December 1, 2002

COMMENTS - DECEMBER, 2002

ACCOUNTING AND AUDITING

The Financial Accounting Standards Board has issued Statement No. 146, *"Accounting for Costs Associated with Exit or Disposal Activities."* It requires companies to recognize costs related to exit or disposal activities when they are incurred rather than on the date of a commitment to an exit or disposal plan. Costs covered by the Statement include lease termination costs and employee termination costs associated with a restructuring, discontinued operations, plant closings and other exit or disposal costs. The Statement is to be applied prospectively to exit or disposal activities initiated after December 31, 2002, and its principal effect will be on the timing of recognition of costs associated with exit or disposal activities.

New legislation and SEC independence rules establish nine criteria for non-audit services performed by CPA firms which would impair a CPA firm's ability to issue an audit report on a public company. Although the rules pertain only to publicly-owned clients that issue stock, there is concern there could be a trickle down effect which might also impede the relationship between the CPA firm and their closely-held clients. In order to gauge public attitudes with respect to independence between CPA firms and non-public clients, a random survey of 600 bankers led to the following assessment about independence and referral fees:

- 80% felt that acceptance of commissions on products sold to clients impeded independence.

- 93% felt independence is impaired when an accounting firm accepts referral fees from others for recommendations it makes to clients without the client's knowledge.

- 65% thought independence is impaired when referral fees are accepted with the client's knowledge.

- 56% thought independence is diminished when the accounting firm pays referral fees for services it offers.

The survey also attempted to gauge the respondents' attitudes with respect to a CPA firm rendering consulting services to a non-publicly held client. In general, respondents did not believe the rendering of such consulting services impaired independence, except in the following specific examples:

- If the accounting firm functions as the company's controller.

- If the in-charge audit partner acts as CEO of the client when the owner takes a month's vacation out of the country.

- If the partner in charge of the client has a supervising partner located in another city who has a 15% ownership interest in the client.

- If the partner in charge of the engagement has a brother who is the controller of the company.

The following were deemed to have virtually no impact on perceived independence: Preparation of tax returns by the accounting firm, representation of the client by the accounting firm before the IRS or the Tax Court, representation of the owners of the client firm before the IRS or before a court, participation of the accounting firm in recruiting and hiring staff, design and installation of the client's financial information system by the accounting firm, rendering of valuation services to assess impairment of the client's purchased goodwill, rendering of the equivalent of an internal audit function by the accounting firm and rendering of bookkeeping services for the client without participating in managerial decision making. In light of the current concerns, we welcome the opportunity to discuss these and related issues with non-publicly held clients as well as their credit grantors.

Despite the headlines about audit failures by some international accounting firms, CPA's continue to rank high as financial advisors. Of 250 prominent professionals listed by Worth magazine in its July/August issue, 42% were CPA's. Furthermore, a survey by Intuit of 100 small business owners using accounting firms with fewer than 100 employees, indicates 88% have great trust in their accountants.

FEDERAL REGULATIONS

The Financial Crime Enforcement Network (FinCEN) of the Treasury Department has announced, effective January 1, 2003, securities broker-dealers will be required to report transactions aggregating at least $5,000 to FinCEN if the firm knows, suspects or has reason for suspecting the transaction:

1. Involves funds from illegal activity or is intended or conducted to hide or disguise funds from illegal activity;

2. Is designed through structuring or other means, for evading the Bank Secrecy Act;

3. Serves no apparent business or lawful purpose or is otherwise suspicious; or,

4. Is intended for furthering a criminal purpose (including terrorism).

The new requirement is designed primarily to intensify the government's efforts to disrupt terrorist activities by disrupting the financial flow to terrorist organizations and cells.

The President has signed the "Small Business Paperwork Relief Act of 2002." The legislation is intended to make paperwork reduction an ongoing effort and to facilitate the ability of small firms to comply with the law. The legislation:

- Requires the Office of Management and Budget to publish an annual list of compliance assistance resources available to small businesses in the Federal Register and on the Internet.

- Requires each Federal agency to establish one point of contact to act as a liaison for small businesses and to make efforts to further reduce paperwork requirements for businesses with fewer than 25 employees.

- Establishes an interagency task force to recommend improvements in information collection and dissemination.

- Requires agencies to report on their enforcement actions against small businesses and penalty reductions so Congress can monitor agency efforts to reduce compliance burdens on small business.

INSURANCE

The IRS has opened the way for employers to establish a tax-free health reimbursement account which can be used in conjunction with high deductible insurance coverage. Contributions to such qualifying health arrangements (HRAs) by employers won't be taxable to employees, and reimbursement of medical expenses from the HRA will also be tax-free, making this a more flexible version of a medical savings account, with the employer determining HRA deductibles and reimbursement limits as part of the plan. To qualify under IRS regulations, the HRA must be funded entirely by employer contributions and the only permissible benefit from an HRA must be reimbursement to the employee for medical expenses of the employee, a spouse and dependents. Employers may also continue to maintain HRAs for ex-employees including retirees. Self-employed individuals may not participate in an HRA. The medical expenses which are reimbursable through an HRA include deductibles and costs which could be claimed as an itemized medical deduction, but, generally, not long-term care expenses. The maximum amount of reimbursement must be set annually and any unused portion of the reimbursement limit may be carried over to subsequent years, unlike flexible spending arrangements funded by salary reduction. Companies which are contemplating establishing HRAs believe the carry-forward aspect will be effective in reducing overall health cost because it encourages careful medical spending by employees who know they can keep unused funds for future medical expenses.

Managed care health insurance premiums are rising between 15% and 25% this year and premium increases of at least 25% are being projected for 2003. Therefore, many small employers are either cutting back on coverage or asking workers to share in the cost. Currently, workers pay an average of $30 per month towards single coverage and $150 per month for family coverage and these amounts are likely to rise as employers pass on health insurance cost increases. One innovative approach for controlling costs is to use a three-tier rather than a two-tier (generic and brand name) system for co-payments on drugs. Here, co-payments would differ depending on whether a generic or brand name drug was prescribed, and there would be an even higher co-payment when a brand name drug was selected over an existing generic drug. Since the cause for premium increases is largely due to a rise in prescription drug costs, another alternative is to join an insurance purchasing coalition. The National Federation of Independent Businesses is just one of a number of groups you might want to contact to see if their programs could lower your health insurance costs. Other alternatives employers are using for cost containment include establishing a preferred hospital program whereby employees who choose a less expensive hospital have a greater portion of the charges reimbursed; requiring employees to pay a

greater portion of the cost of spousal and dependent coverage; replacing fixed-dollar co-payments for drugs with percentage co-payments; carving out coverage for medical outlays which are increasing rapidly and use of self-insurance.

LABOR RELATIONS

Here is a simple way to enhance employee benefits without any cost to your company. Add a section 529 College Tuition Plan to your benefit package. Unlike 401(k) plans and various pension arrangements, the employer is not required to match employee contributions, and employees can be encouraged to participate by being made aware of the potential benefits. These include:

- Income tax free withdrawals if used for qualified educational expenses.
- Ability to make contributions up to $50,000 free of gift tax in some jurisdictions.
- Flexibility in changing beneficiaries if the initial beneficiary decides to forego college.
- Ability to change investment strategies annually.

What are the most valued benefits according to employees? Surveys by a number of consulting firms place them in the following order:

- Health insurance.
- A company retirement plan with employer matched contributions.
- Life insurance.
- Disability insurance.
- Paid sick leave.
- Choice of benefits, such as in a cafeteria plan.
- A retirement health plan.
- A prescription drug plan.
- Preventive health coverage.

Other popular benefits which are directly associated with employee retention include: Tuition reimbursement; flexible work schedules; profit sharing; child care; exercise facilities; clothing allowances and prepaid legal services.

MONEY, BANKING AND CREDIT

Cash at the register is the easiest way to steal from a business since cash does not need to be converted, according to the Association of Fraud Examiners. But cash theft is also fairly easy to detect. On a scale of 1 (most difficult) to 10 (most easy) to detect, it is rated 5.04 by the Association. Common cash register thefts include providing fictitious refunds, voiding sales and not ringing up sales. Telltale signs of a register theft include:

- Decreasing net sales when compared to gross sales, indicating an increase in sales returns and allowances.

- Unusually high inventory shrinkage indicating payout of refunds but no return of inventory.

- Decrease in cash sales relative to credit card sales.

- Forged or missing void or refund documents.

- Altered cash register tapes.

- Increases in refund or void sales transactions for a particular cashier.

- Issuance of refunds or voids just below the supervisor review limit.

While the establishment of sound internal controls is the best and least costly way of preventing cash register theft, if a company's management suspects this kind of activity, a limited fraud investigation will usually uncover the theft quickly.

Despite sound credit screening, it is almost a certainty some of your customers will eventually go bankrupt. Therefore, it is important to monitor your customers for early signs of a looming financial problem. Some common flags are:

- Extended collection periods and declining orders, suggesting a cash flow problem.

- Exceptionally rapid uncontrolled growth coupled with limited financial resources.

- Loss of focus, reflected by straying from the core business to unrelated businesses.

- A shrinking customer base.

- Grandiose expansion plans which are unrealistic in terms of business conditions and the customer's resources.

- Heightened competition.

Frequently customers are anxious to discuss these issues with sales personnel and business associates, providing the first warning sign of potential trouble. So it is important to train salespeople and others who come in contact with the customer, to be observant of activities or conversations which suggest financial difficulties.

If you sell overseas you must take special precautions to insure you will be paid, and you must also guard against currency risk (devaluation), especially if dealing with a developing country. Some precautions you might take include:

- Obtaining political risk insurance which primarily provides protection against expropriation of property.

- Have multilateral organizations such as the World Bank participate in the transaction through loans, guarantees or equity investments.
- Structuring transaction documentation to require funds to be converted into hard currency and transferred offshore quickly for payment.
- Including local lenders if possible, so loans and repayments can be made in local currency.
- Including provisions calling for international arbitration of disputes.

This discussion merely scratches the surface of some of the complexity of engaging in foreign trade.

PENSION AND ESTATE PLANNING

Employers who use money-purchase pension plans are required to make pay-ins of up to 25% of participants' pay regardless of whether the company has a profit. On the other hand, with a profit sharing pension plan, the pay-in is only required if the company has profits. Many companies used money purchase plans to maximize the pension contribution, because the profit sharing plan contributions could not exceed 15% of pay. However, beginning this year, the 25% of pay limit applies both to profit-sharing and money purchase plans. As a result, many employers with money purchase plans are anxious to discontinue them and utilize only a profit sharing plan for their pension contribution. Converting a money purchase plan to a profit-sharing plan is simple because the switch is not treated as a plan termination which would require full and immediate vesting of all plan participants. Instead, participants merely need to receive a notice explaining the change. Incidentally, for self-employed's maximum contributions are limited to 20% of pay under both types of plans.

If you have a child who had a summer job or who works in your business part-time, consider opening a Roth IRA for the youngster. The maximum Roth IRA contribution was increased from $2,000 last year to $3,000, and the money you provide for the child is treated as a gift subject to the $11,000 annual gift tax exclusion. If the youngster is 15 years old and the account grows at the rate of 7% a year til age 65, the account will grow to $88,000. If the money is left until age 70, $124,000 will accumulate. Best of all, since the account is opened with after-tax dollars, no tax is due when the withdrawals are made after age 59½. Here is an easy way to provide a significant retirement nest-egg with only a small investment. And, incidentally, if limited funds are withdrawn earlier by the youngster for education, or to buy a first home, premature withdrawal penalties could also be avoided.

If you are self-employed, a one person 401(k) plan can provide you with greater tax deductible contributions than alternative retirement plans. To qualify, you must: (1) be self-employed or run your own business, (2) have no other full-time employees except a spouse and (3) have no immediate intention to hire full-time workers. (Part-time employees who work under 1,000 hours per year can be excluded from the plan). Owner 401(k) plans can be utilized by corporations, limited liability companies, partnerships or proprietorships and can also be utilized if a business has a number of owners. For illustrative purposes, maximum contributions this year if the business is unincorporated and self-employment compensation is $100,000 it would be $31,000 ($32,000 if the owner is 50 or older). If a business is incorporated, an owner at the $100,000 compensation level it would be able to contribute $36,000 ($37,000 if 50 or older) this year. These limits are higher than if contributions were made to a simplified employee pension plan or a profit-sharing plan because with a one person 401(k) plan for a corporation, the taxpayer can make contributions both as an employer and also defer compensation as an employee. The overall maximum contribution limit to a one person 401(k) this year is $40,000 ($41,000 if 50 or older) and would require compensation of at least $145,000, or $116,000 if the business is incorporated.

PERSONAL FINANCIAL PLANNING

Every year the Small Business Administration publishes a profile representing the typical small business in the United States. The 2002 profile indicates:

- There were 5.8 million small employer businesses in the U.S. and, in addition, 9.8 million people were self-employed.
- Small businesses generated $745.1 billion of income last year.
- 26% of small businesses were owned by women.
- 14.6% of small businesses were minority owned.
- Collectively, the small businesses employed 50.3% of the country's employees.
- There was a 6.5% increase in the number of small businesses terminated.
- Small business bankruptcies rose to 39,719 last year, an increase of 12.8%.
- The complete small business profile can be accessed at www.sba.gov/advo/ research on the Internet.

What if you suffered a sudden debilitating illness or accident that completely disabled you? Is there someone who is thoroughly familiar with all of your business records and affairs so the business could go on without you? If you have not provided for this contingency, you should prepare a personal business organizer. It should include:

- The legal name of the business and trade names, tax I.D number and business phone numbers of important business associates such as the attorney and CPA.
- Location of insurance policies, contracts, financial records, tax returns and keys for access to premises, equipment, safe deposit boxes, etc.
- Day-to-day routines, procedures and responsible employees.
- Financial details about your business and an inventory of assets, outstanding debt, insurance, retirement accounts and benefits and credit cards.
- Listing of key people including yourself, partners and business advisors (accountant,

lawyer, insurance broker).

- Customer and vendor list.
- Short- and long-term objectives and a listing of priority matters.
- Confidential information about patents, trademarks, safe combinations, etc., which would be made accessible only to a trusted advisor selected by you.

Of course, a business organizer is a work in progress which needs to be updated regularly.

Limited liability companies qualify for the same legal protection for the owners as is provided by corporations, but their income is taxed only once at the individual owner's level just as in a partnership. For these reasons, many people believe they provide an ideal form of business ownership. Among the advantages which are often cited for these entities are:

- Avoidance of income taxes.
- Ease of changing the allocation of profits and losses among their owners.
- Ability for owners to deduct more business losses than for S corporation shareholders.
- Ability to create different classes of profits and partners, enhancing flexibility for distributing profits or liquidation pay outs.
- Use of multiple and separate LLC's to lower employment taxes because if a separate LLC is set up as a leasing company, it shelters the income from such tax.
- Ability to use an existing partnership agreement in establishing an LLC without the need for preparing a new member agreement.

LLC's are particularly desirable for professionals such as doctors and attorneys because of their liability limiting provisions.

TAXATION

Recent tax law changes designed to stimulate the economy permit operating losses reported on 2001 and 2002 tax returns to be carried back five years instead of the normal two-year period in order to obtain a refund of taxes paid for the past years. Here is a reminder taxpayers who filed 2001 tax returns using the normal 2-year carry back, or who failed to use the carry back have until October 31, 2002, to amend the return and use the 5-years carry back period to claim a refund.

Self-employed individuals will be facing tougher audits from the IRS. The Agency has come up with a formula for catching unreported income. This will mean the auditors will be performing more lifestyle exams which compare a taxpayer's living standard with the income reported on the tax return. Although Congress has barred use of the lifestyle audits except when the IRS has reasonable suspicion the taxpayer has unreported income, the IRS claims these audits are justified when a taxpayer is flagged by its new formula.