Prohibit exclusive deals between building owners and service providers.
2. Grant rival providers greater access to incumbents' wires into buildings.
3. Ensure access to conduits and rights of way in building to rival providers.
4. Permit tenants the option of installing and operating antennas used for telecommunications.

Further information is available from the FCC.

INSURANCE

The world is becoming increasingly dangerous, and there are now frequent reports of people being kidnapped while on business overseas or while vacationing. High risk individuals such as entertainers, executives, political activists, people with substantial wealth or others who are concerned about this risk can now obtain kidnap insurance as a rider to their homeowner's policy. The insurance provides protection up to $100,000 for kidnap-related expenses other than ransom payments and up to $25,000 in award payments for information leading to a kidnapper.

LABOR RELATIONS

Executives who have been granted incentive stock options must be sure to observe the dual holding period required under IRS regulations to obtain advantageous capital gains tax treatment. These require the shares must be held more than one year from the date of the option's exercise and more than two years from the date of grant of the options. Failure to observe both of these holding period requirements results in the option being treated for tax purposes as a nonqualified stock option and the gain being taxed as ordinary income at rates as high as 39.6% instead of the maximum 20% capital gains rate. Many executives are now making gifts of stock obtained through incentive stock options to charitable organizations to avoid capital gains taxes, and to claim charitable donation deductions based on the appreciated value of the stock. But here too, care must be taken that the dual holding periods are observed. Otherwise the options will become nonqualified options which produce ordinary income for the holder. Unfortunately, we regularly observe examples of mistakes by executives in the

handling of stock options. That's why we recommend transactions in connection with stock options be thoroughly reviewed with a professional tax advisor before they are initiated. At the same time, there can also be careful tax planning to determine the best strategy for disposition of the shares.

MARKETING

One way to enhance business performance is to identify the customers who are most profitable and to utilize your resources to generate more business with them. Measuring customer profitability requires measuring the revenue generated by each customer as well as the cost of generating the revenue. An old rule of thumb holds that 20% of customers generate 80% of a firm's revenue, making it fairly easy to identify the top revenue producers. However, allocating the cost to each customer to assess the profitability of each account is a more complicated process. Factors which can affect costs are:

1. Type of goods ordered and the related profit margins
2. Order size, since it impacts handling costs.
3. Order frequency, since this affects handling, processing and shipping costs.
4. Customer relationship costs (account maintenance, service requirements, and contact time requirements).

Companies who can isolate these costs and allocate them to specific customers can develop a customer profitability profile. Once this is accomplished it's also easy to identify the 10% or so, customers who do not generate any profit because the costs of providing customer service exceeds the revenue generated by sales. The company can then either modify the price structure so the account can be serviced profitably or the customer can be encouraged to do business elsewhere.

MONEY, BANKING AND CREDIT

A lot of people get into financial hot water because they mismanage their credit cards. Frequently the card issuer, encourages irresponsible behavior because it profits from consumer mistakes. Here are some sound credit card management suggestions for everyone:

1. Pay balances in full each month within the payment grace period to avoid high interest, finance charges and late charges of up to $30 per month.
2. If you get an offer for a new card, contact your existing credit card company and ask if they'll match the competitor's offer.
3. Don't be enticed by low-introductory rates to switch credit cards. It's the rate which goes into effect after the introductory period that's crucial. (Some issuers solicit your business by promising a low rate, then issue a card with a higher rate, claiming you didn't qualify.)
4. Check the grace period. The longer the better. Today, 25 days is common, and the grace period should be calculated from the statement date rather than from the transaction date.
5. Discard the "write yourself a loan" checks the issuer frequently sends you. If you use the checks, you're taking cash advances which involve interest and finance charges.
6. Don't be taken in by high credit limit promises on platinum card solicitation.

Credit limits which are approved on platinum cards average $6,000, the same as on the other cards.

7. If you can't pay off the balance each month, limit yourself to a single credit card. Balances on multiple card exacerbate your problem by resulting in duplicate fees and charges on each of the cards.
8. In selecting a credit card, compare the benefits provided. Auto insurance, warranty extension and similar benefits can be valuable if you make use of them in the normal course of your activity.
9. Obtain a debit card if you lack fiscal discipline. Unlike a credit card, it prevents you from becoming a credit junky who never gets out from under credit card debt.

PENSION AND ESTATE PLANNING

The IRS is examining fewer estate tax returns. Data on 1997 estate tax returns was just released and shows 10.2% of all the estate tax returns filed were examined. Five years earlier the examination rate was 16.9% and a decade earlier it was 22.8%. The IRS says it is actually not lowering its vigilance but spreading its manpower to enhance its audit effectiveness. Thus, it says in1998 the audit rate of 1997 returns was: 5% for estates valued at under $1 million; 15% for estates valued at between $1 million and $5 million, and 40% for estates valued at over $5 million. Obviously, there is a close to 50% chance a larger estate will be audited.

The recent stock market plunge has devastated many pension plan investments. If you are a participant over 70 and required to take year-end distributions from IRAs or other qualified employee benefit plans, we'd like to alert you to the fact you need not take distributions from each of the accounts in a particular plan. Instead, calculate your total distribution requirement, then opt to have the sum withdrawn from an account which has been relatively unscathed during the recent stock market crash. Presumably, this will leave the other accounts in the plan intact to participate in a possible recovery.

Want to withdraw money from an IRA without paying the 10% early withdrawal penalty. The penalty does not apply when the withdrawal is used to pay qualified higher education expenses (tuition, room, board, books, supplies and equipment) if a student is enrolled at least half-time in a higher education institution. The payments can be made for the IRA owner, spouse, or any child and grandchild of either spouse. We'll be glad to provide more information.

PERSONAL FINANCIAL PLANNING

Owners of closely-held corporations often take loans from the business as a means of meeting a variety of personal financial obligations. If carefully structured and documented, the loans can be a tax-free source of funds which enhance the rewards of business ownership. However, invariably the IRS will scrutinize the arrangement with a view toward treating the loan as a disguised dividend and impose taxes, interest and possible penalties on the transaction. Here then, are some thoughts for fending off an IRS challenge:

1. Have the corporate minutes specifically authorize the loan and its terms.
2. Have the borrower sign a promissory note for the amount of the loan.

3. Make sure the note is assignable to a third party, like any other note.
4. Establish a specific maturity date and establish precise repayment terms.
5. Charge the borrower a market rate of interest.
6. Preferably secure the loan with collateral provided by the borrower.
7. Reflect the loan on the company's books and records.

However, it is not sufficient simply to document the arrangement in the way we've suggested. The parties must also act in a manner consistent with the terms of the obligation. This means making interest payments as required, making loan repayments in accord with the loan terms, and taking steps to enforce the loan if the borrower violates the loan terms. Since, unlike compensation, loans are not subject to income and employment taxes, they can effectively increase the cash flow of business owners and key executives. We'll be glad to discuss the use of business loans in more detail in a separate consultation or as part of your overall personal financial planning.

The IRS has indicated because of low demand, companies and their employees may still establish tax-sheltered Medical Savings Accounts. Last year Congress extended the pilot program beyond the year 2000. MSAs are tax-exempt trusts or custodial accounts similar to IRAs, to which the individual or the company make tax deductible contributions which can be withdrawn to pay for health care expenses not covered by insurance. To be eligible to set up an MSA, you must be: (1) an employee (or spouse of an employee) of a small employer (one who employed an average of 50 or fewer employees on all business days during either of the 2 preceding calendar years) or (2) a self-employed individual (or spouse) with an individual or family high-deductible health plan i.e. one with an annual deductible of at least (1) $1,500 and not more than $2,250 for individual coverage or (2) at least $3,000 but not more than $4,500 for family coverage. Also, annual out-of-pocket expenses for deductibles and co-payments cannot exceed $3,000 for individual coverage or $5,500 for family coverage. If you think an MSA may be appropriate for you or your business we'll be glad to provide more information about: (1) setting up an MSA; (2) limits on contributions, and (3) the treatment of distributions from these accounts.

REAL ESTATE

A new type of digital subscriber line (DSL) service is about to be launched. Known as very high speed DSL or VDSL, it provides access to the Internet at 10 times today's speed and will make it possible to receive television and other video services in addition to regular phone and fax service over copper phone lines. It means owners of large office buildings and apartment houses with multiple tenant units will be able to offer tenants broadband services even if their properties don't contain fiber cables. Transmission speed of VDSL is 22Mbps downstream towards the end user and 3Mbps upstream for asymmetrical services over 3,000 feet of copper wire. One drawback of VDSL is it works effectively only over relatively short lengths of copper wire. The maximum length of copper wire over which it can travel is 4,500 feet, and at that length, the speed is about half that over 3,000 feet. It is anticipated as the technology is deployed, there will be fiber connected gateways in the basements of buildings with VDSL being transmitted over existing copper wiring to individual building units. Incidentally, it is estimated of the approximately 750,000 multi-tenant office buildings in the United States, only

about 10,000 are wired for broadband. However, to attract office tenants, fast Internet access via DSL is a minimum requirement for landlords.

TAXATION

The IRS is holding about 90,000 undelivered refund checks. About half are to taxpayers in California, Florida, Texas and New York. The checks are returned to the IRS by the Postal Service if the taxpayers have moved and not provided the IRS with a new forwarding address, or because the address information on the tax return was incomplete. If you've been futilely waiting for a tax refund check based on your 1999 taxes, contact the IRS. Your check may be among those the Agency is holding.

Research by the Treasury Department indicates about 1.7 million taxpayers will be impacted by the Alternative Minimum Tax (AMT) this year, and the number will rise to 17 million within a decade. The additional tax liability these taxpayers will incur will rise from $5.8 billion to $38.2 billion over the same period. The AMT was designed to insure very wealthy individuals who used a variety of tax shelters to shield themselves from tax would still incur tax liability on their income. The problem is the AMT was never indexed for inflation, so the middle class has been hit. Essentially the AMT is computed by applying a tax rate of 26% or 28% to regular taxable income which is modified by eliminating certain deductions, adding or subtracting various tax preferences and adjustments, and eliminating most tax credits. Major deductions which are not allowed when computing the AMT include:

1. Personal exemptions
2. State and local income taxes
3. Property taxes
4. Miscellaneous itemized deductions
5. Medical expense deductions up to 10% of adjusted gross income
6. Interest expense on mortgage debt on a first or second house incurred after June 30, 1982, if the debt proceeds weren't used to buy, build or improve the residence.

Taxpayers who become liable for the AMT are also given an income exemption which is phased out above specified amounts. In general, those who become subject to the AMT are advised to accelerate income and defer deductions in that year. The reason is the additional income is only subject to the 26% or 28% tax rate, whereas it could be subject to a higher tax rate under a conventional tax calculation. Similarly, most tax deductions are lost in the AMT year, but would provide a much greater tax benefit in a subsequent year when, as itemized deductions, they may offset income which is taxed at a high rate. We'll be glad to discuss the AMT in more detail and help you with tax planning if you are a potential AMT tax candidate.