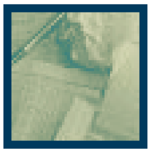
Fall 2003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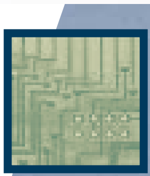
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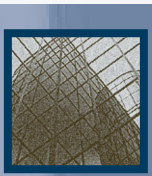
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Are Your Accounting Practices Up To Snuff?

PROFIT IMPROVEMENT

As auditors, we get to see companies that manage their books well and keep their organizations in tip-top financial shape. We also see firms whose accounting practices have room for improvement. Less-than-stellar accounting practices can cause an otherwise sound business to falter. It can crimp cash flow, sour relationships with vendors and customers, open the doors to fraud, and create tax problems.

Here are some of the areas to look at in assessing your company's accounting systems and controls:

Accounts Receivable. Are your days receivable well within industry averages? To get a true picture, monthly figures should be put on a run chart to spot abnormalities or negative trends. Have you benchmarked your bad debt ratio? Is there a process in place for management to review write-offs and refunds? Do you have process and controls in place to ensure all payments received are promptly deposited in the bank?

Accounts Payable. Are controls in place to avoid double payment when a vendor sends both invoices and statements? Do you have clear policies on what a valid company expense is and what documentation needs to be provided before reimbursing employees or contractors? Are responsibilities segregated so the person who approves invoices is not the one who also issues and/or ultimately signs the check? Is your company's cycle time fast enough to take advantage of prompt pay discounts?

Accounting Systems. Most companies have dual-entry accounting systems, but not all take advantage of their systems' functionality. Are there enough different accounts set up to get a clear understanding of what's going on with the business' cash flow? Is a lot of "off the books" accounting taking place on spreadsheets? While spreadsheets are great for planning and analysis, they lack the all-important audit trail.

Corrections And Revisions. Some corrections or revisions are expected, but if they are becoming the rule rather than the exception, then it's time to look at the overall integrity of the accounting process.

Time To Close. How long does it take to close the books each month? Is it within the typical range for a company of your size? Lengthy closing times can indicate loose and inefficient accounting processes. They also make it impossible to assess the financial state of the business in a timely manner.

Reports. Are you aware of the variety of reports available from your accounting software? Do your monthly reports provide the information you need to run the business? Are data in the reports reliable?

If you think that the accounting function in your company could use improvement or just a thorough review, look to us. We can provide an objective outside assessment, identify any problems or opportunities, and if necessary, help you put in place the proper accounting practices and systems that make sense for your organization. ■

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Think Before You Leap Into A Software Upgrade

COMPUTERS

To Leap or Not To Leap? That is the question.

Microsoft is doing it with Office 2003, Intuit regularly does it with QuickBooks. Most other software publishers also periodically do it. What is “it”? Coming out with “new and improved” versions of application software.

With each upgrade comes a decision – if and when to take the plunge. It’s usually not an easy decision. While newer versions may offer increased functionality, there may be very significant direct and indirect costs involved. On the other hand, falling significantly behind can result in lack of support and, at times, compatibility issues. Rather than either blindly jumping in or simply opting out, carefully weigh the benefits and costs to determine if an upgrade is right for your company.

Benefits Of Upgrading

The most obvious benefit to upgrading your software is the new features you can enjoy. However, not every new feature is useful for every customer. Compare the added feature list to the needs of your organization to determine whether the features will actually improve the functionality of your operation. Also make sure that the older version’s features you value are still included.

A benefit of many new software packages is that they are Internet-enabled to seamlessly connect to reference information such as sales tax tables online. Compatibility may also be a benefit. Newer software can often better take advantage of new hardware and operating system features. It may also be needed to maintain compatibility with trading partners. Another benefit is continuing support. Software vendors will frequently phase out support for older versions at some point. This may or may not be an issue depending upon the stability of the product and your own or third-party support resources.

Costs Involved

Sometimes there is an additional charge for the upgrade; sometimes it’s included as part of an annual support contract. Beyond the cost of the software itself, however, there are often very significant additional costs involved.

One of the largest costs may be the need for a hardware upgrade. Typically, additional features mean that more processing power will be required. Carefully assess the suitability of current servers and workstations.

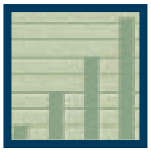
Installation is another cost that can add up quickly, especially if the software must be installed on numerous computers in different geographic locations. If the new software includes major new features or operates differently, also consider training costs and the loss of productivity while employees achieve proficiency with the new package. Finally, previous software customization must be assessed. If it needs to be recreated with the new version, this can also be costly.

Timing Is Critical

If you decide that upgrading is the thing to do, the next question is when to do it. Many experts recommend waiting until at least the first maintenance release has been issued. Early adopters may get the new features first, but they also get to find the bugs and incompatibilities that weren’t discovered during beta testing.

On the other hand, customers that wait too long may discover that the manufacturer no longer supports their version or it’s no longer compatible with other applications that they or their business partners utilize. Once the upgrade process is underway, it makes sense to complete it as quickly as possible to avoid the costs and headache of having to support users on multiple versions of the same software. Other timing considerations for any upgrade project are to schedule most of the work during slow seasons and after hours – to minimize the impact on employee’s workdays. ■

Assess Risk Now To Avoid Losing The Farm Later



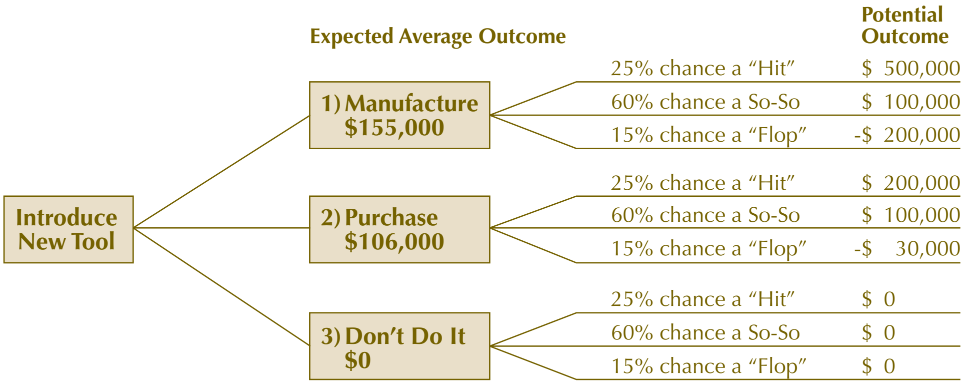
CHARTING YOUR FUTURE

Dealing with risk is a routine part of being in business. Every day we assess whether a modest size customer is credit worthy, whether to hire a particular person for a customer service position, or whether to deal with a new supplier. Each of these situations is risky because it has an uncertain outcome – even if the consequences are typically not earth shattering.

There are other times, however, when we need to take risks that either "bet the company" or are at least big enough to have a serious impact if the outcome is not as desired. In situations like this, a more formal risk analysis is in order.

Example of a Decision Tree Analysis

A company that's deciding whether to introduce a new tool has three options: 1) manufacture the tool, 2) buy it from an OEM, or 3) not do anything. The company's marketing group thinks there is a 25% chance that the tool will be a "hit," a 60% chance that it will be somewhat successful, and a 15% chance that it will flop. The finance department estimates the financial outcomes shown on the right side of the tree below.



The middle section of the tree shows the expected outcome of each option, based on multiplying the financial outcome times the probability. It shows that Option 1 has a modestly higher expected outcome than Option 2. However, it also has the largest potential loss. A business can use this information to help decide the best course of action based on its tolerance for risk.

Types Of Risk Analyses

One of the simplest forms of risk assessment can be done with a ***pro forma financial model.*** For instance, if a company is considering purchasing a new building to increase its volume, a financial statement can be developed that contains the appropriate income and expense categories. The "most likely" amounts are put into each category. A proper risk assessment involves examining alternative scenarios and making appropriate changes.

What if sales targets are not met? What if shipping costs go up or natural gas for heating costs go up or down? This is called a ***sensitivity analysis.*** Through this process, certain factors are identified that create the most significant changes in outcome. In other words, this analysis identifies specific risks, determines which have the biggest impact, and what the outcome (profit or loss) will be in various situations.

Sometimes more sophisticated risk assessment tools are needed. A ***decision tree*** is a graphic that maps the different points of risk tied to a specific course of action. The probabilities and costs are then assigned to each point. The accompanying example shows a simple decision tree representation of adding a product line.

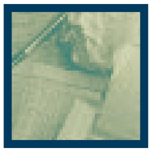
Another technique that can add insight into complex undertakings is a ***Monte Carlo simulation.*** Think of it as a decision tree but with full probability distribution of outcomes instead of one or two possibilities assigned to each branching point. Although this type of model can provide a more precise assessment, it requires a specialized computer program and a working knowledge of statistics to do so effectively.

Get Real

No matter which assessment methodology is used, it's critical to develop realistic assumptions. For this reason, it is worthwhile to get input from unbiased and knowledgeable outside observers that can bring a variety of perspectives to the table. Otherwise, you risk "groupthink," a situation in which a desire for group consensus outweighs an objective analysis of the situation. Also avoid thinking about averages. The average of a $1 million loss and a $1 million gain is zero. To understand the true risk, focus on identifying the range of possible outcomes and breakeven points.

Different businesses are willing to accept different levels of risk. However, understanding risk is a precursor to controlling it and making the best choices for your business. We can help you set up the framework to properly analyze the financial impact of the major decisions your company needs to make. ■

Protecting The Employees Who Protect Our Country



HUMAN RESOURCES

Bosnia, Afghanistan, and most recently Iraq. The steady stream of conflicts in which the U.S. military has become involved combined with a relatively small, voluntary standing military force, means that there is an increasing dependence upon the military reserves and National Guard. The call-up this year of many reservists to support the war in Iraq highlights the need for businesses to address the issue of how to handle employee leaves of absence for military service.

In most circumstances, state or federal law dictates that those called up are guaranteed a job when their tour of duty is over. The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) provides broad employee protections against discrimination and provides generous re-employment rights. It applies to all businesses regardless of size, and all employees regardless of the length of their tenure who are gone for a period of less than 5 years. State laws generally apply when National Guard personnel are called to active duty to provide assistance as a result of natural disasters, civil disorder, or for other state or local needs.

USERRA Requirements

To qualify for USERRA protection, employees must give notice prior to their leave, except in the case of an emergency when it would not be reasonable to do so. The law doesn't require employers to pay the salaries of employees on military leave, but it does mandate that their health coverage be continued for 31 days at no additional cost. Up to 18 additional months of coverage must also be offered, but the employee must pick up the full cost. Employees on military leave may use accrued vacation benefits while they are gone, but cannot be forced to do so.

Upon their return, employees have from 1 to 180 days to report for work, depending upon the length of their active duty. Then, they are entitled to the position they would have held had they not been absent or, in some cases, a close equivalent job. In other words, the seniority and experience clock for an employee on military leave keeps running. If they would have been promoted from a machinist I to a machinist II, would have gone from 2 weeks of vacation per year to 3 weeks, or would have increased their retirement plan vesting from 50% to 75% had their employment not been interrupted, they would still be entitled to these benefits.

Practical Applications

It's likely that periodic call-ups of the reserves will continue for the foreseeable future. If you have reservists in your workforce, be sure your company is fully aware of state and federal employee protections. But also recognize that it can be a challenge for businesses to shift duties or replace key personnel, while also guaranteeing a position when the reservists return.

As long as no discrimination is involved, you may identify those employees who are likely to be called up. Use this knowledge to develop contingency plans and be ready to implement them if military leaves occur. Also don't neglect co-workers who are often both worried about the well-being of their fellow employees and put under added stress by their absence.

Keeping in touch and providing what assistance you can to the families of those called-up can go a long way to increasing the morale on the front-line and in the workplace. ■

Real Estate: Is It The Best Investment Choice For You?

Stock market got you down? With real estate values continuing to climb, you may be looking at real estate investments as a way to boost your returns. Wise move.

Investing in alternative asset classes, such as real estate, gives you diversification. So, when one part of your portfolio plummets, the other investments are (hopefully) continuing to grow. Evidence shows that diversification produces the best long-term results. And real estate has a pretty decent record of appreciation and of running counter to stocks.

However, real estate has a major drawback as an investment because, unlike stocks or mutual funds, you can't sell property easily and quickly. However, this disadvantage may be offset because you can structure the character of gain on the sale or postpone it altogether. You may also be entitled to tax deductions or losses while holding the real estate.

Taxes & Real Estate Transactions

Generally, if you hold the property for more than one year, you will have capital gain treatment when you sell the property. The maximum capital gain rate of 15% (20% for sales before May 6, 2003) may apply to part of the gain, however, the tax rate for certain depreciation recapture can be as much as 25%.

If you have raw land that you want to subdivide to maximize the sales price, you may be able to get capital gain tax treatment. (This rule doesn't apply to real estate developers.) If you're in this situation, get tax advice on how to stay within the rules and maximize capital gain treatment.

If you decide to sell your property and buy other real estate, there are tax advantages to structuring this transaction as a like-kind exchange. Instead of selling the property, exchange it for the new property. You can identify the property you want and use a third party to buy it and set it up as an exchange. Because you must follow some very specific rules, call us to help you structure the deal.

Property used for business can generally be depreciated, and you can deduct expenses – including a loss on the sale, and often any operating losses. There are some restrictions if the property is rented, used for business as well as your residence, or for other personal use.

Other Options To Consider

Deciding whether to invest in real estate involves looking at more than just the tax advantages. Most Americans already have a real estate investment: their home. However, buy a home because you want to live in it. Appreciation is an extra you hope for, but can't count on.

Investing in property beyond your home can be a great way to expand your portfolio. With interest rates at record lows, you could borrow against your home to buy a vacation home or other property. Live in one of the homes and rent out the other.

You may even be able to buy real estate in a self-directed IRA. IRA-owned property presents some complications: you can't live in it, can't manage it yourself, and most likely can't have a mortgage. But, in the right circumstances, it could allow you to buy your dream property at today's prices, rent it out for now, and have it distributed to you from the IRA when you retire.

Another option is to buy property used by your business. You can rent the property to your business, while benefiting from any appreciation. You could wholly own the building, or have co-owners in a partnership or other entity.

If your child is attending college in a town with a good real estate market, consider buying residential property close to campus. Your child can live in the property and you can collect rent from roommates. Rental property can give you deductions, which help "subsidize" the cost of the property. You wouldn't get rental deductions for your child's share, but you would for the roommates' percentage.

Overall, real estate investments are worth a look. Call us to see if they can work for you. ■

This Time They're Serious – The IRS K-1 Matching Program

TAX PLANNING

If you have an interest in a partnership, LLC, or S corporation, watch out. The Internal Revenue Service has ratcheted up its focus on pass-through income from such interests. For tax year 2001, over 23 million Schedule K-1 forms were filed reporting over $1 trillion in income to partners, shareholders, and some trust beneficiaries.

The IRS began sending out notices in late March under its most recent initiative to match Schedule K-1 information against individual income tax returns. This is after a 2-year hiatus – earlier matching efforts were suspended in 2000 after numerous complaints that many IRS notices were incorrect and that no discrepancies existed. More than 60% of the notices issued in the 2000 K-1 matching were ultimately closed as "no-change." The IRS says it will use additional screening to substantially reduce the number of notices issued and to minimize the incorrect and unnecessary notices.

The IRS offers some comfort to taxpayers who received a notice in 2002 that involved no tax change – they are unlikely to receive a notice this time around. However, the Service also warns that if a notice was issued last year because of a mismatch, and this year's reporting has not changed, you will likely get a notice again.

Form Revisions Underway

The IRS effort to improve the matching program includes a long-term plan to revise Schedule K-1 and Schedule E, Supplemental Income. The redesign is expected to make the forms and related instructions easier to understand, simplify the filing process, and reduce taxpayer burden. However, it will still be awhile before the new forms are available. A revised version of Schedule E is projected to be ready by next filing season. The K-1 form, which is quite complex, will take longer.

The IRS is pulling together a working group to focus on needed changes to the K-1 form, although they acknowledge that a complete overhaul of the form could take years. The IRS is contemplating a number of possibilities, including a K-1 EZ for simpler returns and a range of different kinds of K-1 forms to adapt to various specific situations.

More Complicated Than You Think

The IRS has done its part in issuing tips to taxpayers and tax professionals to help avoid errors related to K-1s used to report income from partnerships, S corporations, and some trusts. However, accurate reporting of K-1s is made more difficult because of the:

- Complexity of the transactions and tax law that applies to pass-through entities.
- Inadequacy of the forms used for reporting the transactions due to the limited number of lines and descriptions on the form. Many believe the forms themselves are too complex.
- Inconsistencies among tax preparation software programs and limitations in reporting K-1 information.
- Reporting styles or positions by pass-through entities, which may not accurately reflect the owners' position or treatment.
- Condensed tax deadlines, which allow little time to resolve differences between receipt of the K-1 and filing of the Form 1040.

With changes in place, the matching program should begin issuing notices to some taxpayers later this year, requesting more information about their 2001 tax return. The IRS expects the K-1 changes will reduce taxpayer burden and increase the overall effectiveness of the matching program.

If you receive a notice, be sure to contact us immediately. We can save you time and effort by providing the necessary information to the IRS. ■

S Corporations LLC Partnerships

Planning For Asset Purchases And Sales Can Net You Tax Savings

One of the easiest ways to reduce your tax bill is to properly plan your asset purchases and sales. Here are a few things to consider.

Timing Is Everything

Timing is critical whether you buy or sell investment assets, real estate, or equipment. Watch out for these time triggers.

Holding period for most capital gains is one year. Make sure you exceed the one-year mark to receive the lower capital gain tax rate. And for assets purchased after 2000, a 5-year holding period can net you an even lower rate.

Under the 2003 Tax Act, the ***bonus depreciation*** has been increased to 50% (from the earlier 30%) for property acquired after May 5, 2003 and before January 1, 2005. As with the earlier 30% bonus depreciation, buildings and used property will not apply.

Tax deferral is possible in a like-kind exchange or involuntary conversion (gain from condemnation or insurance reimbursement). However, to postpone the gain, you must meet the strict time deadlines for identifying and acquiring replacement property.

Don't Get Carried Away

Purchasing too many assets in one year can have disadvantages if it triggers deduction limitations. Sometimes waiting to purchase assets can make a huge difference. For instance…

Mid-quarter convention is the depreciation "hit" taken when you buy too many business assets at the end of the year. If over 40% of your purchases are in the last quarter of the year, your depreciation deductions will be reduced on every asset purchased during the year.

The ***expensing election under Code Section 179*** is also reduced or eliminated if you purchase too many assets during the year. Under the 2003 Tax Act, the expense deduction amount has increased to $100,000 (from $25,000) and starts to phase out if you purchase $400,000 (up from $200,000) in assets. It's completely gone at $500,000 of purchases.

Start Off Right With New Purchases

To get all of the depreciation to which you are entitled, set up assets correctly on your in-house depreciation schedule, and get tax advice on the character of expenditures.

Capitalizable costs (such as freight, installation charges, and commissions) associated with purchases are added to the basis of the property and depreciated.

When you purchase real estate, consider a ***cost segregation study.*** This analysis "finds" depreciation deductions by identifying component assets with shorter lives. Examples of such components include: decorative fixtures, land improvements, and architectural fees. Consider a cost segregation study when you construct a new facility, or remodel or expand an existing facility.

Eliminate Surprises

People often enter into a sales transaction thinking they're getting a great deal. Then, when tax time rolls around, they're hit with an unexpected tax bite. Watch out for these traps:

Depreciable property usually triggers ordinary income when it's sold. You must pick up depreciation recapture at tax rates higher than capital gain rates.

Installment sales can have a worse result. The ordinary income depreciation recapture is triggered in the year of sale – even if no payments are received. If you don't factor this in, an installment sale could leave you short on cash to pay tax due on the gain.

Selling depreciable business property to a related person or company can also worsen your tax bite. All gain from the sale will be taxed at ordinary income rates.

Some of the tax benefits associated with property are mutually exclusive. We can analyze your facts and circumstances to find where you will get the most benefit. Remember, we are your allies in reducing your tax burden. Involve us throughout the year as you prepare to buy or sell an asset. ■

WASHINGTON ALERT

9/30 Deadline For Retirement Plan Amendments

September 30, 2003, is the "drop dead due date" for companies who use Master and Prototype or Volume Submitter Plans to update their qualified retirement plans to conform to current law. These plans, sponsored by banks, investment brokers, retirement plan consultants, insurance companies, and lawyers offer employers many design options that have all been pre-approved by the IRS.

September 30, 2003, is also the deadline if your plan must be submitted to the IRS for a favorable determination letter. In general, these plans received automatic reliance from the IRS that the form of the plan is qualified; however, if your Master and Prototype or Volume Submitter Plan was modified in any way, it may not have this required "reliance." Employers should contact their plan adviser NOW. The September deadline is not that far away. ■

IRS Releases Statistics

The IRS has released statistical information on 2001 tax returns, as well as on IRS audit and collection activity for the fiscal year ended September 30, 2002.

The 2001 tax return statistics mirror the economic downturn. Although the number of returns filed for 2001 increased, income on those returns decreased – except in the area of unemployment compensation.

Although income on returns went down, IRS activity for the overlapping fiscal year increased – as they promised it would. This increase was in both tax return examinations and in collection activity. High-income taxpayers continue to be a focus with audits of taxpayers earning $100,000 and more increasing by 22%. Audits of corporations with less than $10 million in assets increased slightly.

Collection activity increased to the highest level in 8 years, with liens rising 50% and levies by 15%. ■

Justice Department Increases Tax Efforts

The Justice Department has also increased activity. Tax fraud prosecutions authorized by their Tax Division increased 16% in 2002, and have increased another 11% to date for 2003.

The Justice Department's criminal enforcement priorities include:

- Employers who fail to withhold or pay payroll and income taxes.
- Taxpayers who use trusts and overseas bank accounts to evade taxes.
- Tax protestors who file false or frivolous returns. ■

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