April 1, 2003

COMMENTS - APRIL, 2003

ACCOUNTING AND AUDITING

Although some major accounting firms have been tarnished by the recent financial scandals, the attitude of most affluent investors towards their accountants has not changed. According to a survey by Nationwide Financial, 85% of high income investors who utilize their own accountants indicate that the Enron case and other accounting fraud situations have not in any way diminished the level of trust they have in their own accountant. The survey result reflects the fact that while the accounting improprieties of one or two CPA firms have made headlines, most clients feel that their CPAs have the high level of integrity and skill that makes them valuable advisors with respect to financial and tax matters.

Fraud can occur anywhere in an organization, but one of the more likely areas is the payroll function. Typically, fraud is perpetrated using one of the following techniques:

- Putting ghost employees on the payroll. The ghost employee is usually someone who is no longer employed by the firm, or it is a friend or relative of the person perpetrating the fraud. Usually, the fraud is perpetrated by forging an endorsement on the check or by having an accomplice deposit the proceeds into his or her bank account.

- Falsifying the hours worked in order to increase the amount of a check. Frequently, a supervisor will approve the falsified hours in exchange for a piece of the action. Alternatively, payroll clerks sometimes adjust their pay rates if they can find an internal control system weakness that enables them to falsify this data.

- Commission schemes designed to boost compensation. These either involve falsification of the amount of sales or falsification of commission rates.

- Phony workers' compensation claims. Here employees fake injuries in order to obtain disability payments. In extreme situations, the workers may actually hold another job while collecting pay from their regular employer for staying home and recuperating. In some, cases physicians have been involved in providing false diagnoses of illness for workers who kick back a portion of the workers' comp payments to the physician.

An effective way of preventing payroll fraud is to have your CPA perform a payroll audit on at least an annual basis.

ADMINISTRATION, SYSTEMS AND EDP

Prescription drug price increases are soaring and are a leading cause of run-away employee health care costs. As an employer trying to control operating expenses in the current competitive business environment, you are undoubtedly searching for ways of minimizing the increased medical insurance outlays. Here is what some employers are doing:

- Establishing co-payments for drugs and lowering the co-payment required for generic prescriptions.

- Initiating prescription pre-authorization requirements so that drugs that are deemed unnecessary won't be reimbursed.

- Providing coverage for all drugs, but requiring a rising scale of co-payments depending on the cost and necessity for the drug. For example, co-payment may be 20% for a generic drug; 30% for the preferred branded medication; and 40% to 50% when a "non-preferred" branded drug is prescribed.

These are just some examples of arrangements that have been effectively used by companies to curtail health care costs of employees and increase cost sharing as well.

Many business managers are lax about letting employees copy software applications they use at home and distributing them to colleagues at work. Did you know, even if management is unaware of the activity, the company can be fined six figures for violation of copyright laws? Under the laws, once the computer programs are licensed for use the copyright is retained by the developer, and copying the software for use by others is prohibited. Both the Business Software Alliance (BSA) and the Software Industry Association (SIA) monitor illegal copying and will obtain a search warrant and swoop down on a suspected office accompanied by a U.S. Marshal to conduct a search for unlicenced software stored on company computers. You might wonder how your firm could have any possible risk for such an action, but usually the agencies are tipped off by a fired or disgruntled employee trying to get even with the company for an alleged wrong. To protect your firm, we recommend employee manuals and policy manuals provided to employees clearly indicate that use of unlicenced software on company computers is prohibited and reinforce this policy by means of periodic audits and immediate removal of any such software found.

Businesses are increasingly issuing corporate credit cards to traveling employees to tighten and simplify control over travel and entertainment expenses. Employees who use the cards are often required to obtain pre-authorization for air fares and hotel room costs before they can actually make their reservation using the credit card. Also, in order to obtain reimbursement, they'll have to provide a receipt from the web site where the travel was booked and a printed statement showing the charge. As of now, before reimbursing travel expenses, 94% of businesses require receipts for lodging; 91% require them for transportation outlays; 80% require

them for substantiation of meals; and, 79% insist on receipts for miscellaneous expenditures. A survey in 1998 showed that a somewhat higher percentage of firms insisted on receipts as substantiation of outlays in each of these areas. Incidentally, if you are approving expense reports watch out for so-called "tax recovery surcharges." They represent tax the rental car agency and other travel providers have to collect on the frequent flyer miles the traveler earns in booking reservations. Since the frequent flier miles are usually retained by travelers, the "tax recovery charge" should also be paid by them.

FEDERAL REGULATIONS

On August 1st, every state but Montana adopted the Federal Mobile Telecommunications Sourcing Act. Under the legislation, subscribers should be charged tax at the rate of the jurisdiction where the company's primary use of mobile telecom services occur regardless of where the calls originate, terminate or pass through. Previously, the tax was based on the latter factors.

Labor Department Secretary Chao has promised small business owners she will work more closely with them to protect workers without necessarily targeting the employers for unintentional Labor Department regulation violations. It is an acknowledgment that small businesses lack the comprehensive legal and other advice to insure they are in compliance with all regulations. To assist small businesses, the Agency is establishing the position of Director of Compliance Assistance whose function it will be to ensure that all of the Labor Department's agencies are doing all they can to help employers comply with the regulations. The Department also has established a new toll-free number, 1-866-487-2365, where small employers can obtain answers to questions about laws dealing with pay, leave, work place safety, health and pension benefits and veterans' re-employment rights.

INSURANCE

A recent survey by AARP, of people aged 45 and older, reveals a number of misconceptions about the need for long-term care insurance. Among its findings:

- 30% thought they had long-term care insurance, while only 6% actually had this coverage.

- 55% believed that Medicare pays for long-term nursing home stays although it doesn't.

- 75% erroneously thought that Medicare pays for assisted living costs.

Since nursing home costs average about $4,600 per month nationally, it's wise to consider the purchase of long-term care insurance. Key factors in comparing policies include:

- Plan coverage beyond just nursing home care (custodial care, home health care etc.)

- Guaranteed renewability of the policy.
- Elimination period which may range from 20 to 100 days.
- Benefit period, which should be 3 years at a minimum.
- Amount of the daily benefit which is contingent on the insured's overall financial condition.
- Inclusion of respite care and hospice care benefits.
- Qualification requirements for obtaining benefits.
- Inflation protection provided.
- Premium waivers while receiving benefits.
- Exclusions for preexisting conditions.
- Financial condition of the insurer.
- Cost.

Since people with limited resources (net worth under $500,000) cannot usually afford the premiums and those with over $1 million in net assets can often afford to self-insure, long-term care insurance is not suitable for everyone.

If you have a youngster in college, check your insurance needs. Renter's insurance generally protects personal property both in a dorm as well as in off-campus housing. In some instances the parent's homeowner's insurance may also provide protection for property located in college housing. However, personal property in off-campus housing is usually excluded from coverage.

Directors' and Officers' insurance premiums have increased about 30% in the last year, but worse, insurers are limiting the scope of coverage provided, and they can deny a company's existing coverage if a misstatement is alleged. Although such rescissions have been rare and usually require a court order, insurers may pursue this avenue of avoiding liability if there are significant restatements of a company's financial results. Depending on the jurisdiction, insurers in most states usually need only to show that there was a misrepresentation that was material to its evaluation of risk in order to rescind an insurance contract, although in some states fraud has to be shown. Many experts believe the new requirement under Sarbanes-Oxley requiring both the CEO and CFO to sign off on the financial statements may give insurers a new tool for claiming there were material misstatements by the company, and thus obtain court permission to rescind existing policies. Whatever the outcome, D & O coverage will become more costly

and more difficult to obtain.

LABOR RELATIONS

Employers can opt to use IRS approved per diem rates instead of policing their employees' lodging meals and incidental expenses by collecting receipts to substantiate deductions. Now the Agency has announced that for 2003, its per diem rate for lodging, meals and incidental expenses to a high cost locality will be $204, and for travel to any other locality in the continental United States it will be $125. These are the identical rates that were in effect for 2002. However, the 2003 Federal meals and incidental expense rates under the optional high-low method increased slightly above the 2002 rates and will be $45 for high cost localities and $35 for other localities. The IRS has also expanded the definition of the term "incidental expenses," but the new definition does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes or the cost of telegrams and telephone calls. Employees and self-employed individuals who do not incur meal expenses for a calendar day of travel away from home, may, however, compute incidental expenses at $2 per day as an optional method. The new rates may be used retroactively for travel beginning October 1, 2002. Companies that reimburse employees for travel at amounts up to the per diem rates can exclude the payment from the employee's income, while those that pay more than the official per diem rates must treat the difference between the Federal per diem rate and the higher company allowance as taxable income of the employee.

Recently, when executives were asked their preference for added compensation, they overwhelmingly opted for some form of cash. Here were their responses:

Increased salary	53%
Performance based bonuses	20%
Added vacation time	12%
Increased equity (including stock options)	9%
Greater autonomy or responsibility	6%

Things certainly have changed in a hurry. Had the same question been asked just a couple of years ago, the executives would have overwhelmingly opted for more stock options.

Did you know:

- The typical worker is interrupted every eight minutes for an average of five minutes, or 50% of the workday?
- Only 20% of the workday is spent on important business while 80% is devoted to activities that generate little value for the firm?
- The typical workers sends and receives over 100 messages per day?
- Workers in cluttered or messy offices spend 1½ hours per day to find what

they need?

To have a productive workplace, it is important that attention be paid to time management as well as to time tracking so management can obtain a better idea of worker productivity. Unfortunately, payroll managers report they are still heavily dependent on time sheets (34%), time clocks (26%) and other antiquated systems (14%) for tracking attendance and workers' activities. Only 26% indicate they use electronic time and attendance systems to get a handle on overall productivity.

MARKETING

Over half of all buyers queried by a consulting firm indicated the most frustrating aspect of customer service is having to use an automated phone system. To prevent customer annoyance, which may affect future business, experts recommend keeping announcements brief, limiting choices to just three options and providing an easy means for the customer to talk to a real person. It's always a good idea to log on to your automated systems and measure your own frustration levels in getting a problem resolved.

Do your register receipts detail the savings the customer obtained by buying "sale" merchandise, utilizing coupons or obtaining special discounts? It might be a good idea to program registers to show this information. Marketing data shows that about 74% of customers increase their purchase based on the cost savings reflected on the register tape. Furthermore, 80% of customers say they will increase purchases from a supplier who can provide hard proof of the savings obtained. The study concludes that savings realized were more relevant for most shoppers than lower prices.

About 15% of merchandise sold over the Internet is returned. Here are the primary reasons given by Internet shoppers:

Product not what was expected	40%
Product arrived broken or damaged	31%
Product quality below expectations	31%
Right product shipped, but it had the wrong features	27%
Wrong product shipped	26%
Change of mind about wanting the product	19%
Product arrived too late	17%

Participants were allowed to provide multiple reason for making returns. The data reveals many Internet retailers have serious problems filling orders which must be corrected expeditiously before the company's reputation is permanently tarnished. As a rule of thumb, about 25% of online shoppers never return to a site if they have had a problem with their order. Interestingly, data indicates that, when a Internet retailer establishes a simple return procedure, sales tend to increase. Among Internet shoppers and browsers who were interviewed, over 40% indicated they'd increase their online purchases if returns were easier.

MONEY, BANKING AND CREDIT

If your vendors are encouraging you to pay bills online, you need to make sure you are not being short-changed. For example:

- If you make online payments you should also be entitled to online dispute resolution so refunds to which you are entitled are obtained quickly.
- You should be entitled to any prompt-pay discount terms to which you were previously entitled.
- You might argue for a special discount based on the fact the online payments provide significant savings for the vendor and enhanced cash flow.

If you meet with resistance, you might point out the vendor incurs significant savings on billings and other paperwork associated with accounts payable administration and collection.

Deteriorating economic conditions are having an adverse impact on collections. According to the Commercial Law League of America, the portion of receivables you can expect to collect, based on the age of the account is as follows:

Current	98.2%
One month past due	93.1%
Two months past due	85.4%
Three months past due	73.1%
Six months past due	50.0%
Nine months past due	40.4%
Twelve months past due	25.0%
Twenty four months past due	10.5%

The data certainly suggests firms must use vigorous collection efforts to recover most of their receivables. Also, direct on-site visits to customer's premises may increase the odds of payment plus your collection personnel may be able to make an assessment of the customer's payment ability.

Check fraud continues to increase and many companies become victims because high-tech computers and printers make it easier for crooks to perpetrate this type of crime. If you haven't done so, it's a good idea to evaluate your existing checks and determine whether they utilize technologies designed to thwart forgers. Following are the five major fraud protection techniques:

- Copy void pantograph in which word "VOID" appears on the background pattern of the check if it is passed through a photocopier.
- Chemical void which causes a huge "VOID" to appear on any check that has been tampered with.

- Security inks that prevent the alteration of checks through use of special inks that destroy the check's normal appearance.

- High resolution micro printing which is tiny printing either around the signature line or around the check's border that looks like a straight line and can not be reproduced by someone trying to forge a check.

- Thee-dimensional micro stripe just like on the back of a credit card, but containing one or several holograms that can not be reproduced without use of costly high-tech laser based etching tools.

Of course, many banks and check printing companies utilize one or more of these, as well as other technologies to protect the checks of their customers. Also internal controls you establish about the use, storage and signature requirements pertaining to checkbooks can be effective deterrents against check fraud.

PENSION AND ESTATE PLANNING

Seniors should be extremely cautious about switching an IRA into a Roth IRA because the change could result in a larger portion of their social security benefits being taxed. Income resulting from the IRA conversion must be included in determining the portion of social security benefits which are taxable. Current tax rules provide that as much as 85% of social security benefits which can may be taxed if the adjusted gross income exceeds $44,000 for joint filers, or $34,000 for single taxpayers. It's important to seek independent professional advice before making any modifications in retirement arrangements.

The Social Security Administration announced that beginning with January, 2003, social security benefits will increase 1.4%. The increase is negligible and will amount to about $13 per month for the average recipient. Meanwhile, the wage base for self-employment tax on net earnings and Social Security tax on wages increased to $87,000 in 2003 from $84,900 in 2002. Since the tax rate remains unchanged at 6.2%, this results in an increase of $130.20, to $5,394 in the maximum social security tax on employees and their employers. The 1.45% Medicare tax also continues to apply to all wages earned. Meanwhile, self employed individuals will be subject to a combined tax rate of 15.3% (12.4% for social security and 2.9% for Medicare tax) increasing their tax $260.40 to $10,788 on the new $87,000 wage base. The 2.9% Medicare tax will apply to all earnings above the base, and as in the past, 50% of the self-employment tax liability will be allowed as an income tax deduction. Social security recipients who elect early benefits forfeit a portion of their benefits if they earn wages exceeding an earnings limit, which is adjusted annually for cost of living increases. For 2003, the earnings limit is $11,520 for recipients who will not reach the social security normal retirement age of 65 years and two months. Those social security recipients who were born after October, 1938, will not reach full retirement age until 2004 at the earliest and their benefits in 2003 will generally be reduced by $1 for every $2 earned above $11,520. Recipients who were born between January and October,1938, will reach the full social security retirement age during 2003 and

will lose $1 of benefits for every $3 of earnings above $30,720, but only with respect to earnings prior to the month in which they attain age 65 years and two months. There is no cap on earnings for those over age 65 and two months. Note, the normal retirement age for Social Security is going up again. For those who turn 62 in 2003, they must wait until they reach age 65 years and eight months in order to obtain full social security benefits.

The IRS and the Department of Labor are on the lookout for firms that have failed to file Form 5500 for their pension and benefit plans. Employers found in a search of data bases will receive notices beginning in December, 2002, asking for an explanation and outlining the penalties for non-filing. Plan administrators who fail to comply with ERISA Form 5500 filing requirements could be fined up to $1,100 per day up to a maximum of $30,000 for each report they neglected to file. Additionally, the IRS can impose penalties of $25 per day up to a maximum of $15,000 with respect to most pension and profit sharing plans.

PERSONAL FINANCIAL PLANNING

Private foundations are entities established by well-to-do families to receive monies set aside for charitable gifts that are not distributed until some future time. However, since the funds have been set aside, under the tax laws, the donor can take a charitable deduction even though the specific charity to receive the gift has not been designated and the funds are under the control of the intermediary organization, the private foundation. Recently some mutual funds have begun providing a variety of services for private foundations. These include providing:

- Record keeping services for the Foundation.
- Summaries of grant-making activities by the Foundation.
- Tax reporting and filing assistance to the IRS and state agencies.
- Compliance alerts for tracking required minimum grant distributions.
- Support services for establishing a Foundation and meeting Federal and State filing requirements.

College tuition at 4-year public colleges is averaging $4,081 for the 2002-2003 academic year, and it is averaging $18,273 at 4-year private colleges. It is understandable many people are fearful about providing their children with a college education. One way of making sure that adequate funds are available is to start putting funds aside utilizing some of the tax favored education savings vehicles provided under the Internal Revenue Code. Here, briefly, are two of the possibilities:

<u>Section 529 college savings plans.</u> These allow you to contribute after-tax money and have the earnings accumulate on a tax deferred basis. Both the contributions

and earnings may be withdrawn tax-free for qualified higher education expenses. (Tax-free withdrawals will be phased out in 2010 unless Congress and the President extends the exclusion.) Among the advantages of these plans:

- Maximum flexibility as to who may establish a plan, who can be a beneficiary, which schools are eligible and the amount of contributions allowed.

- A special gift tax rule enabling contributions to be treated as if a gift was made over a 5-year period, enabling a married couple to set aside $110,000 per beneficiary with no gift tax liability if no other gifts are made to the beneficiary by the donor during the five years.

- Control over the account is maintained by the donor while the assets are excluded from the estate.

- The assets are considered the owner's (parents or grandparents) for financial aid purposes.

The main disadvantages are: (1) there are numerous state plans to choose from, and (2) the investment choices are limited by the state's program.

<u>Coverdell Education Savings Accounts.</u> These used to be known as education IRAs and let you contribute after-tax money which accumulates tax deferred. Both the contributions and earnings may be withdrawn tax-free under current law to pay for qualified education expenses. Advantages of these accounts include:

- Ability to pay for K-12 or higher education expenses on a tax-free basis.

- Wide range of investment choices.

The disadvantages of these accounts are: (1) contributors must meet certain income limitations; (2) the low, contribution limits ($2,000 per year) require early establishment of these accounts; (3) the beneficiary can obtain control of the account upon reaching majority age; and (4) the account assets are considered the child's property for determining financial aid.

Incidentally, tax changes for 2002 now let people make contributions to both 529 plans and to Coverdell Education Savings Accounts in the same year. Remember this is only a cursory overview of these education funding vehicles, and there are other tax-favored options.

In general, if someone takes out up to $100,000 in a home refinancing, the amount is treated as home equity debt on which the interest is fully tax deductible, assuming the taxpayer has no other home equity loan. In general, when more than $100,000 is refinanced, the interest on the excess is not tax deductible home mortgage interest, except to the extent that a portion of the loan is used to improve the residence. But now, the IRS has some good news. It says that if the loan proceeds over $100,000 are used to buy stock or investments, the

interest paid on those funds is investment interest that may be deducted up to the extent of the taxpayer's net investment income. Similarly, if the refinancing is done to provide cash for a business, the interest on up to $100,000 is tax deductible mortgage interest, and the interest on the amount above $100,000 is treated as tax deductible business interest.

REAL ESTATE

With interest rates near record low levels and home values at record heights, many taxpayers have refinanced their existing mortgages in order to secure cash for home improvements or to pay off debts. These refinances are called "cash-out" refinances because the homeowner receives cash from the lender for the difference between the old and new mortgage. It's estimated that about 50% of refinances are of the "cash-out" type, and the IRS is reminding homeowners that only <u>some</u> of the mortgage refinancing fees trigger tax deductions. The IRS says that with respect to original mortgage points paid by a borrower at the time a home is purchased, they are immediately deductible as interest if they are charged solely for the use or forbearance of the lender's money. Points for this purpose include: loan origination fees; processing fees; maximum loan charges; and, premium fees. Amounts paid for services provided by the lender, however, are not deductible as interest. These include: appraisal fees; credit investigation charges; recording fees, and, inspection fees. Unlike points paid on an original mortgage, taxpayers cannot immediately deduct points paid from refinancing. Thus, points paid on a straight refinancing are deductible over the term of the loan. The IRS view is that points paid on refinancing are not paid in connection with the purchase or improvement of a residence when the proceeds are used solely to repay the existing debt. Thus, if refinancing proceeds are used to refinance an existing mortgage and to pay for improvements, the portion of the points attributable to the improvements is immediately tax deductible, but the taxpayer must pay these points using separate funds brought to the loan closing. The continuing decline in interest rates has resulted in many homeowners refinancing for a second time. In these situations the rules are somewhat different, and the taxpayer may immediately deduct points paid and not yet deducted from the previously refinanced mortgage. To determine whether points are currently deductible, the IRS uses a two-part test: (1) Did the taxpayer pay points in the refinancing? and, (2) was the debt incurred to purchase or improve the taxpayer's principal residence? If the tests are met, the points are deductible.

Commercial real estate is depreciated, generally over 39 years if it is non-residential property and 27.5 years if it is residential property. However, many components of a real estate project may be treated as personal property which can be depreciated over a much shorter period, such as five years. Examples include air conditioning systems, light fixtures, partitions, plumbing installed to service machinery, and even reinforcements to foundations to support heavy equipment. If you are the owner of commercial property, have your professional tax advisor make an analysis of the various components of the property and the cost, to maximize the write-off of the property's cost. Frequently, a significant portion of a property's cost is eligible for accelerated write-offs.

Advances in technology are inducing an increasing number of retailers to utilize in-store computers or kiosks with an Internet connection to enable shoppers to buy merchandise or services. If you have percentage rent tenants in your shopping center you'd have to determine whether the tenant is including the sales made through these terminals in the gross sales being reported, or you may not be getting the full rent to which you are entitled. Since leases are often not clear about whether these sales must be included in gross sales, disputes often arise between landlord and tenant. Thus, it's important that on lease renewals, there be specific language covering Internet sales. Furthermore, as a landlord you should also obtain the added protection of being able to terminate the lease if gross sales are understated by more than a specified amount, such as 3%. To assist landlords, we provide auditing services to determine proper tenant reporting of gross sales and proper lease payments.

TAXATION

Free tax filing via the Internet is coming in 2003. The IRS says that as many as 78 million Americans will be eligible to file their 2002 returns online at no cost. However, not everyone will qualify. Under the terms of the program with a consortium of a number of private companies, who will be linked via a centrally located Web portal at www.irs.gov and www.firstgov.gov, only 60% of the filers will be eligible for the electronic free-filing option. In effect, many middle and upper income taxpayers won't be eligible.

If you used a car for business in 2002, and you used the optional mileage rate for calculating your deduction, the per mile deduction rate for business use of the car is 36.5 cents; the rate for driving a car for medical and moving purposes is 13 cents, and the rate for charitable use of a car stays at 14 cents. For 2003, the standard business mileage rate drops, however, to 36 cents per mile. While the rate for charitable use of a car stays at 14 cents per mile, it will be 12 cents per mile if you use a car for medical and moving expense purposes. The rate is based on annual automobile operating expenses and declined because during the first half of 2002, gasoline prices were lower than in the prior year.

The IRS has liberalized its offer in compromise program. Recent regulations permit the IRS to accept an offer even when there is no doubt as to either the liability or collectibility of tax, where payment would create an economic hardship or there are compelling public policy or equity considerations against demanding full payment. The regulations let a taxpayer retain amounts needed for basic living expenses if the taxpayer has no history of noncompliance with respect to filing and paying taxes. The IRS has not provided guidelines on the amount necessary for covering basic living expenses, but such factors as the taxpayers inability to earn a living because of illness or disability, or the need for a taxpayer to support dependents will be considered in making the determination. Taxpayers who cannot prove economic hardship or do not qualify for the offer-in-compromise program automatically qualify for a 3-year installment agreement if the amount owed is under $10,000 and other conditions are met.