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THE ACCOUNTANT'S BUSINESS MANUAL

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THE ACCOUNTANT'S BUSINESS MANUAL

AICPA
American Institute of Certified Public Accountants

THE ACCOUNTANT'S BUSINESS MANUAL

Volume 2

THE ACCOUNTANT'S BUSINESS MANUAL

A Two-Volume Service

Prepared for the AICPA by

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E-BUSINESS

1. SCOPE OF E-BUSINESS

CPAs can most effectively plan for electronic business (e-business) challenges by first assessing their current roles. Are they in organizations planning an e-business transition? Are they sole practitioners with an interest in advising current clients about e-business issues? A CPA facing these challenges should begin by exploring how various tasks and responsibilities can be adapted to Internet technologies.

This chapter is designed to provide a foundation for a knowledgeable consideration of e-business concepts, not only as they relate to e-business practices, but also as e-business affects other departments and functional areas of a firm.

When considering the e-business concepts and practices contained in this chapter, the CPA may find it necessary to ask the following questions:

— How can this idea be implemented in the firm or company?
— How will this affect the role of the financial professional?
— Can these ideas be effectively communicated to co-workers and management?
— How will the e-business concept improve the overall performance of the firm or company?

CPAs have many roles in business today. This chapter provides both general and specific tips. The general tips will apply best to CPAs in industry who work for a wide variety of companies and CPAs in public practice who are offering e-business consulting to a wide variety of companies. The specific tips will apply only if the tip is applicable to the CPA's specific role. Examples are used throughout.

E-Business *is* the latest hot topic of technology. In its narrowest sense, e-business is almost equivalent to the term e-commerce, which is the process of completing a market transaction on the Internet. In its broadest sense, e-business encompasses the business use of any current technology that is somehow tied to the Internet. A more meaningful definition is that it is a set of business processes and systems that tie organizations together in all of their communications, transactions, and interfaces by means of Internet-enabled technologies, increasing value to each participant by reducing redundancies, trimming costs, and increasing productivity and timeliness.

1.1 The Stages and Technologies of E-Business

A typical organization experiences several stages of e-business maturity. At first, companies will struggle to provide employees with email and

Internet access. New issues arise, such as whether there should be a limit on the Web sites employees see or the time they spend online, whether employee behavior should be monitored, and whether email use should be allowed for personal messages. Most companies have long solved these issues and realized the superior benefits of allowing employees Internet access.

The next stage involves deciding whether the company should put up a Web site. The decision to Web or not to Web is akin (in hindsight) to deciding whether to participate in the stock market in 1999. Investors who were risk-averse to the dot.com stocks and stayed out of the market began to see the lost opportunity as the year unfolded. Today, most companies have some form of Web presence. Those that took the plunge early have redesigned their sites at least three to four times on the average and are well past the learning curve of knowing what works and what doesn't.

A company may or may not have implemented a Web site, but in either case, it can still consider hosting an intranet, which is a private corporate network that employees have access to and the public does not have access to. Intranets, like email, are considered a "killer app" (short for a killer application, that is, one that has a chance for a very high return on investment) for almost any organization. In the best implementations, they have transformed the way workers communicate and have brought their organizations to new levels of productivity and interactivity. (See section 5 for more on intranets.)

E-commerce is the next step in the e-business evolution, and the portability of products to the Internet medium varies among industries. Physical goods, software, and certain types of services are easily described and pictured on a Web site, and products that were considered unsellable on the Internet, such as coffee (allegedly because the aroma is missing), do just fine.

E-business is the final maturation phase in the cycle and is characterized by partnerships and the automation of connections among an entire supply chain.

1.2 A Multidisciplinary Approach

Since e-business affects all aspects of an organization, it follows that an e-business team should represent many of the major areas in an organization. Although information technology (IT) will definitely be represented, so should marketing, customer service, production, accounting, and many more areas.

The best e-business team represents a cross-functional slice of the organization. Some people will come from IT, of course, and these

people include the programmers and network administrators. Marketing must be represented, as the Web is a major marketing channel. Writers, graphic artists, and marketers are likely to come from marketing, and traditional marketers will be challenged with learning about the uniqueness of online marketing. Since the Web affects customer service, the customer relations department should be represented too. A project accountant may manage the budget and spending aspects of the project. Any corporate function could participate in feature selection or content creation. The team leader should be someone who can manage large projects and interface with all types of people in the organization, and is often from IT.

The approval body for e-business should also be multidisciplined and perhaps organized as a steering committee. All related projects should be estimated, approved, and prioritized for the e-business team. There should be one executive-level person with the title of executive sponsor who acts as the champion and evangelist of the entire e-business effort. The CEO should also be involved at some level since most e-business decisions affect strategy.

2. INTERNET ACCESS AND BANDWIDTH OPTIONS

2.1 Definitions

One of the first phases a company initiates when curious about the Internet is to provide Internet access for employees. This enables employees to share email both inside and outside the organization. Although email was available to users before the 1980s, email has become known as the killer app due to the Internet's wide reach. Now people can easily reach people in other divisions, other countries, and other continents. The benefit of accessing people through email and accessing information through the Internet is immeasurable, and specific to each individual. It includes saving time and reducing business costs such as labor, postage, and printing.

In order to support employees' Internet access, a company must decide how much bandwidth it needs. The bandwidth is a measurement of how much data can flow back and forth on a network. In other words, it is how wide the pipe of information is. The wider the bandwidth, the faster the information reaches the user.

2.2 Technologies to Consider

A company wishing to access the Internet must build a technology platform for accomplishing that goal. Generally, the first thing an organization must do is create a network of personal computers (PCs) for its employees The network is the foundation for all other technologies. The company must make critical business decisions on technology issues affecting the day-to-day operations, such as what kind of operating system to adopt, what type of PC to use, hardware and software standards, and the company's usage policies. These decisions will affect the e-business planning and strategy for the company.

Once a company has built a solid technology platform and trained employees on the basic uses of their PCs, it can add the functions of email and Internet access. An individual who is trained in network administration and who is willing to get to know the company's needs is best suited to provide connection options. CPA firms with more than twenty or so employees have found they need to hire one or more full-time network administrators to support the network and the Internet requirements of the firm. They often hire an individual who is certified in network administration. Possible vendors involved in the process will be a system integrator, a telecommunications company, a cable company, and an Internet service provider (ISP). An ISP is a company that provides connection service through a telephone line to the Internet.

The most common bandwidth options are presented in the following sections, beginning with the least expensive option.

2.2.1 Regular dial-up access

The slowest way to access the Internet is over a plain old telephone service (POTS) line, the type of regular voice line needed for Internet access. It is a common method for people to use when dialing from home or a hotel room. The PC must be equipped with a modem (a device that allows computers to interact with each other across telephone lines). The current modem speed standard is 56kps or 56 kilobits per second (a kilobit is equal to one thousand bits per second). However, this speed is now judged too slow for all but the smallest of businesses. Even a sole proprietor CPA or a telecommuting CPA will probably need more than a POTS line.

2.2.2 Integrated services digital network (ISDN)

A historically popular communications technology that is now less popular than other offerings (described in the next two sections) is integrated services digital network (ISDN). The difference between a POTS line

and an ISDN line is that POTS is analog and ISDN is digital. Since data is originally digital by definition, ISDN can be a cleaner and faster data transfer solution and offers speeds of up to 128kbps. ISDN requires a terminal adapter instead of a modem. Installation woes and customer service problems have plagued the telecommunications companies offering ISDN. However, some CPA firms are offering ISDN as a choice for their telecommuting employees.

2.2.3 Digital subscriber line (DSL)

Digital subscriber line (DSL) is growing so fast that there can be a waiting period for installations. DSL utilizes existing copper phone lines and is easier to install than ISDN. DSL comes in many styles, and one of the most popular is asymmetrical DSL (ADSL). Asymmetrical means that the speed varies by direction. ADSL offers a downstream (receiving) speed of 1.5 Mbps (megabits per second; a megabit is equal to one million bits per second) and an upstream (sending) speed of 64kbps. Downstream means the data flows from the Internet to a user's PC. An upstream data flow is from a user's PC to the Internet. DSL handles voice, text, data, image, and video transfers.

DSL is appropriate for a very small CPA firm, a CPA working in a small business with a few other employees or contractors, or home access. A DSL connection through an ISP such as Mindspring/Earthlink can average $50 per PC per month. Check with an ISP or local phone or telecommunications company for installation information and local pricing. DSL users should implement a firewall for security (see section 3.2.7 in the section "Information Security" for a definition).

2.2.4 Cable

Cable, like DSL, has also developed into an alternative Internet service provider only recently. Over 90 percent of U.S. homes are already wired with the coaxial cable needed to complete the connection. A cable modem is used both in the PC and at the receiving location. Cable offers a fast download speed of up to 30Mbps, but speed is reduced as more and more homes in the neighborhood sign up for cable, since the hardware is shared. Upload speeds vary with the cable provider. Quite a few CPAs have implemented cable as their choice of connection. These CPAs are using it from home or from a small office.

Cable access costs on average $50 per month per PC. To find out more information on cable access, contact a local cable company, or a national favorite, such as @Home.com. Cable users should implement a firewall for security (see section 3.2.7 in the section "Information Security" for a definition).

2.2.5 Dedicated lines

The telecommunications options discussed in the previous sections are best suited for home or a very small office. CPAs working in a company with any size will need one or more dedicated lines to provide enough bandwidth. A T1 line is one such option, providing transmission speeds of up to 1.544Mbps. For companies with large bandwidth needs, a T3 line offers 44.736Mbps speeds and costs several thousand dollars per month to rent. A dedicated line is connected directly from a private corporate network to a connection within the Internet. The closer the line is to the backbone or primary lines of the Internet, the better the response of the line. Check with telecommunications companies for further information on dedicated lines. Users of dedicated lines should implement a firewall for security (see section 3.2.7 in the section "Information Security" for a definition).

3. INFORMATION SECURITY

Keeping information secure is one of the top priorities of all businesses. But keeping information 100-percent secure is cost-prohibitive. The best solution is to understand which threats have the highest probability of occurrence and which would cause the most damage, and to apply defenses, in the form of an information security plan, against those threats. CPAs are especially astute at understanding internal control issues and are valuable team partners to coworkers who know more about technical systems but are less business-savvy. CPAs in an internal audit role should develop a role with information technology professionals responsible for information security. A short list of threats and possible solutions follows.

3.1 Threats to Information Security

Threats to information security lurk everywhere, from the common household magnet (holding too close to a disk drive demagnetizes it and erases information) to a favorite employee (fraud is big business). Some of the most common threats are discussed in sections 3.1.1 through 3.1.4 below.

3.1.1 Viruses, worms, and Trojan horses

Viruses, worms, and Trojan horses are unauthorized, malicious programs, some of which are designed to destroy information. Each of these threats can gain access to a firm's systems and wreak havoc,

resulting in destruction of files and losses in productivity. The two most common points of entry for viruses include an employee who brings in an infected disk or opens an infected email attachment on the company's network. To learn more about viruses and related malicious programs, visit the Web sites of the companies that make antivirus software. Symantec, at http://www.symantec.com, and McAfee, at http://www.mcafee.com, are two good sites. The best prevention for viruses is antivirus software, installed correctly and updated frequently.

3.1.2 Employees, ex-employees, and other business partners

Employees can cause harm to data, both intentionally and unintentionally. Employee theft and fraud have skyrocketed in the last few years. Accidental data deletions and errors caused by poor training, although not premeditated like employee theft, can also cause loss of information security and productivity. Good access control including the screening of new hires and strict policy enforcement can help to reduce this threat. CPAs knowledgeable in the area of fraud can devise useful safeguards to reduce this threat for their companies.

3.1.3 Hackers and thieves

Individuals outside the system who wish to gain unauthorized access and possibly do harm to a company's data are called hackers. They are street-smart and highly technologically literate. Their tools can vary, including software programs, such as password crackers (which can guess passwords), personal conversational skills to persuade an employee to give out a password, or just an ability to look confidently at a building guard while walking out with a system unit.

Some computer criminals focus on acquiring, through illegal means, competitive information, which can be worth a lot of money.

3.1.4 Natural disasters

Disasters are another form of threat to information security and include fires, hurricanes, tornados, floods, utility explosions, and the like. A significant weather system can cause data losses around the country. To reduce this risk of loss, a proper backup and recovery system should be in place and periodically tested.

3.2 Company Security Solutions

A combination of solutions will comprise a good security defense. A few of the more popular ideas and definitions are described below.

3.2.1 Access control

Limiting access to sensitive data can take many forms. It can include physical security, such as locking the stairway or back entrance to the building, hiring guards, or screening the cleaning crew. It can also include using authentication in system access.

The most common access method is not the PC; it's the telephone. Professionals can phone in, feign an emergency, and usually talk someone into giving out their password. When that happens, it's easy for hackers to enter the system and do whatever damage they have in mind.

3.2.2 Authentication

Implementing user identifications (Ids) and passwords will limit access to the system, and setting up password-protected file access will limit access to sensitive files even further. An authentication system should require users to enter long passwords (eight to twelve digits for most needs), change them periodically, time-out or expire sessions that are not active, and restrict remote access. Good procedures will provide users with information about what type of passwords are the most secure. For example, the most common password in use is the word "password." Users should be trained to avoid dictionary words, and to use a combination of letters and numbers for best results. Users should also be advised not to give out their passwords to anyone, even fellow employees, including management.

Authentication procedures can also involve the use of biometrics technology, which identifies a person biologically through the use of identifiers such as a handprint, fingerprint, or a retina (eye) scan.

3.2.3 Policies and procedures, plus training

Since employees are by far a larger threat than hackers, strict human relations policies can help prevent problems down the road. Strict screening at hiring is suggested. Have the new hire sign a nondisclosure agreement that includes being responsible for terminal use. A training session with new employees can help avoid the inadvertent deletion of files and can inform them of the company's expectations concerning file management, passwords, and other technology issues. Access to files should be on a need-to-know basis.

3.2.4 Encryption

Encryption is a process that is used to rearrange information so that it appears garbled and travels in a secret code that others cannot read. A key, which is like a digital password, can unlock, or rearrange the data so that the end user can read it. Sensitive data can be encrypted,

not just during sessions, but also while stored. A centralized key file should be created with limited access to store the keys.

3.2.5 Secure sockets layer (SSL)

Secure sockets layer (SSL), is a protocol that is used to encrypt information being transferred from a Web page to a company's server. Information that is entered into a form on a Web page can be securely transferred to the host computer where it will be processed if SSL is in place and if the user is using a browser that enables SSL. Microsoft's Internet Explorer and Netscape's Navigator or Communicator are such browsers. The browser displays clues such as a gold-haloed lock on either the toolbar or status bar to indicate the connection is secure. Good Web design dictates that SSL be used when asking for sensitive information such as birth dates, Social Security numbers, credit card numbers, bank account numbers, passwords, and other identifying information.

3.2.6 Digital certificates

A digital certificate tells users who they are doing business with on a secure site. It also enables the site to become secure. All companies that wish to offer site security should obtain digital certificates, and they can get one from a certificate authority such as Verisign. The application process can be made through the company offering the e-commerce solution or the company's Web host. (See section 6.5.2, "Certifications," for a discussion of certification programs, including the AICPA's WebTrust.)

3.2.7 Firewalls

A firewall is a standard solution for a company that has connected its internal private network to any Internet connection. A firewall can be composed of hardware (a workstation), software (such as a package), or a combination of both. It acts as a gatekeeper of requests, letting authorized requests or users into the private network while keeping unauthorized users, or the general public, out.

Firewall selection and installation are best handled by a trained professional. This professional will not only be a network expert, but also a security expert. Although the market consists of "add-water-and-stir" solutions, these solutions are worthless if installed incorrectly, since an experienced hacker can know all of the default configurations of these products.

3.3 Staff Security Responsibility

Security affects the entire organization. It affects the screening process of new hires and therefore, affects staff in the Human Relations department. It affects every systems development project in the Information Technology (IT) department. It affects internal control, data handling, and reporting issues in the Accounting department. It affects all employees and the way they handle and store information at their desks.

Generally, one business functional area should take responsibility in the organization for the security function, and the head of that function will likely be a director-level manager in IT, reporting to the chief information officer (CIO). Some companies will not be able to allocate an entire headcount or department to this position and should outsource or contract the expertise. These companies should not assume that the network administrators have knowledge of information security; it is a highly specialized area of IT and is not network-specific. Larger companies or companies dealing with highly sensitive information may have an entire team devoted to protecting corporate information. CPAs can review plans and controls and periodically audit for compliance. They should be part of the information security team.

3.4 An Information Security Plan

The creation of an information security plan is a valuable exercise in order to organize the many details of information security and to properly allocate the budget toward prevention of the highest security risks.

Such a plan should be implemented and the implementation should be audited. Breaches of security should be analyzed immediately at the time of occurrence. The plan should be revised periodically, based on the information learned from auditing the execution of the plan and security breaches that have been experienced in the past.

4. WEB SITE PLANNING AND DESIGN CONSIDERATIONS

4.1 Web Site Trends

Internet usage is growing every day if media reports are to be believed. Nearly 123 million people have accessed the Internet to date according to Nielsen's NetRatings (as of February 2000). The average household logs on eighteen times and visits ten sites a month. How long does the

average user take to view one Web page? Customers may pause an average of fifty-three seconds on a page before leaving.

Some of the emerging demographic trends include—

— The increase and eventual majority of women as a Web audience.

— The increase and eventual majority of non-English-speaking Web visitors.

— The increase in new beginner-level Web visitors.

If an organization wishes to do business with any of these groups, its site design should reflect the tastes and needs of the particular audience. For example, to attract a beginner, the site should be very clean, intuitive, navigable, and offer lots of help, terminology definitions, and education in general.

Another trend is that both small and large businesses have sprinted out of the Web starting gate faster than medium-sized businesses. Large businesses have the financial resources to develop e-business capabilities quickly, and small businesses have the decision-making abilities to commit to an e-business strategy as part of their overall business plan. Caught in the middle are medium-sized businesses; some that have waited will have to catch up in the e-business arena if they want to remain competitive long-term.

Follow the trends at sites such as http://www.idc.com, http://www.nielsen-netratings.com, and http://www.computereconomics.com.

4.2 Benefits for CPAs

Businesses are benefiting tremendously from having a Web site. Cisco Systems receives close to 85 percent of its orders online (*Information Week Online,* "Cisco Simplifies Business," Brian Riggs, 12/13/99, found at www.informationweek.com). Other companies such as Pro2Net (the old AccountingNet) exist solely on the Web and have no "brick and mortar" presence. The Big Five accounting firms are benefiting from offering e-business services and creating Web sites and strategies for customers. Some of the most common benefits to a CPA of having a Web site include—

— *A global reach.* Executives and customers from Canada, Australia, England, Singapore, South Africa, and more can read a firm's Web pages. If the Web site is translated into languages other than English, the firm will reach even more people.

— *A low-cost marketing channel.* A Web site can reach beyond the local community to the younger and somewhat more affluent demographic group that uses the Internet. Sites that offer an email newsletter subscription service can capture sign-ups in an unobtrusive way.

— *A tech-savvy presence.* A Web site enables a firm to illustrate to clients and prospective clients that it is up-to-date with technology trends and committed to changing and growing with the times.

— *Customer self-service.* A firm can ask its reception staff what the top ten client and prospective client questions are and post the frequently asked questions (Fans) and answers on the firm's Web site. Soon, clients and prospective clients will be helping themselves, freeing up some support staff at the firm.

— *24/7.* The firm can maintain a presence with clients and prospective clients twenty-four hours a day, seven days a week.

— *A platform for future technological advances.* By taking the first step in creating a Web site, a foundation for further, phased technological growth is formed. As the firm grows and changes, it can layer new technologies on top of the initial platform. The first site can be developed quickly and improved on as the firm's Web knowledge and expertise grows.

— *A foundation for a new business model.* The Web has created new product and service opportunities for many. During the 1999–2000-tax season, H&R Block, American Express, and Intuit are battling for the low-cost Web-based tax return system. Most CPAs who offer tax services believe that their services are too high-end to be affected. But at the rate of today's technological development, high-end tax returns will be available on the Internet in only a year or two. Forward-looking CPAs will watch this trend and develop offensive growth strategies for their own companies. Many CPAs with experience in mergers and acquisitions are assisting dot.com start-ups and other companies with business plans, valuations, and the financial aspects of new business models.

— *An opportunity to educate customers about the best way to do business with the firm.*

— *An opportunity to develop or explore affiliations with other companies and firms.*

— *An opportunity to provide additional customer value through articles, newsletters, tips, and other actionable Web-based content.*

— *An opportunity to deliver services digitally.* Firms that offer customers a section of the Web site for file transfer (rather than "snail mailing" everything) cut down on delivery time, postage, and labor.

4.3 Web Site Costs

There are two primary costs of developing a Web site. One is the hosting of the site, which consists of storage and file transfer costs. The other

is the cost of development and design, which includes both content generation and layout design. The latter is by far the largest of all the Web costs. The specific cost components of implementing a Web site are described below.

4.3.1 Domain registration

What will the firm name its site? Once that question is answered, the firm can register the name directly with Network Solutions, or usually better, its Web host, who will handle everything. In 1999, costs averaged $70 for the first two years, and $35 per year thereafter. The Web host may also charge a setup fee.

4.3.2 Web hosting

There are hundreds of excellent companies that host Web sites for businesses. A vast majority of Fortune 500 companies do not attempt to host their own sites and instead use hosting companies. The complexity of hosting a site requires employees to become experts in network administration, performance loading and balancing, 24/7 support, information security, Web standards and domain updates, telecommunications, backup and disaster recovery, database management, program troubleshooting and debugging, help desk, and much more. Yet some CPAs have tackled their own Web hosting at great financial expense and time. Unless a firm is committed to this task full-time or has very unique requirements, it makes both financial and strategic sense to outsource Web hosting to someone who is focused and devoted to this line of business.

Web host companies offer a number of services that fall into two primary categories: virtual and dedicated. In a virtual setup, a company's Web site shares a machine with other companies. This is the least expensive solution and will be the right one for the vast majority of small businesses. Currently, this service costs about $15 to $25 per month. Included in the service can be email post office protocol (POP) accounts, file transfer capabilities, Telnet or terminal access where batch jobs and other commands can be executed, secure server availability, forms, database, and programming processing, video and audio capability, a control panel with maintenance options, and much more. There may be extra charges and setup fees for some features. Companies expecting less than 30,000 hits per day (most receive 300 per day) with Web sites containing less than a few thousand pages can select the less expensive virtual solution.

A dedicated solution earns a company its own Web server. This solution is appropriate for larger sites with a heavy amount of traffic.

It is also correct for companies with unique processing, database requirements, or security issues.

Two operating system platforms are generally offered, UNIX and Microsoft Windows NT. A majority of Web servers are run on UNIX. A UNIX platform will host a site created in Microsoft Front Page if Front Page extensions are offered. Most experts say UNIX is a more stable platform than NT and usually prefer it, unless the Web site has been designed with Microsoft programming that does not readily port to the UNIX environment. The decision about which platform to use is a major one that should be decided by independent technical experts and cannot be thoroughly covered here.

> ***Caution*** A firm should be careful not to overspend in this area. Many firms spend much more than they really need to in this area.

4.3.3 Design costs

The costs to design a Web site vary from site to site, since not all Web sites are the same size or offer the same functionality. The components that make up site design include—

— *Design and layout.* Questions to be decided upon during the design of a site include how many pages it should be, how the navigation should be designed, whether the pages should have a common look and feel, and what features should be included in the site.

— *Graphics/multimedia.* The popularity of the Web stems from its graphical nature, and pictures, photos, videos, audio clips, and clip art are all essential items for the best multimedia experience.

— *Content.* Web pages must be written and edited prior to putting on the site.

— *Coding and testing.* Once the site is designed, it must be coded and tested for functionality.

4.3.4 Maintenance

One of the top five items customers and clients want in a Web site is for it to change frequently and offer new tips and tricks. Once a Web site is up and operational, maintenance can become a day-to-day need. Some sites will need updating hourly, others monthly. The costs to maintain the site are the same as what is listed in the design section above, but are repeated over time as new versions of the Web site are implemented and new features and content are added. Current trends indicate most companies are averaging a complete site redesign every six months.

4.3.5 Other Web site development costs

Other costs to consider when developing a Web site include—

— *Customization.* Factor in costs to integrate the site's electronic commerce transactions with the back office.

— *Hardware and software.* These could include a graphics package, a Web development package, and servers if the firm hosts its own site, as well as workstations for new employees, Internet connectivity, and the like.

— *Training.* Consider training costs for new employees who are responsible for various Web team duties.

— *Help desk.* Costs of support function for people who visit the Web site and get lost.

— *Marketing.* The cost of implementing a complete online marketing plan and integrating Web marketing with the firm's existing marketing plan should be accounted for in the budget.

4.3.6 Cost estimates

Some general cost ranges of Web sites for initial design and implementation only, and not including maintenance, depending on the size of the firm, can include the following:

— Small business: $1,000–$20,000

— Medium-sized business: $30,000–$50,000

— Large company or special type of site, such as online banking: $1 million and up

The most common costs that get left out of Web site budgets include marketing, strategy, and maintenance. On the flip side, some costs are actually free. Beware of taking shortcuts, however. An educated eye can tell if a site is designed in Microsoft Front Page (because of the common templates and the general look and navigation). The industry calls these McWeb sites, a play on the fast food industry. It all depends on personal opinions about quality and value when considering how much a firm will be comfortable spending on the Web site. But right now, most people will agree that the opportunity cost is almost immeasurable.

4.4 Features and Best Practices

4.4.1 Visitor requirements checklist

Before designing the firm's site, consider and review what people want when they visit a Web site. More specifically, what does the firm's existing

(or future) customer want in a Web site? Here are some common answers.

Visitor Requirements Checklist

☐ New, actionable content	Keep the Web information fresh, updated, and "news they can use." Sites announcing events that have already occurred and sites that haven't changed in a year will not see many repeat visitors.
☐ Relevant links	Visitors want to know if there are more sites like the firm's or another site with information that is logically related in some way.
☐ Navigable	The 3-click rule means the average visitors had better find their information in 3 clicks or less or they won't come back.
☐ Answer the mail	If the site provides an email link, whom does the email go to? It should be the president or an assistant, not the Webmaster. It should also be answered promptly. If the firm takes longer than a few days to answer email, post this notice on the site so expectations are set correctly.
☐ Downloads quickly	Bandwidths such as DSL and cable struggle to keep up with graphic-laden sites; the visitor with a lowly 56k modem doesn't have much of a chance. Know who the site's visitors are, what bandwidth they are using, and cater the firm's pages to those visitors.
☐ Coupons and incentives	Some users are attracted to discounts. Does the firm have a discount for first-time clients?
☐ Favorite brands	Some users are brand-conscious. Does the firm have an expertise with specific brands of services or software?

4.4.2 Determining the company's Web strategy

Web sites fill various needs of their audiences and can be classified by purpose. The following list includes the most common types of sites, to help in determining which type of site will best suit the organization's Web and business strategy.

— *Brochureware, or just another marketing channel.* One of the first phases many Web sites pass through is that of displaying advertising information about the organization. The information posted on the Web site is essentially the same as information that is written in a marketing brochure, hence the name "brochureware." There is no real payback at this stage—there is no reason for the Web visitor to return to the site since the information is primarily static.

— *News or advice site.* This site may be an online magazine, newsletter, or contain a series of articles about a topic. There is a reason for the Web visitor to return if the information is updated. If the information is very specialized, the site can remain small; otherwise, generally speaking, a news site is a huge undertaking. CNN, Motley Fool, and CNET are examples of news and advice sites.

— *A self-service application.* Sites that provide order tracking or that answer customer's questions fill this purpose. Federal Express has consistently served as a model for this type of site.

— *A store.* Web sites that sell merchandise fall into this category, such as eToys, Amazon, and Lands' End.

— *A portal.* A portal is a Web site that aggregates offerings from other sites. Some appeal to a particular constituency (a vertical portal), for example, women. In this niche, there are iVillage, Oxygen, and Women.com. Search engines also fall into the portal category (Yahoo! or Excite are considered horizontal portals in that they appeal to a wider range of users).

— *A service merchant that offers a community marketplace.* This site specializes in matching two people who want to do business with each other and that have specific needs. These sites include Priceline.com, where airlines with extra seats are matched with people who want to pay less and have flexible schedules; eBay, an auction site; and Matchmaker, a site for singles looking for dates and mates.

On the Internet, there are two primary audiences: consumers and businesses. There are also two primary types of transactions: business-to-business (B2B), and business-to-consumer (B2C). These lines have blurred, and consultants have come up with more acronyms recently, but these are the basic choices. B2B commerce, in dollars, is expected to far outstrip consumer sales and growth on the Internet.

4.4.3 Site features checklist

Some of the features to consider listing on the firm's site include the following:

Site Features Checklist

☐ Company information	Name, logo, contact information, address, map, directions, phone, and email address. Many sites neglect to include important phone numbers.

Site Features Checklist *(continued)*

☐ Employee directory	Names, biographical information, photos, service or product affiliations, phone number and email address. Some organizations do not post employee names for fear of headhunters.
☐ Products and services	Catalog, prices, photos, descriptions, characteristics, and delivery information.
☐ Advice, in the form of articles, newsletters, tips, checklists, interviews, forms, white papers, presentations, and case studies	These materials can be included in the form of HTML, Adobe Acrobat Reader (PDF), and Word (less commonly), or other files the user can download. (See section 4.6.2 for definitions of HTML and PDF.)
☐ Links to other sites	This is one of the main features surfers look for.
☐ Customer testimonials	Customer testimonials, referral letters, or other positive feedback can be collected over time. Placed together in a notebook, file, or inbox, they can be periodically added to a special section on the site.
☐ Important information and policies	Legal information and policies, such as privacy policy, security policy, return policy, copyright, and usage disclaimer.
☐ Audio and video information	The Web is multimedia, and companies that make good use of it will stand out. However, the information must be meaningful and add value; otherwise the site will be accused of wasting the visitor's time.
☐ A site search engine	If the site is over twenty pages, add a search feature that will help surfers find what they are looking for easily.
☐ A feedback page	This can include email, or bulletin board areas.
☐ A discussion group	If this application is being considered, first find out the likelihood of audience participation, to judge whether it will be worthwhile to pursue. Content must constantly be monitored, and the board must be constantly "fed" with the firm's staff comments and emails to people, inviting them to contribute. A firm site considering a discussion group application should include a copyright notice where applicable and legal disclaimers that the content posted may not necessarily reflect the company's views.
☐ A set of tools such as a loan calculator, tax	This type of application keeps the site interactive and offers free "toys."

Site Features Checklist *(continued)*

calculator, budget tool, or more	
☐ An email subscription page to capture visitors who are interested enough to share their email addresses	The firm will have to send them an email once in a while, which can be done by simply mentioning one or two quick tips or news items, or it can be expanded to include a full-blown regular newsletter.
☐ Customer service features, such as a hot line, order tracking, or account maintenance	See more about related e-commerce features in section 6.3.4.
☐ Private sections for existing customers	This can involve permissioning certain areas of the site to specific customers.
☐ Personalization and customization for visitors	A site is personalized when each user views a different home page than the next visitor. Examples of this can be seen at My Yahoo! or even Amazon, once a visitor has ordered his or her first book. Personalization can be used very effectively to provide the user with the exact information he or she has requested and can be used to increase sales. Once a visitor has purchased a few things, Amazon uses a combination of data mining and personalization to suggest books it thinks he or she might like to purchase in the future (based on prior purchases).

4.4.4 Best practice sites

Web sites that are successful have a few characteristics in common, and the main ones revolve around customer service. A site that knows what its customers want and that can deliver will have a competitive edge on the Internet. A successful site can quickly, logically, and efficiently deliver information that is useful to the customer so the customer can act on it, perhaps by purchasing product on the Web site. A site that piques the customer's interest by offering related useful information will enjoy longer stays and perhaps more sales from its visitors. A site that can help a user who has gotten into trouble will be remembered and revisited by the grateful user. Some of the sites practicing these characteristics include the following:

— Amazon.com is by far one of the most advanced sites on the Internet.

— E*Trade has opened an entire market niche and displaced stock-brokers at the traditional brokerage houses.

— Priceline.com has found a way to take advantage of supply and demand by offering last-minute airplane tickets and other products to consumers.

— Sites that save research time or help in purchasing decisions. In the technology area, these include CNET, TechWeb, PC Magazine, and Computerworld.

— Sites that have completely automated their entire sales transaction (or a significant portion of it) include iPrint, WebHosting.com, and numerous software companies such as Macromedia (user can download a free software package and pay later online).

Discover more best-practice sites in the book, *StrikingItRich.com,* by Jaclyn Easton. Learn the top twenty most visited sites from watching the ratings service at http://www.nielsen-netratings.com. Everyone has their favorite sites that they visit regularly.

4.5 Five Steps In the Development Process

Developing a Web site is a special type of systems project, but some of the traditional systems development techniques are appropriate here. One approach is to use a traditional systems development methodology that incorporates phases such as feasibility, requirements analysis, design, programming (buy or build), testing, implementation, and maintenance. Presented below are some major parts of this process.

4.5.1 Step One: Domain Registration

A domain name is the dot.com address of the site. It is also part of the uniform resource locator (URL). An example of a domain name is sandismith.com, while the full URL is http://www.sandismith.com. A user types in the URL in the browser window to travel directly to the home page of the site.

In order for this to work, all domain names must be registered so they can be attached to their physical servers, or the machine that contains the Web page files. This is done by means of a directory structure, and a company called Network Solutions handles the domain registration process at this time. Once an organization or user has determined the domain name it wants, it can register it in two ways. If it already has a Web host selected, it should go through its Web host to register the name to eliminate the need to provide the physical Web server information. (If it hosts its own site, its network administrator will do this.) If it does not have a Web host, and therefore does not have the physical Web server information yet, it can register it directly

with Network Solutions, which is called "parking it." Parking it is akin to reserving it and costs a bit more.

Naming the site is crucial. Most of the good names are now gone or have been registered through a broker (much like a scalper of sports tickets). The site name should be clear, free of abbreviations if possible, short, and easy to spell. Avoid a combination of letters and numbers that contain the easily-confused I's, L's, 0's and O's. Most CPA firms have registered their sites as abccpa.com (for Able, Baker, and Cohen, CPAs), which is very acceptable. Ernst and Young kept its domain name very short, selecting ey.com. Some people have registered multiple spellings and misspellings of their site name, such as bobbrown.com, bobbybrown.com, and robertbrown.com. A Web host can point these three domain names to the same site, and a customer can be unsure of the spelling and still find the site. If a firm hasn't reserved its name, it should do so immediately before a competitor or other party reserves the name it wants. Visit http://www.networksolutions.com to find out what's left.

4.5.2 Step Two: Content Development

Deciding exactly what should go on the Web pages is one of the most difficult tasks of the entire process. The company strategy should drive this decision. If part of the strategy is to provide extra customer information, then the content should include information that the customer sees as adding value to the existing relationship. Items such as a free newsletter, directions to the office, a company phone directory, and a list of products on special for the month may fit the bill.

Luckily, most companies will not find themselves starting from scratch on content development. Content is everywhere, and it should be recycled. Look in the firm's business plan and other planning documents, marketing brochures and other handouts, press releases, business cards, product catalog, sales presentations, customer testimonials, and photos of the recent picnic or awards dinner. All of these items tell the story of the business and can be transported, or "webified," for use on the Web site.

Once these materials have been gathered, a list can be made of what will and won't be included. The guiding focus should be the overall strategy and purpose of the site and how the company's inclusion of a variety of information can add value. If the list is turned into a hierarchy chart, a site map is created. For example, the list might include a newsletter, a white paper, a contact page, a map, and the president's biography. A chart may start with the home page, which describes the company and products very generally. The home page might include a library section and a company section. The library will contain the

newsletter and white paper, and the company information section will contain the contact information, the president's biography and the site map.

4.5.3 Step Three: Presentation design

What will the firm's Web pages look like? A Web site should contain a combination of text and graphics, laid out in a professional-looking design. It can start with a graphic of the company logo and name. These should be prominent at the top of the page.

The site map created earlier will determine what links are needed. To continue our example, two links, one for Company Information and one labeled Library, should be placed on the left side or at the top of the page. In polls of Web visitors, the left and top sides of Web pages have been the preferred placement for links, buttons, and other navigational aids. A typical CPA firm Web site, at minimum, will have links to a mission statement, service descriptions, biographies of partners, industries and testimonials of existing customers, newsletters, and contact information.

Site design should be visually appealing, intuitive in navigation, and reflective of the corporate culture or "look." If the firm is young, still developing, and energetic, the Web site should probably use multimedia, such as Macromedia Flash files, to get its message across. A conservative culture should use conservative colors and graphics. It's a good idea to have all of the firm's marketing materials match. The Web site should be the same color, look, and feel as a firm's letterhead, logo, and other marketing materials.

A few things to stay away from in Web site design include frames, too many graphics, and pop-up windows. Frames are maintenance-intensive, do not work the same in all browsers, and are generally frowned upon from a style standpoint. Both pop-up windows and heavy use of graphics, including too many swirling and flashing objects on one page, can be considered annoying by users and usually do not add value to the content.

Web pages can be static or dynamic. They can also be coded from scratch with no automation or modularized into nonredundant components. The use of Web design programs and good basic systems design techniques will keep the Web site from becoming a dinosaur or a maintenance nightmare.

To get design ideas, go to any of the search engines and look at other sites in your industry. Then *don't* do what they do. Look outside your industry for the freshest ideas in Web design.

4.5.4 Step Four: Testing and implementation

Once all of the Web pages have been created on a new site, they should be tested. Links and buttons, for example, should be tested to see if

they work. Consistency in font size, navigation bar placement, and color scheme should be reviewed to make sure each page is correct. Length of scroll bar can also be checked (one that is too long should be broken up into more pages). A copy editor should check for not only grammar errors and spelling mistakes, but also conciseness and clarity of the message. All the graphics should be checked to make sure they load correctly and quickly. Any graphics that are too large should be reworked in a graphics package to fit the site's requirements.

If any forms are used, a test should be done to make sure the data is captured correctly and any editing is working as designed. If a database is being used, the records should be reviewed to make sure the data is being collected accurately.

Since there are too many of these testing cases to memorize or remember, a test plan is usually a document that is created and used during testing. It lists every item to be tested, assigns a tester, and contains a column to record the results of the test.

Once a site is tested, it can be installed, which is basically a step that transfers files from a test area to the live or production area. A retest should be conducted as soon as the files are installed to ensure the installation worked correctly and that there are no environmental problems that were overlooked.

4.5.5 Step Five: Maintenance

Once the initial Web site is up and operational, it can already be viewed as out-of-date; it's time to change it with new, fresh, and relevant content. The best approach to this conundrum is to set a maintenance schedule and delegate this responsibility to an employee. The employee should be constantly looking for possible new content, such as the announcement of a new account or service, another installment of a newsletter, an employee recently promoted who can be spotlighted, or a testimonial letter from a customer. The employee should be trained to update the site and work with the Webmaster on a periodic basis.

There can be more work than simply maintaining a site. If there are forms on the site such as a customer feedback form, this information must be evaluated by the right parties. If there is an email sign-up function, an employee must manage the process. If the site captures orders, the orders must be processed. All of these functions must be delegated to employees who have the skill sets and training to get the job done. The new jobs must be added to their existing accountabilities and be part of their performance review process.

A CPA will likely be working with the Web development team and presenting them with content and ideas for items that can save time. Let's say that a CPA is getting the same question over and over again

from customers. Posting a page that addresses the question could save staff and customers time. Contributing to Web content is an ongoing process, and CPAs are encouraged to develop ties with Web design team members so that they have input into the Web site process.

4.6 Technologies to Consider

4.6.1 Web development software

A good Web designer will use a software package to store and generate Web site pages. The most basic of programmers might use Microsoft Windows Notepad or WordPad. The next level up is Microsoft's Front Page. Because Microsoft products are unique in regard to protocols and standards, the use of Front Page requires "Front Page extensions" when working with a Web host.

More advanced designers will use a package such as Macromedia's Dreamweaver. Larger Web sites will need a package or custom programming (or both) to dynamically generate pages once some base templates have been defined.

4.6.2 Programming languages, protocols, and other terms

The Internet, as with any technology, has developed its own vocabulary. A few terms are listed below for familiarization.

ASP. This acronym has a double meaning right now. In the context of Web pages, it stands for a Microsoft technology, active server pages. At the end of the Web page address, a user may see a file name that ends in .asp. This type of file exists dynamically and is generated from a combination of Microsoft technologies. It could also stand for application service provider, which is a company that offers or outsources the use of software packages through the Internet.

bps (bits per second). The measurement of the speed of data transfer in a communications system.

Browser. A browser is a class of software that interprets Web languages and displays Web pages. The two most prominent Web browsers are Netscape's Communicator and Microsoft's Internet Explorer.

C++. A fast, powerful programming language.

Common gateway interface (CGI). When a user completes a form with information, there must be a way to send it from the browser form to the server, and CGI acts as a standard to define this transfer of information.

Domain. Domain refers to a portion of a Web site address, such as aicpa.org.

Domain name server (DNS). DNS is a numerical address of a Web site consisting of four sets of numbers, such as http://209.111.241.38.
File transfer protocol (FTP). FTP is a protocol for transporting files from one server to another. It is also a program that does the same thing. A user needs FTP to update its small Web site so that the files on its local computer can be transferred to its Web server.
Graphics interchange format (GIF). A type of graphics file that is small and suitable for the Internet. It is not high enough in quality to be used in print media.
Hypertext markup language (HTML). A tag-based programming language for Web pages. A browser is the software that interprets the HTML and turns it into the Web pages that a user will see.
Hypertext transport protocol (HTTP). The communications protocol that enables the Web and allows the display of Web pages.
Index.html. Also index.htm. The likely title of a user's home page, or the first page the visitor sees on someone's Web page. The name is a default name that can vary by site.
Java. An Internet programming language that is independent of hardware platform.
JavaScript. A scripting language used in Web sites. This differs from the Java language above.
Joint photographers expert group (JPEG or JPG). A type of graphics file that is higher in quality than GIF and is suited for the Web.
kps (kilobits per second). One thousand bits per second.
Mbps (megabits per second). One million bits per second.
Portable document format (PDF). A type of file created by Adobe Acrobat Reader. It's a common way to make graphical or forms-based documents available to Web surfers and is a step up in sophistication from Microsoft Word.
PERL. An Internet programming language that is interpreted and very popular among small sites. There are a lot of free PERL modules available on the Internet for use.
Post office protocol (POP). Refers to a type of Internet email account.
Transmission control protocol/Internet protocol (TCP/IP). The primary network protocol of the Internet and of intranets.
Uniform resource locator (URL). The address of the Web site, such as http://www.aicpa.org.
VBScript. A scripting language used in Web sites.

4.7 Tips for Selecting Vendors

4.7.1 Web hosts

Some of the criteria with which to judge a Web host includes technical expertise, reliability, reputation, support, price, and experience. Some

of the questions a CPA should ask a prospective vendor that they are evaluating include:

— Is support available? If so, what are the hours? Are setup instructions clear and posted? Most sites are lax in offering clear setup rules, which means everyone must call the help line. As a test, call the help line and see how long it takes to get connected, and how well the questions are answered.

— How fast did the Web host's site load? Ask the Web host to furnish the names of customer sites that are similar. Test how long it takes for these sites to load.

— What hardware platforms do they offer, and do they have the services the firm will need? This should include programming needs, file transfer availability, email boxes, passwording, multimedia capabilities, and more.

— Is the price within the budget? Are there setup fees? Monthly fees? Per megabyte fees?

CPAs who offer technology consulting to clients will likely form a relationship with one or two Web hosts and will recommend these hosts to their clients.

4.7.2 Key questions to ask Web designers

The other partner in Web development besides a Web host is the Web designer. In some cases, this can be the same company. Some Web designers also prefer to work with specific Web hosts and can shelter a client from having to get involved in the technical decisions of Web host selection. Some questions to ask potential Web designers are listed below.

— Do they know the industry? Ask them for Web sites they have created that are in the same industry or similar to the firm's. Are they excited about the firm's products, services, and company?

— Does their style fit the firm's? Even though some work for large companies, Web designers are individuals with individual tastes. Can the designer match the style the firm or company needs to portray? The best way to answer this is to visit several sites they have designed.

— Do they offer the services that the firm needs? If the firm doesn't know what it wants in a Web site, can they lead it through a systematic design process? Do they have artists on staff who can manipulate graphics or create them? Do they offer content creation or editing?

— If programming is necessary, what programming languages do they use? Does that fit with the firm's standards and needs?

— Can they handle ongoing maintenance? Would they train one of the firm's employees to handle the maintenance task?

— Do they offer site marketing? Offline? Online? Exactly what do they do to market the site?

— How do they price their services? Is the fee in line with the firm's budget?

CPAs may or may not be the ones selecting the Web designers, but they can offer these and other questions to the person or team who is making the choice.

5. INTRANETS

5.1 Definition

An intranet is a private corporate network utilizing Internet technologies. It can be a place where employees can access common documents (previously only available in hard-copy form), share files, work together in a group environment, work easily in a remote setting, and customize their views of information. An intranet is commonly set up as a Web site, with an index page, but only accessible to authorized employees of the corporation and definitely not accessible to the general public.

An intranet can also include an extranet, which is part of a company's private network where certain suppliers, vendors, or key business partners have access, but the general public does not.

5.2 Benefits and Costs

Intranets provide a whole new way for employees to work together. In addition, they reduce publishing costs such as paper, printing, delivery, and clerical labor. They save time for employees who have to answer questions of other employees, such as those in Human Relations. An intranet with powerful features can transform an organization's productivity.

The costs of an intranet include its hardware and software. A network is the foundation of an intranet, and it should be Internet protocol (IP) based to take advantage of Internet technologies such as browsers. A browser is commonly used to view intranet pages. The Microsoft Internet Explorer browser is free and is commonly used. The largest portions of the expenses are incurred in the areas of design, implementation, and maintenance of the intranet. A help desk function and training should also be components of an intranet's budget.

5.3 Intranet Features and Considerations

A good first step of an intranet project is to gather all of the documents that are distributed to all employees, publish them on the intranet, and then destroy the paper versions. These could include—

— Phone lists

— Biographies or resumes

— Division addresses and maps to offices

— Organization charts

— Employee handbooks

— Company newsletters

— Various policies and procedures

— Standard contracts

A feature to modify or update any of the documents could be added with security for the employees who are allowed to make such modifications. The intranet publishing model immediately saves time and money for all employees and provides a fast payback that can seed the next development phase of the intranet.

Many intranets are used for collaborative purposes and document-sharing. Employees who do not reside in the same physical office can review each other's comments and information about common work goals. Some type of groupware, such as Lotus Notes, is usually installed on the intranet, enabling teams to work together in a common user view.

The Internet technologies enable employees to customize their views on their intranet, just as you can now on My Yahoo! or other Web sites. One goal of an intranet, especially as it grows in size, is to allow employees to find information they need very quickly. Organization is key, and customization technologies allow the filtering of selected data that employees find most useful.

Training is an essential part of today's corporate environment, and numerous training programs have been adapted for the Web. An intranet can be fitted with the right training courses, and employees can take the training right on the intranet without leaving their cubicles.

Customer service is driving a huge part of the changes in today's businesses. Customer relationship systems are great for an intranet since they can centralize the notes about a client that has been interacting with more than one employee. The employee can look in the system to determine the most up-to-date information about the client.

As intranets grow, they have become the center of the organization and touch many systems. A real-time, interactive intranet will become the organization's life center and will drive the business model.

5.4 Staff Functions

An intranet staff is similar to a Web team. Designers, coders, content writers, graphic artists, and managers must be part of this team. To a large extent, the intranet must be marketed internally to encourage adoption and high use rates; a marketing function must be present as well. In addition, and most important, all function heads throughout the organization should ask themselves how each new project affects the intranet, and communicate the appropriate requirements to the team.

CPAs will likely find themselves in the role of content providers for intranets. CPAs in public practice who offer technology consulting and who become good at their own intranets can coach clients on how to set one up.

6. E-COMMERCE TRANSACTIONS

6.1 Definition and Terms

E-commerce, or electronic commerce, is a term that describes the process of initiating the purchase of goods or services using an Internet or other network-based system. The transaction can be entered by a person using a Web site form or by a computer program that has met some trigger criteria, such as a stock price or a reorder quantity. The transaction can be completed online if it is purely informational in nature, such as a software program download or a stock transaction. If the goods are physical in nature, then part of the transaction must be completed off-line, such as grocery delivery or shipping toys at Christmas.

Electronic commerce transactions usually fall into two categories: business-to-consumer and business-to-business. When a consumer purchases a book at Amazon.com or bids on an item at eBay.com, it's known as a business-to-consumer transaction. When a CPA firm orders routers from the Cisco Web site, it's known as a business-to-business transaction.

The technologies included in the enabling of e-commerce are many. They may have begun with electronic data interchange (EDI), which is a somewhat ancient (in technology terms) but still widely

used standard for sharing transaction information among mostly large businesses. Today, a company cannot do business as a supplier of Sears or WalMart without being EDI-capable.

One prerequisite for e-commerce is a network. The two entities that wish to transact business must be connected in some way. The Internet has sped the connection of many firms and has hastened the ability of small firms to enhance their market reach. Larger companies that already have a business connection will perhaps do business through each other's extranets. As stated earlier, an extranet is a part of a company's private network where certain suppliers, vendors, or key business partners have access, but the general public does not.

6.2 The Shopping Cart Metaphor

A company that has developed a product or service catalog will find it easy to transfer that information to the Web and create an electronic product or service catalog. As Web visitors browse the catalog of items, picture them pushing a shopping cart. As they find items they wish to purchase, they "place" them into the cart, usually by clicking a check box or a button contained in the product display.

The shopping cart metaphor continues when the Web visitor has completed shopping and is ready to go to the checkout line. The Web site pages will contain a button entitled "proceed to checkout" (or something similar). Pressing this button will move the Web visitor through the purchase process. The Web visitor is generally asked for name, address, phone, credit card, and shipping information. The order is confirmed at this time.

The shopping cart metaphor is one of the most common ways to shop online. To view examples of the shopping cart metaphor in action, go to Amazon's Web site (http://www.amazon.com), eToys (http://www.etoys.com), or Lands' End (http://www.landsend.com).

The shopping cart metaphor does not apply to all industries. For example, online banking, stock trading, the media industry, and many business-to-business models will use another electronic commerce model besides the shopping cart metaphor.

6.3 E-Commerce Site Design Requirements and Considerations

6.3.1 Product, service catalog, and site navigation

The first part of the development process for an e-commerce site is for a business to determine what items, services, or products it will sell

online. Does it have a product or service catalog developed? What items of information do its customers need to know about the products it will be selling? For example, colors, sizes, price, year published, testimonials, units of measure, author, awards received, fabric type, washability, and more are all characteristics of products that people purchase. Which characteristics apply to a CPA's products and services?

Note that CPAs in service industries can create a catalog of services as well. Some of the services CPAs in public practice could offer include—

- Accounting software installation packages
- Tax return preparation services for particular types of taxpayers
- A day of computer training
- Corporate tax return services
- Monthly bookkeeping service
- Network installation based on the number of nodes installed
- Payroll tax return services
- Year-end tax planning consultation, and more

If a firm offers monthly services, it should list at least three products: three-months, six-months, and a one-year sign-up. Although some proposals can't be cookbooked, and some CPAs will be shy about placing prices on the Web for all to see, they should be creative and think about these possibilities with a new perspective.

After a business has determined the items it will list for sale and has completed its catalog, it can proceed to determining the Web page layout for its products. The business will want to collect some photos since the Web is graphical and include them along with the information. What information should be placed prominently on its site? Perhaps for this job, the business should look for someone who has professional graphical design and layout experience.

A business will also want to consider navigation. How will people get to its products? A topical drill down is common. A product index is also a good addition. A great site search engine is a must. At times, the site should also be able to feature certain products as new or on special for that month. Customers will need several ways to find the products that suit their needs, and the Web site pages should be laid out in such a way that customers can reach these products very quickly and intuitively.

6.3.2 Ordering and payment options

When a customer is ready to order, what options will they be offered? Can they order only over the Internet? Can they call customer service

or fax the order? How will they pay? Does the company's site take credit cards? Nearly 90 percent of all online transactions occur using credit cards. Can they mail in a check? Not only must these procedures be determined by the business and written up as policy in the firm, but they must also be posted on the Web site in a very clear way so the customers can read, evaluate, and follow the options presented.

Always consider giving the customer at least two ordering options. Sales can be lost if the customer is not given enough ordering options. A fax option for product-based items and a phone option where a customer can talk to a knowledgeable person for service-based items is recommended. It is a good idea to list a phone number (an 800 number is a plus) on every Web page.

If the business site will take credit cards, start with an existing bank and ask about setting up a merchant account for credit card transactions. The setup fees for an account can be reasonable—less than $400. The application process is not complicated, and in this day and age of ultimate customer service, it is a nice option to have available. Combined with online banking, it saves trips to the bank and moves the company toward a more virtual, paperless existence.

Will the customer get into trouble during the ordering process? It is likely that someone will, and the company won't want to lose the sale. Consider providing a help desk to answer questions that could come up during ordering and visiting the Web site. Other issues that deserve some research include a company return policy, shipping methods and policies, inventory levels and management, sales tax collection, and export rules and regulations.

There are quite a few policies that need to be developed around e-commerce ordering and payments. CPAs knowledgeable in policy development can provide a key role in policy development as well as decision-making for the firm.

6.3.3 Account management

Hopefully a business Web site will generate repeat visitors and buyers. Account management allows customers to enter personal information only one time. The assignment of user IDs and passwords allows customers to retrieve that information the second, third, and subsequent times they order. Providing this function does add complexity to the e-commerce site, but is pretty much essential for most sites.

It works as follows: The first time customers visit a site, they are asked for their name, address, shipping, and credit card information. They should also be asked to choose a user ID and password. Once they have provided this information, the order can be completed. When they return to the site for a new order, they should be able to enter

only their user ID and password. The account management function should be able to retrieve their information, which is stored in a secure corporate database, and use it to process their second and subsequent orders.

What if a user changes address, name, credit card number, or more? A change function must be provided for all of the user information that has been captured. All of these functions must be available on the site or via another method, such as email, fax, or phone.

Some sites offer other account management features, such as order tracking, viewing account history, and email notification preferences. Whether by automated system, email, or phone, these functions should be planned into an e-commerce system.

To view how account management is working on a live Web site, choose a site where an order has been placed. Visit it and study the layout of the pages, what information is asked for, and how the process differed from the first order that was placed. Note what this function entails and how businesses have implemented it.

CPAs who are experts in customer service can help design these account management functions and provide input for future modifications.

6.3.4 Special e-commerce features

The premier sites are now competing on more than the basic ordering functions. Some of the more advanced features include the following list.

— *Wish lists.* This feature is similar to a wedding registry. It allows users to enter products they desire and allows others to view their lists. CPAs in public practice with customers who sell retail products and CPAs in industry who work for retail companies will find this feature profitable.

— *Speed ordering.* This feature streamlines the ordering process for existing customers, usually by using cookies. (Cookies are defined in section 6.5.1, "Privacy Policy.")

— *Special occasion reminders.* If users have events such as a birthdays or holidays (for example, Valentine's Day) that they wish to purchase gifts for, they can record these events and people in a reminder system. For an example, see Hallmark Cards' service at http://www.hallmark.com.

— *Community services.* Services such as chat, discussion boards, and file-sharing create a community among customers. This trend is one of the many "latest things" in e-commerce marketing and customer relationship management.

6.4 Vendor and Package Selections

6.4.1 Vendor interview questions

Once the requirements have been determined for an e-commerce system, the business will likely find a package or a solutions company that fits its needs. A number of options are available in packages, although some have issues such as lack of security or no credit card processing. The major functions of an e-commerce package include order-taking, payment processing, and back office integration, and each package offers one or a combination of these features. For larger companies where package options will not meet the company's needs, an e-business solutions company can take the business requirements and create a custom solution.

Many questions should be asked of a software company before buying the product. A list can be personalized but a few common questions are listed below.

— How many products will it handle?

— What does the user interface look like? Test-drive a sample store at the Web site; serious vendors will have a model set up. Look for as few clicks as possible, intuitive button labeling, and flexibility in layout, to name a few.

— What types of transactions does the package handle, including orders, back orders, returns, or other exceptions? Does it correctly figure sales tax and shipping fees?

— How are the orders stored and retrieved?

— How secure is the system?

— Is payment processing included?

— Is there any integration with back office systems? If so, what accounting systems are used?

— What is the performance of the system on various bandwidth options?

— Are any tracking reports provided? These are important for marketing; they include number of hits, page views, and volume of products sold.

— What is the cost?

6.4.2 Vendor sources

The hot e-commerce companies are constantly changing. Look to great technology Web site sources for recent articles on e-commerce package

comparisons; including PC Magazine (http://www.pcmagazine.com), TechWeb (http://www.techweb.com), and CNET (http://www.cnet.com), for more information.

If a company already has a Web site, it can look to its provider for an e-commerce option that can be added on to its existing site. It can even be a free service.

A few sites to consider, as of spring 2000, include:

— Bigstep.com (http://www.bigstep.com)

— Freemerchant.com (http://www.freemerchant.com)

— Econgo.com (http://www.econgo.com)

— IBM Home Page Creator (http://www.ibm.com/ebusiness/ecommerce/solutions/hpc.phtml)

— Icat Commerce Online (http://www.icat.com)

— BroadVision (http://www.broadvision.com)

— Oracle (http://www.oracle.com)

— Open Market (http://www.openmarket.com)

6.5 Privacy Issues and Considerations

6.5.1 Privacy policy

Any e-commerce site must post a privacy policy that informs its customers about how it intends to handle the private customer information that it collects. This policy need not be long; the best ones are no more than two pages in length. Most sites place a small-font link to their privacy policies at the bottom of every Web page and near their shopping cart buttons.

Visit the Web sites of several popular merchants and read the privacy policies; there are some common elements in each of them. A company that reviews another's policies can find that this aids in developing its own.

The privacy policy should begin by listing what information is collected at the site. Next, tell visitors how the information collected will be used. Is the information used outside the company? Is the visitor put on a mailing list, and if so, is there a way to opt out? If children will be accessing the site, items such as age limitations and parental authorization should be discussed. Legal portions of the privacy policy might include disclaimers, legal and reporting requirements, and the right to change the policy at any time.

Customers today are very concerned about security. Include in the privacy policy how customers' information is kept secure during their

Web visits as well as in back office operations. A site with posting facilities, such as a chat room or discussion groups, should include a copyright notice where applicable and legal disclaimers that the content posted may not necessarily reflect the company's views.

Does the site use cookies? Cookies are parts of files on a computer that are created when a user visits certain Web sites. They are used for tracking and marketing information and for the convenience of the visitor. Cookies can track a user's ID and password so that they don't have to enter them each time they return to a site. Some people are wary of cookies and consider them a privacy violation. If the site uses them, it should state its policy and define and explain its use of cookies thoroughly to its visitors.

6.5.2 Certifications

To help businesses assure visitors that their sites follow certain guidelines, several certification authorities have sprung up. TRUSTe, the Better Business Bureau *OnLine,* and AICPA's WebTrust have programs that businesses can join if they pay a fee and meet certain procedural guidelines. Although TRUSTe and BBB *OnLine* are far more prevalent, the AICPA's WebTrust program is the most comprehensive and offers an assurance service in the true sense of the word. Each candidate is periodically audited according to the WebTrust principles and criteria, and the Web site must disclose a number of policies to be in compliance.

More information about any of these certifications can be found at TRUSTe (http://www.truste.org), BBB *OnLine* (http://www.bbbonline.org), and the AICPA (http://www.aicpa.org).

6.5.3 Privacy standards

One of the World Wide Web Consortium's initiatives is on the subject of privacy and is called P3P, which stands for "Platform for Privacy Preferences." As the Consortium completes the guidelines for businesses in the use of customer information, the businesses that follow these rules will help their customers understand exactly how their information will be used. Businesses and individuals alike will do well to keep up to date on this project and can do so at http://www.w3c.org.

7. THE INTEGRATED E-BUSINESS APPROACH

7.1 System Components

What is the difference between e-commerce and e-business? E-business takes the development of e-commerce much further and applies an

integrated electronic systems approach to all of business, not just the transaction base.

Imagine ordering a widget. Company A is the buyer and must place the order in its system. Company B is the seller and must place the order in its system. An integrated e-business approach would enable both companies to enter the transaction once and for each other. The order is placed by Company A and flows not only through Company A's and Company B's systems, but also down the entire supply chain of widgets. Dell was one of the first companies to offer the ability to update systems across the chain. These advances will reduce redundancy and increase productivity. Additionally, with an e-business approach, the companies have access to each other's pricing, order-tracking, and other account management features in order to provide a seamless customer relationship experience. The back offices are tied together in a way that the purchase orders, shipping documents, invoices, and accounts receivables–payables tracking are synchronized and on time.

The definition of e-business, then, is a set of processes and systems that tie businesses together in all of their communications, transactions, and interfaces so as to increase value to each participant by reducing redundancies, trimming costs, and increasing productivity and timeliness.

Common e-business system components, according to an *Information Week* poll published in its online edition (*Research Survey of E-Business 100 Companies*, 12/13/99, found at www.informationweek.com), include the following:

- Web site
- E-commerce site
- Intranet
- Extranet, which is an intranet that allows external business partners access
- Self-service application, such as order tracking
- Web-enabled electronic data interchange (EDI)
- Custom product configuration
- Business-to-business supply chain automation
- Enterprise portal
- Call center automation

7.2 Back Office System Integration

A traditional brick-and-mortar company, or one that already has an existing business model outside or in addition to the Internet, will have

the added challenge of integrating its Web-based ordering system with its traditional ordering system. This is referred to as back office system integration and generally encompasses ordering, shipping, payment or receivables, tracking, and customer account management. It might also include production, delivery, and many more business functions. For example, a magazine site will build a production system to publish articles online and on paper. A software site will build a delivery system for downloading the software.

A company can take a number of approaches in achieving integration. If it feels the need to speed its implementation of its e-commerce site, it will probably go live with an entirely separate system just because this is faster. Companies that do this must still work out how to handle new shipping volumes and new customer service inquiries. Some of the brand new dot.com companies failed to anticipate rapid growth and have suffered when a reputation for poor customer service spread. Other companies will wait until they can integrate their systems completely. This delays the Web implementations and can cost valuable market share.

The best approach is a hybrid one, where some but not all integration has been achieved and the remaining integration is planned in phases. With the hybrid approach, the company can implement a modified business model while programmers work in the background to create the desired business model. Another benefit of this approach is the opportunity to revise plans during the valuable learning period that occurs once a company has its Web site operational and starts experiencing how customers react to it.

The integration itself is generally a large systems project that should be managed formally and approached using a systems development methodology to insure timeliness, budget limitations, and overall functional success. A small company will probably hire a team of people to implement such a project, while a larger company may have the talent in its existing IT department staff. Typical skills of a project manager will include the following—

- A technical Web and networking background
- Design skills
- Excellent communication skills
- Supervisory knowledge

The team may consist of programmers, marketers, content editors/writers, graphic artists, and possibly a project accountant.

7.3 Customer Relationship Management

The *Information Week* poll mentioned in section 7.1 (*Research Survey of E-Business 100 Companies,* 12/13/99, found at www.informationweek.-com), confirmed that improved customer satisfaction, first, and improved customer service, second, were the top two key goals and objectives companies cited for entering e-business. Customer-related functions are integral to e-business and can take many shapes.

One of the basic ways customer functions can be automated is through self-service. This can occur on a Web site, an intranet, or an extranet. Some companies, such as Dell, are focusing on their larger customers first, by providing them with a customized extranet to simplify ordering and tracking. To approach the possibilities in a firm, the firm must determine all of the interfaces it has with its customers and decide which ones are suitable for automation. These interfaces can include—

- Price and inventory inquiries
- Order placement and tracking
- Account management
- Payment through electronic billing and payment systems
- Shipping and delivery function
- Customer service

Another major point of e-business automation is the call center. A common Web site feature includes buttons that allow a user to chat in an open browser window or phone through the Internet and talk with a customer service representative. At the very least, an 800 number should be displayed on every page that could lead to a Web visitor question (which means every page). A company that offers a one-stop shopping experience for its customers is far ahead of others. This means that at one point of contact, the customer can ask a question, order something, or change their address without being forwarded to another department. An eye-opening exercise for many executives is to try to do business with their own firm and see how hard it is. The Web and e-business implementations that companies are embracing may change the customer service experience forever.

7.4 New Revenue Models

One of the biggest challenges of e-business is finding the right business model. CPAs with business savvy can bring a lot to the table in working with younger, technology-savvy yet business-inexperienced partners.

The two largest types of revenue models on the Web also have their place in brick-and-mortar companies. The first revenue model involves companies with a traditional product and service income that fits well within an e-business adaptation. Some of these companies have found that the line between products and services tends to blur these days. (For a further source on this, read the book called *Blur.*)

The other revenue model is the advertising model, which takes on a few different forms on the Internet. Some sites charge companies to display an advertisement, commonly a banner, and these are priced based on the number of viewers who see it. Others have a sponsorship model, where a flat fee is agreed upon in exchange for some advertising space. This replicates the media industry (particularly radio and TV) in the brick-and-mortar world.

7.5 Technologies to Watch

7.5.1 Extensible markup language (XML)

A new technology standard to watch is extensible markup language (XML). This technology will enable companies to share data in a predefined format so that databases across companies can be easily interpreted and converted for use. XML will accelerate data-sharing across companies while keeping development costs down. In August of 1999, the AICPA initiated a joint project with six information technology companies and the five largest accounting and professional services firms to develop an XML-based specification for the preparation and exchange of financial reports and data. The project will define such information as is contained in balance sheets and income statements so that they can be defined and shared across firms. This project will define extensible financial reporting markup language (XFRML). For further information on this project, visit http://www.xfrml.org.

7.5.2 Agents

Agents are extremely common today (for example, they are present in antivirus software) and will play a large role in Web development. Agents, also called bots, are programs that will find things for users. One of the most common examples is a shopping bot, which will compare prices of items for consumers. In the future, bots will filter data for users and perform clerical tasks such as ordering a meal or creating the shopping list. Today, they are playing a part in customer relationship management systems, training courses, and Web site customization, among other applications.

7.6 Checklist of Key E-Business Planning Considerations

Information Week devotes much of its technology coverage to the area of e-business. Its *Research Survey of E-Business 100 Companies* (12/13/99, found at www.informationweek.com) details many of the challenging planning considerations that must be addressed when researching an entry into the e-business arena. A number of those challenges can be summarized as follows.

E-Business Planning Challenges and Considerations

- ☐ Hire and train staff
- ☐ Integrate legacy or existing systems with new e-business systems
- ☐ Choose the right business model
- ☐ Change culture in the organization to make it e-business savvy
- ☐ Provide effective customer service
- ☐ Choose the right technology, outsourcing provider, and tools
- ☐ Build awareness of the brand in the marketplace
- ☐ Improve the quality of the e-business offerings
- ☐ Recruit traffic to the Web site
- ☐ Provide fulfillment and other logistics of product sales
- ☐ Plan for a 24 hours/7 days-a-week operation
- ☐ Educate business managers about e-business
- ☐ Provide for capacity planning
- ☐ Plan a response to pricing pressures
- ☐ Integrate with existing brick-and-mortar locations
- ☐ Solve channel conflict (For example, Merrill Lynch is currently trying to balance services to customers through its stockbrokers via its traditional services, and simultaneously meet the needs of self-service customers who require online research and trading. This requires a marketing strategy that looks at issues such as pricing, customer types, service levels, disintermediation, and job security.)

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SOCIAL SECURITY AND OTHER ISSUES FACING ELDERLY OR DISABLED CLIENTS

1. INTRODUCTION

As of October 2001, there were over 45 million workers receiving Social Security benefits, compared to approximately 25 million at the end of 1990 and approximately 19.5 million at the end of 1980. Senior citizens represent one of the fastest growing segments of the U.S. population. In addition, as of October 2001, there were approximately 6 million workers receiving Social Security disability benefits.[1] This chapter presents an overview of the U.S. Social Security system and certain other issues of increasing relevance to the practitioner representing elderly or disabled clients.

2. SOCIAL SECURITY

2.1 Introduction

The Social Security Act, published as Chapter 7 of Title 42 of the United States Code, governs a wide variety of programs that presently cover nine out of ten workers in the United States. The administration of the Social Security Act is the responsibility of the Social Security Administration, an independent federal agency headquartered in Baltimore, Maryland, with approximately 1,300 local offices located throughout the United States, the U.S. Virgin Islands, Puerto Rico, Guam, and American Samoa. Information regarding the Social Security Administration can be obtained by calling (800) 772-1213 or by visiting the Social Security Administration's Web site at http://www.ssa.gov.

The Social Security Act provides for programs such as old age, survivors, and disability insurance benefits (commonly referred to as OASDI or Social Security benefits), Supplemental Security Income benefits, Medicare benefits, and Medicaid benefits, each of which is discussed further below. While the future of the Social Security system remains the subject of great controversy and concern, Social Security provides the primary source of retirement and disability benefits for many Americans.

2.2 Funding

Social Security benefits are generally funded by the withholding of taxes from employees and contributions by employers pursuant to the Federal

[1]Source: Social Security Administration.

Insurance Contributions Act (FICA) and by the collection of self-employment taxes from self-employed individuals.

2.2.1 Employees

The FICA tax imposed on employees consists of the following two components:

— A tax of 6.20 percent of wages up to the "Social Security wage base" ($84,900 for 2002) which is used to fund OASDI benefits (retirement, survivor, and disability benefits)

— A tax of 1.45 percent of total wages which is used to fund Medicare hospital insurance benefits

FICA taxes are collected from the employee through withholding from the employee's paycheck. The employer also pays a tax equal to the total FICA tax collected from the employee.

Example. For an employee earning $400,000 per year, total FICA taxes will be calculated as follows:

Employee Portion:		
6.20% × $ 84,900 =	$ 5,263.80	
1.45% × $400,000 =	$ 5,800.00	
Total		$ 11,063.80
Employer Portion:		$ 11,063.80
Total:		$ 22,127.60

2.2.2 Self-employed persons

Self-employed persons having "net earnings from self employment" in excess of $400 annually are subject to self-employment tax consisting of the following two components:

— A tax of 12.4 percent on net earnings from self-employment up to the Social Security wage base ($84,900 for 2002) to fund OASDI benefits

— A tax of 2.9 percent on total net earnings from self-employment to fund Medicare hospital insurance benefits

For purposes of calculating net earnings from self-employment, an individual is entitled to a deduction equal to the product of (a) net earnings from self-employment (computed without the deduction) up to the Social Security wage base, multiplied by (b) 50 percent of the total self-employment tax rate.

Example. For an individual having net earnings from self-employment of $53,000, the self-employment tax is calculated as follows:

Net Earnings:	$53,000.00
Less: $53,000 × 7.65%	($ 4,054.50)
	$48,945.50
Times: Total Tax Rate	× 15.3%
Self-Employment Tax	$ 7,488.66

Nonfarm optional method. Self-employed taxpayers who are not engaged in farming may elect to compute net earnings from self-employment under the nonfarm optional method for any year if

— Actual earnings for the year are less than $1,600.

— Net earnings from nonfarm self-employment constitute less than two-thirds of the taxpayer's gross income from nonfarm self-employment for the year.

— The taxpayer had net earnings from self-employment of $400 or more in at least two of the three years immediately preceding the year in question.

If a taxpayer is eligible to elect the nonfarm optional method, he or she can elect to treat two-thirds of his or her gross nonfarm income (up to $1,600 per year) as his or her net earnings from self-employment for the year. The advantage of the election is that it allows taxpayers to pay into the Social Security system based on a higher earnings level (thereby potentially increasing benefits payable). A taxpayer may elect to use the nonfarm optional method no more than five times.

Example. Farley, who is otherwise eligible to elect the nonfarm optional method, has gross nonfarm self-employment income of $2,000, with net earnings of $500. Farley can elect to report self-employment earnings of $1,333 (two-thirds of $2,000) rather than $500.

Farm optional method. Taxpayers with gross self-employment earnings from farming of not more than $2,400 can elect to report as net earnings from self-employment two-thirds of gross earnings. If gross earnings exceed $2,400, the taxpayer may elect to report as net earnings from self-employment the greater of actual net earnings or $1,600. There is no limit on the number of times an eligible taxpayer may elect to use the farm optional method.

2.3 Retirement Benefits

2.3.1 Eligibility

Eligibility for Social Security retirement benefits is determined by the number of "Social Security credits" (previously called "quarters of coverage") earned by a worker from employment or self-employment subject to Social Security. The maximum number of Social Security credits that can be earned during a calendar year is four. For years prior to 1978, an individual generally earned one Social Security credit for each calendar quarter during which the individual earned $50 or more. Beginning in 1978, the amount of quarterly earning required to earn a Social Security credit has increased annually, from $250 per calendar quarter in 1978 to $870 per calendar quarter in 2002.

In order to achieve "fully insured status," which is required in order to receive Social Security retirement benefits, workers must earn the following number of Social Security credits:

A worker reaching age sixty-two in:	*Is fully insured if he or she has earned at least the following number of Social Security credits:*
1983	32
1984	33
1985	34
1986	35
1987	36
1988	37
1989	38
1990	39
1991 or later	40

Certain employees of nonprofit organizations who were at least fifty-five years old on January 1, 1984, can achieve "deemed fully insured status" with less than the number of Social Security credits set forth above.

Beginning October 1, 1999, the Social Security Administration (SSA) launched the largest customized mailing ever undertaken by a federal agency by sending out an annual Social Security Statement (formerly Personal Earnings and Benefit Estimate Statement) to 125 million workers who are ages twenty-five and older and not receiving Social Security benefits. SSA staggered the mailing of the statements for workers to automatically receive their statements about three months before their birth month.

Practice Tip. If a worker has not received a Social Security statement, the worker or an authorized representative can obtain a printout of his or

her Social Security credits, and an estimate of the worker's future Social Security retirement benefits, by completing Form SSA-7004-SM, Request for Earnings and Benefit Estimate. Copies of Form SSA-7004-SM can be obtained and submitted on the Internet at http://www.ssa.gov.

2.3.2 Amount of benefit

The amount of a worker's OASDI benefits is based on the worker's "primary insurance amount" or PIA. A worker's PIA is calculated based on average taxable earnings over the worker's career and is designed to partially replace the income lost as a result of retirement, disability, or death. The actual mechanics of the PIA calculation are quite complicated and beyond the scope of this chapter. The Social Security Administration has produced a software program, known as ANYPIA, that will perform the calculations. Copies of ANYPIA can be obtained for $47 by calling (703) 605-6000, or can be downloaded free of charge from the Social Security Administration's Web site. For 2002, the average monthly Social Security retirement benefit for an individual worker is $874. For married couples both receiving benefits, the average monthly retirement benefit is $1,454.

2.3.2.1 Annual earnings limitation

Workers under age sixty-five. An individual receiving Social Security retirement benefits who has not reached age sixty-five by the end of 2002 can receive up to $11,280 of earned income without a reduction of benefits. For each $2 of earned income above $11,280, the individual's retirement benefit will be reduced by $1.

Workers age sixty-five and over. As of January 2000, the Retirement Earnings Test has been eliminated for individuals age sixty-five to sixty-nine. A modified test applies for the year an individual reaches age sixty-five (The Senior Citizens' Freedom to Work Act of 2000, signed into law by President Clinton on April 7, 2000). An individual who has attained age sixty-five during 2002 can have earned income of up to $2,500 per month before age sixty-five without reduction of benefits. For every $3 earned above $2,500 per month, the benefits will be reduced by $1. The Act eliminates the earnings limit beginning the month an individual reaches age sixty-five.

In most cases it pays for an individual who is continuing to work beyond age sixty-five to start to collect his or her Social Security at age sixty-five, and not defer higher benefits payable at age seventy. An individual who defers benefits would have to reach age eighty-five before the total payments received equal payments that would have been received if the benefits started at age sixty-five.

Planning Tip. In 2002 if a worker who attains age 65 and delays payments until age seventy, an individual can bump up retirement credit by 6.5 percent a year, so that by waiting until age seventy to collect Social Security, the individual's maximum monthly income will increase from $1,660 to about $2,200. This should be considered for someone who is planning to continue to work until age seventy and has a younger spouse who has limited working experience. By waiting to start drawing benefits, it will give a spouse a bigger pension to live on after the death of the working spouse.

To qualify for the special monthly benefit, an individual cannot perform substantial services in self-employment before age sixty-five. Substantial services are judged based on amount of time devoted to business, type of service rendered, and how services rendered compare with those performed in the past. Work totaling more than forty-five hours in a month is generally considered substantial. Work of fewer than fifteen hours in a month is not considered substantial. Consulting services of fifteen hours or more per month performed by the former owner of a business are generally treated as substantial services.

What counts as earnings. For purposes of the limitations on earned income discussed above, the following amounts are treated as earnings:

— Gross wages earned by an employee during the year (regardless of when received by the employee)

— Net earnings from self-employment received during the year (regardless of when they are earned)

— Cash tips of $20 or more per month

— Director's fees

For purposes of the limitations on earned income discussed above, the following amounts are generally *not* treated as earnings:

— Passive income (such as interest, dividends, and rent from real estate activities in which a nondealer did not materially participate)

— Gain from the sale of capital assets

— Retirement income (such as payments from an IRA, pension plan, and certain trusts and annuity plans that are exempt from tax)

— Retirement payments received by retired partners from a partnership if:

  • The retirement payments are to continue for life under a written agreement that provides for payments to all partners (or to a class or classes of partners)

- The partner's share of capital was paid in full before the end of the partnership's taxable year and there is no obligation from the partnership to the partner except to make retirement payments

— Social Security benefits

— Sick pay received more than six months after the last month in which the worker performed services

— Workers' compensation and other unemployment compensation benefits

2.3.2.2 Early or delayed retirement

Full retirement age. The amount of a worker's Social Security retirement benefit depends on whether the worker retired before, at, or after the worker's "full retirement age" as listed on the following chart:

For a worker born in:	*Full retirement age is:*
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943 through 1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Early retirement. A worker who has achieved fully insured status can elect to begin receiving reduced Social Security retirement benefits for the first month following the month of his or her sixty-second birthday. If a worker elects to receive early retirement benefits, the retirement benefit payable to the worker is permanently reduced by a percentage that is determined based on the number of months between the month in which the worker first elects to receive early retirement benefits and the month in which the worker will attain full retirement age. The number of intervening months is then divided by 180 (up to a maximum of 36 intervening months). Any intervening months in excess of 36 are then divided by 240.

The following chart details the amount of benefits received by taking early retirement.

For a worker born in:	*Worker will turn 62 in:*	*The percentage of benefits worker receives if worker takes early retirement (%)*
1937 and before	1999 and before	80
1938	2000	$79\frac{1}{6}$
1939	2001	$78\frac{1}{3}$
1940	2002	$77\frac{1}{2}$
1941	2003	$76\frac{2}{3}$
1942	2004	$75\frac{5}{6}$
1943–54	2005–16	75
1955	2017	$74\frac{1}{6}$
1956	2018	$73\frac{1}{3}$
1957	2019	$72\frac{1}{2}$
1958	2020	$71\frac{2}{3}$
1959	2021	$70\frac{5}{6}$
1960 and later	2022 and later	70

Example. Adams, a worker born in 1962, plans to begin receiving retirement benefits for the first full month following his sixty-second birthday. Adams' full retirement age is sixty-seven. Accordingly, there are sixty months between the month of his first payment and the month in which he will attain full retirement age. Thus, Adams' retirement benefits will be permanently reduced by 30 percent, calculated as follows: 36 months divided by 180 (20 percent), plus 24 months divided by 240 (10 percent).

Delayed retirement. A worker electing to delay receipt of Social Security retirement benefits beyond full retirement age is entitled to a "delayed retirement credit" which permanently increases the retirement benefit payable to the worker. The delayed retirement credit is earned for each month during which a fully insured worker has attained full retirement age, but has not yet attained age seventy, and elects not to receive Social Security retirement benefits. The amount of the delayed retirement credit that can be earned by a worker is set forth on the following chart and depends on the year in which the worker attains age sixty-five.

If a worker attains age 65:	*The monthly delayed retirement credit is:*
Prior to 1982	1/12 of 1%
1982 to 1989	1/4 of 1%
1990 to 1991	7/24 of 1%
1992 to 1993	1/3 of 1%
1994 to 1995	3/8 of 1%
1996 to 1997	5/12 of 1%
1998 to 1999	11/24 of 1%
2000 to 2001	1/2 of 1%
2002 to 2003	13/24 of 1%
2004 to 2005	7/12 of 1%
2006 to 2007	5/8 of 1%
2008 or later	2/3 of 1%

Example. Baker, a worker who attained age 65 in 1991, elects not to receive retirement benefits until the month in which he attains age seventy. Baker's full retirement age is sixty-five. Baker's retirement benefit will be permanently increased by 17.5 percent, calculated as follows: 60 months multiplied by 7/24 of 1 percent (.0029).

Planning considerations. The decision of whether to take reduced early retirement benefits, normal retirement benefits, or the delayed retirement benefit will depend on a number of factors, the most important being whether the benefit will be reduced or eliminated because of the annual earnings limitations described above. Another important consideration is that a worker electing to receive early retirement benefits will receive benefits for a longer period of time than a worker who waits until full retirement age or beyond. As a general rule of thumb, it will be twelve to fifteen years after full retirement age before the aggregate increased benefit payable at full retirement age exceeds the aggregate benefit payable at the reduced early retirement rate.

(Text continued on page 11)

Example. Carter is entitled to receive retirement benefits of $600 per month beginning at his full retirement age of sixty-five. Carter can elect to receive reduced retirement benefits of $480 per month (80 percent of $600) beginning at age sixty-two. If Carter elects to receive full retirement benefits, then by age seventy-seven he will have received total benefits of $86,400 (144 months times $600 per month). If Carter elects to receive reduced early retirement benefits, then by age seventy-seven he will have received the same amount of total benefits (180 months times $480 per month).

2.3.2.3 Maximum family benefit

The maximum retirement benefit payable to a retired worker and his or her family is computed based on the worker's PIA. For 1998, the maximum family benefit is equal to:

- 150 percent of the first $609 of the worker's PIA, plus
- 272 percent of PIA over $609 up to $880, plus
- 134 percent of PIA over $880 up to $1,147, plus
- 175 percent of PIA over $1,147.

2.3.3 Dependent coverage

The spouse, former spouse, and children of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker.

2.3.3.1 Spouse

The spouse of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker in the following circumstances:

— The worker has achieved fully insured status.

— The spouse has filed an application for spouse's benefits.

— The spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA.

— The spouse is either (a) age sixty-two or over; or (b) caring for a child under age sixteen or a disabled child who is entitled to benefits based on the worker's earnings history.

— The spouse meets one of the following requirements:

  - The spouse has been married to the worker for at least one year at the time of the application for benefits.
  - The spouse is the natural parent of a natural child of the worker.
  - The spouse was entitled or potentially entitled to certain benefits under the Social Security Act or the Railroad Retirement Act.

The retirement benefit payable to an eligible spouse is generally one-half of the worker's PIA, subject to the limitation on annual earnings of the worker and the limitation on maximum family benefits discussed. In addition, if the worker has elected to take reduced early retirement benefits, the spouse's benefit will be reduced in a similar (but not identical) fashion.

2.3.3.2 Former spouse

The former spouse of a worker may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

— Either (a) the worker has achieved fully insured status, or (b) the former spouse has achieved fully insured status and has been divorced from the worker for at least two continuous years

— The former spouse has filed a claim for former spouse's benefits

— The former spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA

— The former spouse is age sixty-two or over

— The former spouse is not married

— The former spouse had been married to the worker for at least ten years prior to the date of divorce

2.3.3.3 Child

A natural or adopted child of a worker (and, in some cases, a grandchild or stepgrandchild of a worker) may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

— The worker has achieved fully insured status

— The child is dependent upon the worker

— An application for child's insurance benefits is filed

— The child is unmarried

— The child is either (a) under age eighteen; (b) age eighteen to nineteen and a full-time elementary or secondary school student; or (c) age eighteen or over and disabled.

2.3.4 Taxation of retirement benefits

The taxation of Social Security retirement benefits (and Tier 1 Railroad Retirement Benefits) is governed by Section 86 of the Internal Revenue Code.

50 percent inclusion. Section 86 generally provides that a worker is taxable on the lesser of:

— One-half of the retirement benefits received during the year

— One-half of the excess of (a) the worker's "provisional income" for the year over (b) the "base amount"

A worker's "provisional income" is equal to the sum of:

— The worker's adjusted gross income for the year; plus

— Any tax-exempt interest earned by worker during the year; plus

— Any amounts earned by the worker during the year in a foreign country, U.S. possession, or Puerto Rico that are excluded from gross income; plus

— One-half of the worker's Social Security benefits for the year.

For 2002, the base amount is:

— $32,000 for a married worker filing jointly.

— $0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.

— $25,000 for any other worker.

> *Example:* Davis is an unmarried worker receiving annual Social Security retirement benefits of $10,000. Davis has adjusted gross income for the year of $21,000 and receives $4,000 of tax-exempt interest during the year. Davis' provisional income for the year is $30,000 ($21,000 + $4,000 + 1/2 of $10,000). Accordingly, Davis is taxable on the lesser of (a) $5,000 (1/2 of his retirement benefits) or (b) $2,500 (1/2 of the excess of $30,000 provisional income over $25,000 base amount).

85 percent inclusion. Workers with provisional income in excess of the "adjusted base amount" are subject to inclusion of up to 85 percent of Social Security retirement benefits. For 2002, the adjusted base amount is:

— $44,000 for a married worker filing jointly.

— $0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.

— $34,000 for any other worker.

For those workers, the amount of Social Security retirement benefits includable in gross income is equal to the lesser of:

— 85 percent of the retirement benefits received during the year

— The sum of:

- 85 percent of the excess of provisional income over the adjusted base amount; plus
- The lesser of (x) the amount that would be taxable under the 50 percent inclusion test, or (y) one-half of the difference between the adjusted base amount and the base amount (currently $6,000 for married workers filing jointly, $4,500 for unmarried workers).

Example: Evans is an unmarried worker receiving Social Security retirement benefits of $12,000 for the year. She has adjusted gross income of $40,000 for the year and receives $5,000 of tax-exempt interest for the year. Because Evans has provisional income in excess of $34,000, she is subject to the 85 percent inclusion provisions. Nonetheless, the first step in calculating the portion of Evans' retirement benefits that are subject to tax is to calculate the result under the 50 percent inclusion provisions as follows:

Provisional income	$51,000
Less base amount	(25,000)
Excess provisional income	$26,000
Divided by 2	$13,000
1/2 of retirement benefits	$ 6,000

Thus, under the 50 percent inclusion provisions, Evans is subject to tax on $6,000 of retirement benefits. Under the 85 percent inclusion provisions, Evans is subject to tax on the lesser of (a) $10,200 (85 percent of retirement benefits) or (b) $18,950 (the sum of (x) $14,450 [85 percent of the excess of $51,000 provisional income over $34,000 adjusted base amount] plus (y) the lesser of (i) $6,000 [as determined above under the 50 percent inclusion rules] or (ii) $4,500). Thus, Evans is taxable on $10,200 of retirement benefits.

2.3.5 Applying for retirement benefits

In order to receive Social Security retirement benefits before full retirement age, a worker must file an application with the Social Security Administration. The application, which should be filed by the last day of the first month for which the worker desires to receive benefits, can generally be completed over the telephone by calling a local Social Security office. A worker who chooses not to apply for retirement benefits prior to reaching full retirement age should contact the Social Security Administration two to three months prior to reaching full retirement age, even if he or she is not planning to retire.

2.4 Survivor's Benefits

In addition to the retirement benefit discussed above, Social Security benefits may also be payable to a spouse, former spouse, child, or parent of a deceased worker in the circumstances described below.

2.4.1 Lump-sum death benefit

Upon the death of a worker who is fully insured or "currently insured," a lump-sum payment of $255 is payable to a surviving spouse of the worker who was living in the same household as the worker at the time of the worker's death or was eligible for or entitled to survivor's benefits (as discussed below) based on the worker's earnings history at the time of the worker's death. If there is no eligible surviving spouse of the worker, the lump-sum death benefit is payable to children of the worker who are eligible for or entitled to survivors' benefits based on the worker's earnings history at the time of his or her death. The lump-sum death benefit is payable in addition to any other survivor's benefits that may be payable to the recipient. A surviving spouse or child generally must apply to receive the lump-sum death benefit within two years after the worker's death.

For purposes of the Social Security Act, a worker is "currently insured" if he or she has earned at least six Social Security credits during the full thirteen-quarter period ending with the calendar quarter in which the worker:

— Died.

— Most recently became entitled to Social Security disability benefits.

— Became entitled to Social Security retirement benefits.

2.4.2 Surviving spouse

A surviving spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The spouse is age sixty or over (or age fifty or over and disabled).

— The worker was fully insured at the time of death.

— The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the worker's PIA.

— The spouse has filed a claim for survivor's benefits.

— The spouse is not married (waived if the marriage occurs after the spouse is age sixty [or after age fifty if disabled]).

— One of the following conditions (the "survivors conditions") is satisfied:

- The spouse was married to the worker for at least nine months prior to the worker's death.
- The spouse is the biological parent of a child of the worker.
- The spouse legally adopted a child of the worker during the marriage and before the child reached age eighteen.
- The spouse was married to the worker at the time they both adopted a child under age eighteen.
- The worker legally adopted a child of the spouse during the marriage and before the child reached age eighteen.
- The spouse was potentially entitled to Social Security benefits during the month before the spouse married the worker.

The amount of a surviving spouse's benefit is 100 percent of the worker's PIA subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings. In addition, if a surviving spouse elects to receive spouse's benefits prior to full retirement age, the amount of the benefit is permanently reduced by a certain percentage for each month that benefits are payable prior to full retirement age.

If a surviving spouse does not qualify for a survivor's benefit based on the worker's earnings history, the spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

— The spouse is caring for a child of the deceased worker who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.

— The worker was fully insured or currently insured at the time of death.

— The spouse has filed an application for mother's or father's benefits.

— The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.

— The spouse is not married.

— One of the "survivors conditions" described above is satisfied.

The amount of the father's or mother's benefit is equal to 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings.

2.4.3 Surviving divorced spouse

A surviving divorced spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The former spouse is age sixty or over (or age fifty or older and disabled).

— The worker was fully insured at the time of death.

— The former spouse is not married at the time of the worker's death (waived in the case of certain accidental deaths or if remarriage occurs after age sixty [age fifty if disabled]).

— The former spouse is not entitled to a Social Security retirement benefit that is equal to or greater than the worker's PIA.

— The former spouse filed a claim for survivor's benefits.

— The former spouse was married to the worker for at least ten years at the time the divorce became final.

The amount of the former spouse's benefit is calculated in the same manner described above for a surviving spouse.

If a surviving divorced spouse does not qualify for a former spouse's benefit based on the worker's earnings history, the former spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

— The former spouse is caring for a child of the deceased worker who is the natural or legally adopted child of the former spouse and who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.

— The worker was fully insured or currently insured at the time of death.

— The former spouse has filed an application for mother's or father's benefits.

— The former spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.

— The former spouse is not married.

— One of the "survivors conditions" described above is satisfied.

The mother's or father's benefit payable to a surviving former spouse is calculated in the same manner described above for a surviving spouse who is entitled to mother's or father's benefits.

2.4.4 Surviving child

A surviving child of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The worker was fully insured or currently insured at the time of death.

— The child was dependent on the deceased worker.

— The child is not married.

— A claim for child's insurance benefit is filed on behalf of the child.

— One of the following conditions is satisfied:

- The child is under age eighteen.
- The child is under age nineteen and a full-time elementary or secondary school student.
- The child is age eighteen or older and under a disability that began before age twenty-two.

The amount of the child's benefit is 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation.

2.4.5 Surviving parent

A surviving parent of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

— The worker was fully insured at the time of death.

— The parent files an application for parent's benefits.

— The parent has reached age sixty-two.

— The parent is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the parent's insurance benefit payable.

— The parent was receiving at least one-half support from the worker (evidence of such support must be filed with the Social Security Administration within a specified time period).

— The parent has not remarried following the worker's death.

— One of the following conditions is met:

- The parent is the natural parent of the worker.
- The parent had legally adopted the worker before the worker reached age sixteen.
- The parent became the worker's stepparent by a marriage ended before the worker reached age sixteen.

The amount of the parent's benefit is 82½ percent of the worker's PIA if only one parent is entitled to parent's benefits. If more than one parent is entitled to parent's benefits, the amount is 75 percent of the worker's PIA for each parent. In each case, the amount of the parent's

benefit is subject to reduction or elimination by the maximum family benefit limitation or the limitations on excess earnings.

2.5 Disability Benefits

2.5.1 Eligibility

Disabled worker. A worker who is "disabled" within the meaning of the Social Security Act (as discussed below) may be entitled to Social Security disability benefits if the worker has achieved "disability insured status." To achieve that status, a worker must satisfy each of the following conditions:

— The worker has earned at least twenty Social Security credits during the forty-quarter period that ends with the quarter in which the worker is determined to be disabled.

— The worker has earned at least one Social Security credit for each calendar year after 1950 (or, if later, after the year in which the worker attained age twenty-one).

In addition to achieving disability insured status, a disabled worker must file an application for disabled worker's benefits and complete a waiting period of five consecutive full calendar months before receiving disability benefits. The five-month waiting period is waived for certain worker's who had been entitled to disabled worker's benefits within the previous five years.

Disabled child or surviving spouse. Under certain circumstances, a disabled child of a worker may be entitled to Social Security disability benefits if the child became disabled before age twenty-two. In addition, a disabled surviving spouse or surviving former spouse of a worker may be entitled to disability benefits.

Nondisabled dependents. Social Security benefits may be available to nondisabled dependents of a disabled worker (a) if an unmarried child of a disabled worker is under age eighteen; or (b) if a spouse of disabled worker is caring for a child of the disabled worker who is under age sixteen (or disabled) and is receiving benefits based on the worker's earnings history.

2.5.2 Disability benefits

The Social Security disability benefit is generally equal to the full amount of the worker's PIA. The benefit may be reduced, however, in any of the following circumstances:

— The sum of the Social Security disability benefit plus any worker's compensation benefits or other disability benefits payable to the

worker under a federal, state, or local public law program exceeds 80 percent of the worker's "average current earnings."

— The worker becomes disabled after electing to receive reduced Social Security retirement benefits.

— The benefit is limited by the maximum family benefit limitation.

Social Security disability benefits generally continue until the earliest of:

— The second month after the disability ceases.

— The month before the month in which the recipient attains age sixty-five (after which the benefits are converted into Social Security Retirement benefits).

— The month before the month in which the recipient dies.

2.5.3 Definition of disability

For purposes of the Social Security Act, a disability is defined as "the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."

Substantial gainful activity. Substantial gainful activity must involve the performance of physical or mental activities that are productive in nature and that are performed for remuneration or profit. A special definition of substantial gainful activity applies to individuals disabled by blindness. The determination of whether an individual has engaged in substantial gainful activity is generally made by reference to the amount of earnings received from the performance of the activity. As a rule of thumb, earnings of $780 or more per month from an activity generally demonstrate that the activity is substantial and gainful. Earnings of less than $300 per month from an activity demonstrate that the activity is not substantial and gainful.

Physical or mental impairment. The regulations issued under the Social Security Act contain a "Listing of Impairments" that identifies physical or mental conditions that, absent evidence to the contrary (such as excess earnings), generally establish that an individual is unable to engage in substantial gainful activity. Examples of such conditions include:

— Diseases of the heart, lung, or blood vessels that have resulted in serious loss of heart or lung reserves as shown by X-ray, electrocardiogram, or other tests and, in spite of medical treatment, there is breathlessness, pain, or fatigue.

— Severe arthritis that causes recurrent inflammation, pain, swelling, and deformity in major joints so that the ability to get about or use the hands is severely limited.

— Mental illness resulting in marked constriction of activities and interests, deterioration in personal habits or work-related situations, and seriously impaired ability to get along with other people.

— Damage to the brain or brain abnormality that has resulted in severe loss of judgment, intellect, orientation, or memory.

— Cancer that is progressive and has not been controlled or cured.

— Diseases of the digestive system that result in severe malnutrition, weakness, and anemia.

— Acquired immunodeficiency syndrome (AIDS).

— Progressive diseases that have resulted in the loss of a leg or have caused it to become useless.

— Loss of major function of both arms, both legs, or a leg and an arm.

— Serious loss of function of the kidneys.

— Total inability to speak.

Trial work period. An individual receiving Social Security disability benefits who continues to be disabled is entitled to a trial work period of nine months (which need not be consecutive). During that period, any work and earnings are disregarded for purposes of determining whether the individual continues to be disabled. Any month during which the individual performs "insignificant work" does not count as part of the nine-month trial work period. For these purposes, an individual is considered to have performed insignificant work for any month in which (a) the individual's earnings from employment are $200 or less, or (b) the individual's earnings from self-employment are $200 or less and the individual spends forty hours or less in the performance of self-employment.

Determination of disability. The determination of whether a person is disabled for purposes of the Social Security Act is made by the Disability Determination Services (DDS) office in the person's home state. The DDS employs physicians and other specialists to evaluate the person's condition. If the DDS determines that a person is not disabled, the person can appeal the decision in writing to any Social Security office within sixty days after receipt of notice from the DDS.

If the DDS determines that a person is disabled, the DDS will review the person's condition periodically to determine whether the disability has ceased. Reviews are generally scheduled as follows:

— If improvement is expected: first review scheduled six to eighteen months after initial disability determination

— If improvement is possible: once every three years

— If improvement is not expected: once every five to seven years

If, following a review, the DDS determines that a person is no longer disabled, disability benefits will cease after the second month following the month in which the disability terminated. If the person disagrees with the determination, he or she can file an appeal in writing with any Social Security office within sixty days after the determination. If the person appeals within ten days after the determination, disability benefits will continue during the appeal. If the appeal is denied, the person may be required to return payments received during the appeal period.

3. SUPPLEMENTAL SECURITY INCOME

3.1 Introduction

In addition to the other benefits described in this chapter, the Social Security Act provides for Supplemental Security Income (SSI) for individuals with limited income and resources who are age sixty-five or older, blind, or disabled. Unlike OASDI benefits, which are financed through FICA and self-employment taxes, SSI is funded from general funds of the U.S. Treasury. SSI benefits are available to elderly, blind, or disabled individuals having "resources" (as discussed below) of $2,000 or less ($3,000 or less for married couples) and having monthly income that is less than the maximum federal monthly SSI benefit payable. The amount of SSI benefits payable to an eligible recipient depends on the income and living arrangements of the recipient. For 2002, the maximum monthly federal SSI benefit is $545 for an individual without an eligible spouse and $817 for an eligible married couple. In addition, some states supplement federal SSI benefits payable to state residents.

3.2 Resources

For purposes of SSI, resources generally include cash and other liquid assets and any other property that an individual or the individual's spouse could convert to cash to obtain support and maintenance. The following items, however, are not counted as resources:

— An individual's principal place of residence (regardless of value)

— One wedding ring and one engagement ring (regardless of value)

— Items needed because of a person's physical condition (such as a wheelchair or prosthetic devices)

— Other household goods having an aggregate value of less than $2,000

— One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed $4,500

— Certain life insurance

— Burial spaces and certain burial funds of up to $1,500

3.3 Income

For SSI purposes, monthly income generally includes all earned or unearned income, and the value of property or services, actually or constructively received by an individual during the month. The following items, however, are generally not treated as income:

— Medical care and services

— Social services

— Gain from the sale, exchange, or replacement of a resource

— Income tax refunds

— Loan proceeds

Even if an item is treated as income for SSI purposes, there are numerous exclusions for items of income that are not counted for purposes of SSI monthly income limitation (including most payments under federal assistance programs).

3.4 Reporting Requirements

Persons receiving SSI benefits are responsible for reporting changes that could affect the amount of their benefits. Reports can be made by phone, by mail, or in person and must be made by within ten days after the end of the month in which the change occurred. Fines of up to $100 are imposed for failing to report changes timely. In addition, criminal penalties (including imprisonment) can be imposed on a person who intentionally makes false statements on an SSI report.

An individual must file a report if he or she:

— Moves or changes address.
— Has a change in his or her household.
— Has a change in income.
— Has a change in resources.
— Receives help with living expenses.
— Leaves the United States.
— Marries or ends a marriage.
— Has a change in citizenship or alien status.
— Improves in condition while receiving benefits based on disability or blindness.
— Starts or stops attending school.
— Violates a condition of parole.
— Becomes eligible for any other benefits.

In addition, many states impose additional SSI reporting requirements.

4. MEDICARE

4.1 Introduction

Medicare is a federal health insurance program for people sixty-five or older, people of any age with permanent kidney failure, or people with certain other disabilities. Medicare is administered by the Health Care Financing Administration (HCFA) and covers eligible recipients receiving medical or hospital care anywhere in the United States (including the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Samoa). Medicare is divided into two parts: hospital insurance (Part A) and medical insurance (Part B). Hospital insurance helps pay for inpatient hospital care and certain outpatient follow-up care and is financed by the hospital insurance portion of the FICA and self-employment tax. Medical insurance helps pay for doctors' services and other medical services and is financed by the monthly premiums paid by people enrolled in the program (see section 4.3.1, below) and by general federal revenues.

4.2 Medicare Hospital Insurance (Part A)

4.2.1 Eligibility

To be eligible for Medicare hospital insurance coverage, people age sixty-five or older must meet at least one of the following criteria:

— They are entitled to monthly Social Security or railroad retirement benefits.

— They have worked long enough to be insured under Social Security or the railroad retirement system.

— They have worked long enough in federal employment (see the table at the end of this section) to be insured for Medicare purposes.

People are entitled to coverage before sixty-five if they meet one of the following conditions:

— They have been entitled to Social Security disability benefits for twenty-four months.

— They have worked long enough in federal employment and meet the requirements of the Social Security disability program.

People are eligible at any age if they need maintenance dialysis or a kidney transplant for permanent kidney failure and:

— Are insured or getting monthly benefits under Social Security or the railroad retirement system.

— Have worked long enough in federal employment.

Spouses and children of workers may also be eligible for maintenance dialysis or kidney transplant. Under certain conditions spouses, divorced spouses, widows, widowers, or dependent parents of a worker may be eligible for hospital insurance at age sixty-five based on the worker's earnings history. This may also apply to disabled widows or widowers under sixty-five, disabled surviving divorced spouses under sixty-five, and disabled children eighteen or older.

WORK CREDITS NEEDED FOR FEDERAL EMPLOYEES

If you reach age 65 in	*Years you need*
1983	7 1/4
1984	7 1/2
1986	8
1990	9
1994 or later	10

People receiving Social Security or railroad retirement checks do not have to apply for hospital insurance; it will begin automatically at age sixty-five (except for federal employees, who should apply three months before their sixty-fifth birthday). People who plan to keep working after

age sixty-five should also file an application three months prior to turning sixty-five. Those not eligible for coverage at sixty-five because they do not have enough work credits or are not receiving benefits can purchase hospital insurance for a monthly premium of $319 for workers with less than thirty Social Security credits; $175 per month for workers with thirty to thirty-nine Social Security credits in 2002 (provided that they also purchase medical insurance). People with permanent kidney failure should apply for Medicare as soon as the condition appears. There is a twenty-four-month waiting period for disabled workers under sixty-five and a two-month waiting period for people receiving maintenance dialysis treatment.

4.2.2 Coverage

Hospital coverage provides benefits for inpatient care, skilled-nursing-facility care, home health care, and hospice care. If a person needs inpatient hospital care, Medicare hospital insurance covers the first ninety days of a hospital stay and includes sixty additional lifetime reserve days that can be used at the discretion of the patient. Coverage includes:

— Semiprivate room and board.

— General nursing service.

— Lab tests, X-rays, other radiology services, and radiation therapy.

— Drugs furnished by the hospital.

— Medical supplies.

— Rehabilitation services.

— Cost of special-care units.

For patients requiring home health services, Medicare coverage includes:

— Part-time skilled nursing care.

— Physical and speech therapy.

— Medical supplies and services provided by an agency.

— Occupational therapy.

Skilled nursing facility care and hospice care are also available to patients whose conditions require these services.

The following chart summarizes the hospital insurance-covered services, and the patient's financial obligations for 2002.

MEDICARE (PART A): HOSPITAL INSURANCE-COVERED SERVICES

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
HOSPITALIZATION Semiprivate room and board, general nursing, and miscellaneous hospital services and supplies. (Medicare payments based on benefit periods.)	First 60 days	All but $812	$812
	61st to 90th day	All but $203 a day	$203 a day
	91st to 150th day*	All but $406 a day	$406 a day
	Beyond 150 days	Nothing	All costs
SKILLED NURSING FACILITY CARE Patient must have been in a hospital for at least 3 days and must enter a Medicare-approved facility generally within 30 days after hospital discharge.† (Medicare payments based on benefit periods.)	First 20 days	100% of apprvd. amt.	Nothing
	Additional 80 days	All but $101.50 a day	$101.50 a day
	Beyond 100 days	Nothing	All costs
HOME HEALTH CARE Medically necessary skilled care.	Part-time or intermittent care for as long as patient meets Medicare conditions.	100% of approved amount; 80% of approved amount for durable medical equipment.	Nothing for services; 20% of approved amount for durable medical equipment.
HOSPICE CARE Pain relief, symptom management, and support services for the terminally ill.	As long as doctor certifies need.	All but limited costs for out-patient drugs and inpatient respite care.	Limited cost sharing for outpatient drugs and inpatient respite care.
BLOOD	Unlimited if medically necessary.	All but first 3 pints per calendar year.	For first 3 pints.‡

* This 60-reserve-days benefit may be used only once in a lifetime.
† Neither Medicare nor private Medigap insurance will pay for most nursing home care.
‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U.S. Department of Health and Human Services, Social Security Administration.

4.3 Medicare Medical Insurance (Part B)

4.3.1 Eligibility

People eligible for hospital insurance will automatically be enrolled for medical insurance unless they specifically refuse it at the time they

become eligible for hospital insurance. The monthly premium for 2002 is $54.00 (for 2001, it was $50.00). People who must apply for medical insurance include:

— People planning to work past age sixty-five.

— People age sixty-five who are not eligible for hospital insurance.

— People with permanent kidney failure.

— People eligible for Medicare on the basis of federal employment.

Planning Tip. Low income individuals may be eligible for the Qualified Medicare Beneficiary Program which pays for all out-of-pocket expenses (premiums, deductibles, copayments) for which the individual would otherwise be responsible.

4.3.2 Coverage

Medical insurance coverage provides for doctors' services and outpatient care and includes:

— Medical and surgical treatment.

— Services of a doctor's nurse.

— Drugs and biologicals that cannot be self-administered.

— Medical supplies and equipment (does not include basic first-aid equipment).

— Medically required ambulance services.

— Blood transfusions provided on an outpatient basis.

The following chart summarizes medical insurance-covered services, and the patient's financial obligations, for 2002.

MEDICARE (PART B): MEDICAL INSURANCE-COVERED SERVICES

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
MEDICAL EXPENSES Doctors' services, inpatient and outpatient medical and surgical services and supplies, physical and speech therapy, ambulance, diagnostic tests, and more.	Medicare pays for medical services in or out of the hospital.	80% of approved amount (after $100 deductible).	$100 deductible,* plus 20% of approved amount and limited charges above approved amount.†
CLINICAL LABORATORY SERVICES Blood tests, biopsies, urinalyses, and more.	Unlimited if medically necessary.	100% of approved amount.	Nothing for services.

Services	*Benefit*	*Medicare Pays*	*Patient Pays*
HOME HEALTH CARE Medically necessary skilled care.	Part-time or intermittent skilled care for as long as patient meets conditions for benefits.	100% of approved amount; 80% of approved amount for durable medical equipment.	Nothing for services; 20% of approved amount for durable medical equipment.
OUTPATIENT HOSPITAL TREATMENT Services for the diagnosis or treatment of illness or injury.	Unlimited if medically necessary.	80% of approved amount (after $100 deductible).	$100 deductible, plus 20% of billed charges.
BLOOD	Unlimited if medically necessary.	80% of approved amount (after $100 deductible and starting with 4th pint).	First 3 pints plus 20% of approved amount for additional pints (after $100 deductible).‡

* Once patient has had $100 of expenses for covered services, the Part B deductible does not apply to any covered services patient receives for the rest of the year.

† Physicians who do not accept assignment of Medicare claims are limited by law as to the amount they can charge a Medicare beneficiary for covered services. The charge cannot be more than 120% of the Medicare fee schedule amount for physicians who do not participate in Medicare.

‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U. S. Department of Health and Human Services, Social Security Administration.

4.4 What Medicare Does Not Cover

Services and supplies not covered by either hospital insurance or medical insurance include:

— Custodial care such as help with bathing, eating, and taking medicine.

— Dentures and routine dental care.

— Eyeglasses, hearing aids, and examinations to prescribe or fit them.

— Personal-comfort items such as a phone or TV in a hospital room.

— Prescription drugs and patent medicines.

— Routine physical checkups and related tests.

4.5 Filing a Medicare Appeal

Decisions on the amount Medicare will pay on a claim, or on whether services received are covered by Medicare, may be appealed.

The notices sent from Medicare telling of the decision made on a claim will also tell exactly what appeal steps can be taken. Claimants have at least 60 days from the date they receive the notice in which to file their appeals. For more information about appeal rights claimants should call any Social Security office, the Medicare intermediary or carrier, or the peer review organization (PRO) in their states. The following is a brief summary of the different Medicare appeals processes.

4.5.1 Appealing decisions by peer review organizations

Peer review organizations are groups of doctors in each state who are paid by the federal government to help Medicare decide when hospital care is necessary and whether such care meets standards of quality accepted by the medical profession. Medicare-participating hospitals can provide a brochure, "An Important Message From Medicare," which describes a hospital patient's appeal rights and supplies the name, address, and phone number of the PRO in that state.

If claimants disagree with the decision of a PRO, they can appeal by requesting a reconsideration. Then, if they disagree with the PRO's reconsideration decision and the amount in question is $200 or more, claimants can request a hearing by an Administrative Law Judge.

Cases involving $2,000 or more can eventually be appealed to a Federal Court.

4.5.2 Appealing all other hospital insurance (Part A) decisions

Appeals of decisions on all other services covered under Medicare hospital insurance (skilled-nursing-facility care, home health care, and hospice services) are handled by Medicare intermediaries. If claimants disagree with the intermediary's initial decision, they may request a reconsideration. The request can be submitted directly to the intermediary or through the claimant's Social Security office. If there is further disagreement with the intermediary's reconsideration decision and the amount in question is $100 or more, the claimant can request a hearing by an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

4.5.3 Appealing decisions on medical insurance (Part B) claims

Under Medicare medical insurance, either the claimants, their doctors or their suppliers submit the claim for payment. Medicare will send the claimant an explanation of the decision of the claim on a form called

"An Explanation of Medicare Benefits" (EOMB). The EOMB also explains how the claimant can appeal denials or payment decisions with which he or she disagrees, and gives the name, address, and statewide toll-free number of the carrier (the names and addresses of the carriers and areas they serve are also listed in the back of *Your Medicare Handbook*).

If a claimant disagrees with the decision on the claim, he or she can ask the carrier to review it. Claimants have up to six months from the date on the EOMB to request the review and the request must be sent to the carrier in writing.

If there is further disagreement with the carrier's written explanation of its review decision and the amount in question is $100 or more, the claimant can request a hearing by the carrier. (Other claims that have been reviewed within the previous six months can be counted towards the $100 amount.)

If there is disagreement with the carrier hearing decision and the amount in question is $500 or more, claimants are entitled to a hearing before an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

4.5.4 Appealing decisions by health maintenance organizations and competitive medical plans

If the claimant is a member of a Medicare-certified health maintenance organization (HMO) or competitive medical plan (CMP), the same appeal rights that all other Medicare beneficiaries have apply. However, the initial steps of the grievance or appeals procedure may vary from plan to plan. Federal law requires Medicare-certified HMOs and CMPs to provide a full, written explanation of appeal rights to all members at the time of enrollment. If claimants are members of such a plan and have not received a written explanation of appeal rights, they should request one from their plan's membership office or write to: Health Care Financing Administration, Office of Prepaid Health Care, Humphrey Bldg., 200 Independence Ave., S.W., Washington, D.C. 20201.

4.6 Supplemental Health Insurance

Insurance companies offer supplemental (or MediGap) policies designed to provide coverage for amounts in excess of the amounts covered by Medicare and for services that are excluded from Medicare coverage. By law, Medicare supplemental insurance policies must follow a uniform format and must provide certain minimum coverage. You can obtain more information about Medicare supplemental insurance policies from the state insurance commissioner's office of the relevant

state. In addition, many employers offer group health insurance for retired workers that supplements the coverage provided by Medicare.

Medicare beneficiaries can assign their Medicare benefits to an HMO or a managed care organization (MCO). HMOs and MCOs are required by law to provide all Medicare benefits. Many HMOs and MCOs also offer additional benefits, such as prescription drug coverage, to encourage enrollment. Beneficiaries who choose to assign their Medicare benefits to an HMO or MCO are, however, generally required to obtain health care services from "participating" doctors and hospitals.

4.7 Medicare + Choice MSA Plan

Effective for taxable years beginning after December 31, 1998, the Balanced Budget Act of 1997 provides that individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a new type of plan called Medicare + Choice MSA (medical savings accounts). See the Insurance chapter, herein, for a detailed discussion of using medical savings accounts.

If the individual chooses the Medicare + Choice MSA plan, the Secretary of Health and Human Services (not the individual) makes specified contributions directly into the Medicare + Choice MSA, and the individual is not eligible for regular Medicare.

Under a Medicare + Choice MSA plan, the individual must have a high-deductible medical insurance policy (no more than $6,000 in 1999). Medicare will not pay for any medical expenses. The individual's medical expenses will be paid out of the Medicare + Choice MSA funds, plus any amount the high-deductible insurance plan pays.

5. MEDICAID

5.1 Introduction

The Medicaid program, first established by Congress in 1965, is a federal program operated at the state level to provide medical assistance to families with aged, blind, or disabled members who cannot afford necessary medical services. The federal Health Care Financing Administration (HCFA) is responsible for the administration of the Medicaid program, but has delegated that authority to the departments of health (or equivalent agency) of the individual states. The individual states set eligibility requirements and determine the scope of Medicaid services provided within the state, provided that such requirements and services meet

certain federally established minimum guidelines. Funding for the Medicaid program comes from both the federal government and the individual states.

While Medicaid benefits are available only to persons who satisfy certain need-based criteria, Medicaid has become an important resource for paying for nursing home care (even for middle-income Americans). Given that the Medicare program (discussed in section 4 above) only pays for a limited amount of nursing home care, and given the high cost of long-term nursing home care, more and more Americans must look to the Medicaid program to provide for their nursing home care needs. This, in turn, has led to an increase in personal financial planning designed to create Medicaid eligibility for elder clients.

5.2 Eligibility

All states must provide Medicaid benefits to persons who are "categorically needy." In addition, states may elect to provide Medicaid benefits to persons who qualify as "optional categorically needy" or "medically needy."

5.2.1 Categorically needy

General requirements. The categorically needy generally include the following:

— Aged, blind, or disabled persons who are eligible for SSI benefits (see Section 3 above)

— Individuals qualified for Medicare hospital insurance (Part A) benefits whose income does not exceed 120 percent of the federal poverty guideline and whose resources do not exceed the SSI limits

— Qualifying lower-income pregnant women and their infants

Section 209(b) states. Because the SSI program is more liberal than the assistance programs offered by several states prior to the enactment of SSI, states are allowed to elect to apply standards that are more restrictive than the SSI standards for purposes of determining eligibility for Medicaid assistance. The states making such an election (known as "Section 209(b) states") are:

Connecticut
Hawaii
Illinois
Indiana
Minnesota
Missouri

Nebraska
New Hampshire
North Dakota
Ohio
Oklahoma
Utah
Virginia

5.2.2 Optional categorically needy

The optional categorically needy generally include the following:

— Persons eligible for SSI (but who are not actually receiving benefits)

— Persons receiving optional state supplements to SSI benefits (but not receiving federal SSI benefits)

— Persons who are ineligible for SSI benefits because they reside in certain medical institutions

5.2.3 Medically needy

Spend-down states. In so-called "spend-down" states, a person is considered medically needy if his or her income (after deducting medical expenses) is below a threshold level and his or her countable resources are below a threshold level. Accordingly, a person must "spend-down" his or her income each month on medical expenses in order to qualify as medically needy for the month.

Income cap states. In so-called "income cap" states, a person is considered medically needy if such person's income is below a threshold level. If the person's income for a month exceeds the threshold, then the person is not considered medically needy even if the person's medical expenses exceed his or her income for the month.

5.3 Medicaid Benefits

For eligible recipients, Medicaid benefits generally include the following:

— Nursing home care

— Inpatient and outpatient hospital care

— Physician's services

— Laboratory and X-ray services

— Nursing services

— Home health services

— Dental services
— Prescription drugs
— Hospice services
— Physical therapy services

5.4 Resource Requirements

In order to qualify for Medicaid benefits, a person must not have "countable resources" in excess of a prescribed threshold amount.

5.4.1 Excluded resources

For Medicaid purposes, the following resources are generally excluded from the determination of eligibility:

— An individual's principal place of residence (regardless of value)
— One wedding ring and one engagement ring (regardless of value)
— Items needed because of a person's physical condition (such as a wheelchair or prosthetic devices)
— Other household goods having an aggregate value of less than $2,000
— One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed $4,500
— Certain life insurance and burial insurance
— Certain business property essential to the individual's ability to support himself or herself

For an unmarried person living in a nursing home, the person's home is an exempt resource only if the person expects to return to the home after release from the nursing home (regardless of the likelihood that the person will ever be released from the nursing home).

> **Planning Tip.** A person may be able to obtain eligibility by converting countable resources into exempt resources. Examples include paying off a mortgage, purchasing a car, or making home improvements. The conversion of resources to exempt resources is a far less risky method of creating Medicaid eligibility than the transfer of ownership of assets, discussed in section 5.4.3.

5.4.2 Spousal resources

For Medicaid purposes, the resources of each spouse are generally counted in determining the Medicaid eligibility of one spouse (although

the income of a spouse is generally not counted in determining the eligibility of the other spouse if the other spouse enters a nursing home after September 29, 1989). For 2001, if one spouse is institutionalized, the other spouse (referred to as the "community spouse") may retain resources equal to the greater of $17,400 or one-half of the total resources of the couple up to a maximum of $87,000. The value of any resources of either spouse above that limit is deemed to be available for the support of the institutionalized spouse.

5.4.3 Transferring excess resources

In order to achieve Medicaid eligibility (especially in the case of a person in a nursing home), many clients may wish to transfer ownership of "excess resources."

> **Warning.** Practitioners must be extremely cautious when counseling clients to transfer assets in order to obtain Medicaid eligibility. As discussed below, such transfers may result in criminal sanctions against the client and any professional that counsels the client to transfer assets.

Effective August 12, 1993, the transfer of assets without adequate consideration within thirty-six months prior to applying for Medicaid benefits leads to a period of ineligibility for benefits for a period of months equal to the total value of the assets transferred divided by the average monthly cost for a private nursing home patient in the transferor's state of residence.

The thirty-six month look-back period is increased to sixty months in the following circumstances:

— In the case of an irrevocable trust that is funded by the applicant but does not provide benefits for the applicant or his or her spouse, any transfer of property by the trust is subject to a sixty-month look-back period.

— In the case of an irrevocable trust that is funded by the applicant and provides benefits to the applicant or his or her spouse, any transfer of property by the trust to a third party will be subject to a sixty-month look-back period only if the trust prohibits the distribution of principal to the applicant or the applicant's spouse.

— In the case of a revocable trust funded by the applicant, any transfer of property by the trust to a person other than the grantor is subject to a sixty-month look-back period.

A period of ineligibility will not result, however, if the transfer was made to any of the following:

— The transferor's spouse

— The sole benefit of the transferor's spouse
— A child of the transferor under age twenty-one
— A blind or disabled child of the transferor
— A trust that is solely for the benefit of a disabled individual under age sixty-five

If a transfer of assets results in a period of ineligibility, however, the transferor and, arguably, any professional advising the transferor to make the transfer, may be subject to criminal sanctions. The Health Insurance Portability and Accountability Act enacted in August 1996 makes it a crime for any person to "knowingly and willfully dispose of assets (including by any transfer in trust) in order for an individual to become eligible for medical assistance under a [State Medicaid plan] if disposing of the assets results in a period of ineligibility for such assistance." While the precise scope of that provision is unclear, and has been subject to great controversy and criticism, practitioners must use extreme caution when advising clients to transfer assets if the transfer will result in a period of Medicaid ineligibility under the rules discussed above.

6. PLANNING FOR SUBSTITUTE DECISION MAKING

There are situations in which an elderly or disabled client may no longer be competent to make important decisions regarding his or her own care or the management of his or her assets. Even a young, able-bodied client may suffer an injury or disability that renders him or her incapable of making decisions. In such an event, it is important that the substitute decision maker be someone acting solely in the client's best interest. Accordingly, the professional advisor should recommend that clients consider the legal documents described below whereby they can designate the substitute decision maker in the event of incapacity. Note that the following legal documents are subject to the provisions of state law governing such documents (and that the laws of the different states vary widely) and should be prepared only by an attorney familiar with the laws of the relevant states.

6.1 Durable Power of Attorney

A durable power of attorney allows a client to designate an attorney-in-fact to manage his or her assets and affairs in the event of an incapacity. A

durable power of attorney generally lists broad powers that the attorney-in-fact may exercise on behalf of the grantor, such as:

— The power to manage or sell assets of the grantor

— The power to bring lawsuits, and defend against lawsuits, in the name of the grantor

— The power to deal with the grantor's pension plans, retirement benefits, and insurance policies

— The power to vote with respect to stocks and other securities owned by the grantor

— The power to make gifts of the grantor's assets

A durable power of attorney can be revoked by the client at any time (except during periods of legal incapacity).

6.2 Living Will (Advance Directive)

A living will (also known as an "advance directive") is a legal document in which the patient expresses his or her wishes to receive (or not to receive) certain artificial life-prolonging medical treatments, such as artificial feeding, mechanical breathing devices, and kidney dialysis. A living will is only effective in the event that the patient is incapable of communicating his or her present desire to the treating physician, and can be revoked or amended by the patient at any time. A living will directing that life-prolonging procedures be withheld will generally not be respected if the patient is pregnant. There are certain legal formalities that must be respected when executing a living will and, at present, not all states recognize a living will as a legally binding document. (See appendix 1, "Sample Advance Directive (Living Will)," on the *Accountant's Business Manual Toolkit CD-ROM.*)

6.3 Health Care Surrogate

A health care surrogate is a legal document whereby a person appoints another individual to make health care decisions in the event the person is incapable of providing informed consent. The designated surrogate is generally prohibited from consenting to treatment such as the following:

— The withholding or withdrawing of life-prolonging medical treatment (which is why it is necessary to have both a health care surrogate and a living will)

— Abortion

— Sterilization

— Electroshock therapy

— Voluntary admission to a mental health facility

A health care surrogate generally can address subjects such as:

— Whether or not the patient wishes to make anatomical gifts (organ donation).

— Whether the surrogate has the power to consent to an autopsy with respect to the patient.

— The manner in which the patient wishes to have his or her remains disposed of (burial versus cremation).

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HUMAN RESOURCES

1. RECRUITMENT

Given the expansion of laws and regulations affecting business today, companies should establish recruitment and hiring policies that are clear and concise and that take into consideration the internal environment as well as the objectives and goals of the organization. These should include procedures and guidelines that clearly identify the approach the organization intends to use in identifying the potential employees who will best meet the long-term needs of the organization.

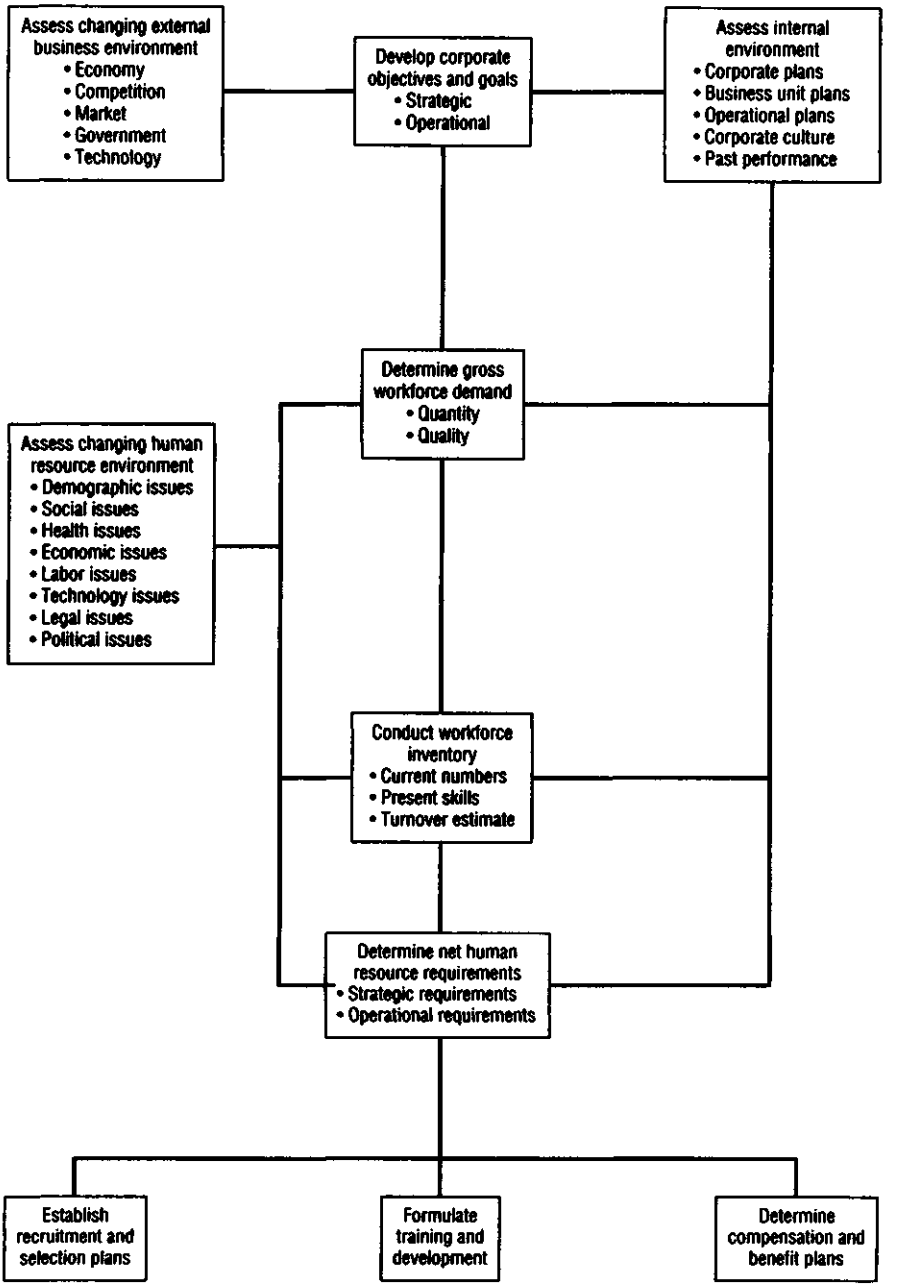
Most people would agree that planning for the firm's human resources is as important for an organization's success as is planning for its physical and financial resources. Human resource planning is a process by which a firm ensures that it has the right number of people, the right kind of people, in the right places, at the right time, doing what is economically most useful. However, if a business is to join the ranks of the most progressive organizations, it must expand beyond mere head-count planning.

Today, businesses are expected to plan, develop, and implement an integrated set of policies and programs designed to improve productivity, boost quality, and control costs, while managing diverse issues such as corporate culture and business ethics. To be fully effective, the overall business strategic plan needs to be integrated with the human resource plan. Effective human resource planning is a process that determines how the organization will move from its current to its desired human resource position as defined by its business plan and the changing environment. Exhibit 1 depicts a flowchart of human resource planning.

1.1 Policy and Objectives

If an organization recognizes people as key to its success, then the recruitment and selection of employees is likely to become the most important management function. Recruitment and selection policies and practices can make the difference between a workforce that is mediocre and one that is exemplary. That, in turn, can have a major impact on operations, growth, and profitability. The process of identifying and hiring personnel entails labor costs that add to the importance of making sure that recruitment is conducted carefully and results in the selection of quality people. Hiring costs have been skyrocketing, not only because of advertising, but also because of the time involved in campus interviewing, in-house interviewing, relocation, benefits and, most importantly, the time of the organization consumed by these activities.

Exhibit 1: Human Resource Planning



Another compelling reason to be concerned with recruitment and selection methods is the danger of employment discrimination charges. Complaints of discrimination in employment, whether justified or not, are very costly in terms of time, money, and reputation. Lawsuits can be devastating to growth and profitability. Therefore, the many pitfalls that can lead to charges of discrimination must be avoided in hiring practices.

Finally, companies today are faced with the erosion of the "employment at will principle"—the idea that employers have the right to discharge an individual at any time and for any reason. The conflict surrounding this issue is sufficient warning that the decision to hire an individual should be made with extreme caution and care, since dismissals can engender protracted and costly litigation.

The key to successful recruitment and selection practices and procedures is a clear, consistent, and well-thought-out corporate policy. A recruitment policy ensures a greater degree of uniformity in position approval and hiring practices, which is becoming more important as society becomes increasingly intolerant and suspicious of favoritism, nepotism, and other forms of personal preferences among employers.

Without a company policy, managers and supervisors act hesitantly, indecisively and sometimes with regard only to expedience. Uncertain of what the corporate policy is, they grope for answers, and the result is inconsistent recruitment practices, contradictory procedures, exposure to regulatory discipline, and threats of litigation.

A sample firm hiring policy is shown in appendix 1 (also see the *Accountant's Business Manual Toolkit CD-ROM*).

1.2 Determining Needs

As stated in the AICPA management consulting service Practice Administration Aid[1] on human resource planning, seven areas should be considered before beginning the employment process:

- Identify the purpose of the position and justify its cost.
- Draft a job description detailing areas of accountability, responsibility, and specific duties.
- Evaluate the pros and cons relative to the utilization of part-time, full-time, seasonal, and potential "shared jobs."
- Consider internal promotions and transfers.
- Evaluate the labor market with an eye to future employment needs.

[1]AICPA, MCS Practice Administration Aid, *Human Resource Planning and Management for an MAS Practice.* New York: AICPA, 1991.

- Understand specifically what the company is looking for in background, skill level, qualifications, salary range, and so forth.
- Research opportunities and obligations that take advantage of federal and local programs, grants, and other legal obligations the company may have.

In larger organizations, administrators or human resource departments may require the completion of a personnel requisition form for additional or replacement staff. The form summarizes the impact on budget and organizational functioning as well as all approvals required for hiring. A sample staffing requisition form is shown in appendix 2 (also see the *Accountant's Business Manual Toolkit CD-ROM*).

1.3 Development of a Job Description

Job descriptions have increased in their relative importance to an organization primarily because of the Americans with Disabilities Act (ADA), 1990, which gives their existence or absence greater weight when deciding whether an employer's decisions to hire were reasonable or discriminatory. A job description enables interviewers to understand all parameters of a job before the recruitment process begins and allows the applicants to know specifically what the responsibilities, duties, and accountabilities for a given position will be. Appendix 3 provides sample job descriptions.

2. RECRUITMENT SOURCES

Once a determination has been made regarding the need for a given position, the specific criteria have been developed, and the job description is in place, the specific recruiting mechanism must take over. Inevitably, there are two resources for recruitment: internal and external.

Internally, by means of manpower and career development planning, individuals may be selected for given positions as promotions or transfers. Employers can only benefit when they allow employees to grow within their careers and capabilities. The more knowledge and skills employees possess, the greater their potential contribution. Training, combined with transfers or promotions to different responsibilities, enables employees to accumulate more knowledge so that their talents can be developed to meet the employers' needs. For this reason, many employers identify employees with potential for promotion early on and actively encourage them to pursue advanced training. Likewise, when a job posting system is in place, employees can be notified of all

job vacancies. Job openings should be announced through a variety of methods—and current employees should be adequately informed—to minimize any appearance of discrimination. In order to take advantage of the value of knowledge of "Corporate Culture," all businesses should establish an internal job posting system. This allows current, valued employees with an understanding of the company's direction and mission to become aware of job vacancies, assess their *own* skill level in response to the dictates of the job description, and make applications accordingly. Internal posting has a positive impact not only on the firm but on employees that recognize the commitment that a company is making to the growth and development of its staff. A sample job posting request is shown in appendix 4.

External recruitment can take many avenues:

- Walk-ins
- Unsolicited resumes received in the mail
- Advertising in newspapers and industry publications
- Resumes received through college placement offices
- On-campus interviews
- Personal referrals
- Employment agencies and professional recruiters

Before launching a search for a suitable applicant, all unsolicited applications and resumes that have been received (as well as those of people who have been rejected for previous positions) should be reviewed. It simply is not cost-effective to start every search from scratch.

2.1 Unsolicited Applications

Often unsolicited applications are an effective and inexpensive source of potential candidates. People who apply directly often turn out to be good candidates. They probably applied because the company is conveniently located or is in an industry in which they have experience. They may have heard of the company or have familiarized themselves with it. Many firms meet the majority of their workforce needs in this way. At the very least, receipt of the resume or application should be acknowledged, as a matter of courtesy; in most cases, a follow-up letter should be sent.

2.2 Print Advertisements

When it is necessary to extend a search for candidates, the most common method is to place a newspaper advertisement. Recruitment ads should

be viewed as part of the company's overall effort to sell a job to prospective employees. The aim of this ad, as with an entire recruitment program, is not to attract the largest number of applicants, but to attract the most qualified applicants. The ideal candidate should want to answer the ad as soon as possible.

Where advertisements are published affects the time and money spent in recruiting. The key is not to select publications with the largest readership, but ones that are most likely to be read by the kinds of applicants being sought.

Newspapers' help wanted sections are read by nearly everyone who is looking for a position. A newspaper ad is easy to place, and often appears within days of its submission. Ads in trade and professional journals are usually cost-effective, since they are normally read by people with precisely the qualifications for those trades or professions. The problem is that many of these publications are published infrequently, monthly at best, and have long lead times. Thus, it can take weeks and even months for an ad to appear and for suitable candidates to respond.

2.3 Open Houses

When a company is seeking to employ several individuals in the same job category, or planning a rapid expansion into a new service area or locale for which it may be considering a substantial number of people, it may want to consider the feasibility of holding an open house. This is a cost-effective way of screening a large number of applicants over a one- to two-day period. It is also a good way to get managers and supervisors to meet large numbers of prospective employees and to discuss the vacancies with them personally. For the potential employees, an open house can serve to introduce them to the company and its staff and effect some self-selection among applicants.

2.4 Job Fairs

Though similar to an open house mentioned earlier, this involves many companies located within a geographical area. By exhibiting at job fairs, a company can learn whether or not its salaries are competitive, and about employment trends and changes in the labor market. Participation in a job fair is normally very cost-effective since advertising and rental costs for the site are shared with other employers. The major cost is the expenditure of time.

2.5 Campus Recruiting

It is useful to maintain an ongoing relationship with administrators, faculty members, and counselors at local schools, colleges, and universities. This kind of recruitment offers many advantages over the other techniques. One significant advantage is that people are recruited with recent state-of-the-art knowledge. New graduates can often make significant contributions because of their enthusiasm. College students are particularly interested in getting their careers off to a good start and they normally want to work for a good company. For them, this generally means one with growth potential, opportunities for advancement and personal development, and a good reputation in the community.

2.6 Employment Agencies

Many employment agencies are part of a nationwide recruiting network. These agencies have the capability to recruit from outside the immediate labor market area. This is particularly important if you are trying to fill positions that require special skills and talents that are not easily available locally. Fees of employment agencies, particularly for key, highly paid personnel, can be high. Agencies usually charge a fee of anywhere from 10 percent to 15 percent of the placed applicant's annual salary, with some fees as high as 30 percent.

3. INTERVIEWING

How many people need to be interviewed to fill a job opening? Ideally, one—if that person meets all the job requirements. It is not true—although many people believe otherwise—that the greater the number of applicants interviewed, the better the chance of finding the ideal employee. One person with the right qualifications is all it takes. And the best interview candidates can be identified before any meetings take place, through an effective screening process.

3.1 The Process of Elimination

3.1.1 Related skills

Although it may be important to be critical in evaluating resumes and other applicant information, it is also necessary to be able to recognize the transferability of skills and abilities. The failure to do the latter may

result in bypassing individuals who lack exactly the ideal experience or education, but who nevertheless have excellent capabilities. Applicants with less experience than desired in a certain field may have other qualities that could prove suitable for the job.

3.1.2 Basic qualifications

The resumes or job applications received should indicate which individuals are sufficiently qualified to be given further consideration. The first step is to check for the *minimum* requirements that have been established for the job. These may include minimum skills, basic levels of education, or the same or related experience. Only those applicants having at least these basic qualifications should be considered. This screening process prevents wasted time spent interviewing unsuitable applicants.

3.1.3 Work experience

The best way to evaluate work experience is to design a checklist of job specifications and duties and compare the applicants' experience against the established job criteria. The more experience an applicant has in a greater number of specified areas, the better prospect he or she may be.

The applicant's job history, including the frequency of job change, should be used to evaluate growth, development, and achievement over a period of time. There is substantial evidence that an individual's employment history is a major predictor of tenure—how long an individual will remain with the company. These factors should all be used to rate the applicant in terms of related work experience.

3.1.4 Education

An applicant's academic, vocational, or professional education should be examined in terms of how it relates to a job's requirements. First, check the degree earned, if any, and the major area of study, and determine whether they are relevant to the job. In many cases, an applicant's educational background will help to assess not only a candidate's ability to perform a job, but his or her intellectual ability to cope with difficult situations or to prioritize a number of different kinds of assignments. Educational background should have more importance for jobs that require specialized knowledge or for applicants with little or no related work experience.

3.1.5 Personal characteristics

When screening applicants who are still good prospects at this stage, look for factors that are potentially significant indicators of success in

the job, such as personality, motivation, and interests. Consider the amount of independent action and judgment required, the pressures of the job, and the future potential of the job and the employee. There may be, as well, long-term consideration of the applicant's potential for future promotion.

3.1.6 The application itself

The appearance of the resume or application says something about the applicant.

— Is the resume or application neat and legible?

— Is the information presented well?

— Are there inconsistencies or contradictions?

Observe whether there are any omissions in the application, or questions that have been left unanswered. Although an applicant should not be rejected because of failure to answer a question, it should be noted that if the applicant is invited to interview, these gaps should be filled in. A sample application is found in appendix 5.

3.2 Preparing for the Interview

There are five major steps in preparing for interviews, and each plays a critical role in the selection process.

3.2.1 Know the job

The most important part of preparing for an interview is to know the job. The interviewer should carefully review the job description to understand the job to be filled and the qualifications it requires. The interviewer needs to review the job duty specifics and know how the job fits into the specific function or department of the organization. The interviewer will also need to know relevant information, such as travel and overtime requirements, opportunities for promotion, and working conditions.

3.2.2 Determine the objective of the interview

Although the general purpose of interviewing is to select a candidate for a position, each particular interview should have a specific objective. Screening interviews are intended to select potential candidates for further consideration. Once several good candidates have been selected, the objective of the next interview may be to determine the best-qualified candidates. In this instance, individuals are judged against each other in an attempt to establish which ones have overall superiority.

In a number of circumstances, individuals may be interviewed to determine whether they have potential for later hiring.

3.2.3 Plan the format

Planning is an important part of preparing to interview. Things to be determined in advance include:

— The number of interviews to be conducted and by whom before making the final decision

— The approximate time allotment for each interview

— The specific issues to be covered

Included in appendix 6 (also see the *Accountant's Business Manual Toolkit CD-ROM*) is a sample form for listing interview questions. Maintaining a standard set of core questions and topics ensures that all important job-related issues will be covered in the interview and establishes a uniform set of topics on which an array of candidates' responses can be judged.

Additionally, the *Accountant's Business Manual Toolkit CD-ROM* contains three more forms, appendixes 16, 17, and 18. Appendix 16 represents a set of questions which can be posed to management to help the interviewer clarify the specific requirements of a job prior to conducting the actual interview. Appendix 17 contains an extensive set of sample questions which can be used during the interview process. Appendix 18 contains a list of questions that are inappropriate to ask during an interview or on an application. Adding such questions may be discriminatory if not directly job-related, as rejected candidates could contend they were turned down due to their race, sex, age, religion, or nonaffective disabilities. If desired, questions from appendix 17 can be used in conjunction with appendix 18 in designing a standard set of interview questions.

3.2.4 Learn about the applicant in advance

An essential part of the interview strategy is for the interviewer to carefully review in advance each candidate's job application or resume. This practice precludes using interview time to ask for information that has already been provided, as well as giving the interviewer a chance to get acquainted with the applicant before the meeting. The application form or resume provides some clues about the candidate. Specific questions to be asked by the interviewer may be based on aspects of the person's background.

3.2.5 Provide for privacy

Make sure that there will be no interruptions during an interview. Arrange for privacy. If a private office is not available, reserve a conference room. Inform the receptionist that there are to be no telephone

calls, messages, or other interruptions during the interview. Intrusions can distract attention and destroy the momentum of an interview.

In order to establish a controlled, objective evaluation procedure, it is useful to prepare an interview report following each candidate's interview. The report helps to standardize evaluation criteria so that, regardless of each candidate's personal differences in expression, experience, and bearing, the interviewer can characterize responses in standardized terms to permit comparative evaluation. Appendix 7 (also see the *Accountant's Business Manual Toolkit CD-ROM*) shows a sample interview rating report and a sample interviewer's evaluation form.

4. REFERENCE CHECKING AND TESTING

4.1 References

Due to the legal ramifications of the release of information received from a reference check, all employers are cautioned to check with applicable state statutes, which vary widely. A number of states restrict employers from releasing information without written authorization from the applicant.

Because most companies are reluctant to give any information other than name, dates of employment, and positions held, it is advantageous for all employers to have a *consent to release employment information* form prepared for all employees to sign when they leave the organization. Likewise, you may wish to develop a form to include in the interviewing packet that all applicants will sign, which is a release of information to you from the respective applicant's prior employers. Appendix 8 is a form to use in collecting telephone reference check information (also see the *Accountant's Business Manual Toolkit CD-ROM*).

4.2 Testing

After reviewing all the information contained on an application or resume, having conducted the interview itself, and having performed any reference checking that was feasible, an employer may also choose to test candidates for their ability to perform certain key job duties.

Some standardized ability tests measure the candidate's relative skill levels in typing, keyboarding, and calculating. Employers can themselves devise tests of particular specific job skills, such as written communication, logical problem solving, proofreading, or aptitude for specific complex tasks. These measure how well an individual may perform an activity on the job.

A second kind of test is called a "screening test." Screening tests include those for drug and alcohol abuse, polygraph or written integrity or honesty tests, and medical examinations. The administration of any of these tests entails a legal concern about whether negative results are attributable to race, sex, nationality, religious affiliation, age, or disability.

It should be noted that under the new ADA, businesses employing fifteen or more persons can ask medical questions or require a medical examination of job candidates only after a conditional job offer has been made.

It should be noted that although personality tests, aptitude tests, drug tests, and so forth, are still prevalent in the employment process, studies indicate that their use is waning.

5. COMMUNICATION WITH APPLICANTS

5.1 Job Offers

Candidates should be notified whether or not they have been selected for a position within a week or two of having been interviewed. A person is either right or wrong for a job, and procrastination in the decision-making process is counterproductive. There is no reason to think that a better candidate will appear next week; that other person almost never materializes, and in the meantime, a good candidate who has been kept waiting may no longer be available.

When a decision is made to hire an individual, one person within the firm should be designated to respond with a job offer. Job offers are usually made verbally, followed by a letter of confirmation stating the starting date and salary agreed upon by the firm and the candidate. Appendix 9 (also see the *Accountant's Business Manual Toolkit CD-ROM*) contains a sample job offer letter.

It is wise to set up a special file for all application forms from applicants who were rejected for employment. This should include not only the application forms, but a record of all correspondence between the company and the applicants and all reputable telephone contacts. If, at some future date, the firm is called upon to explain why a certain candidate was not hired, these records will provide all the necessary information.

5.2 Informing Rejected Applicants

As soon as applicants are no longer under consideration, they should be informed. If a candidate is interviewed and immediately eliminated

from consideration, a letter should be sent out the next day. Appendix 9 and the *Accountant's Business Manual Toolkit CD-ROM* contains a sample rejection letter.

Every individual who has been interviewed should receive a response. Not to do so is unprofessional and creates a poor image. People who receive no response will communicate this to their friends and other potential employees.

5.3 Responding to and Retaining Applications and Resumes

All businesses who have an image to maintain in the community should respond to all requests for employment—be these walk-in candidates, telephone inquiries, or unsolicited resumes. A firm should preserve a good positive image in the event that these candidates become viable at the time of the next vacancy.

Retain potentially viable resumes and applications. As stated earlier, the second step in any recruitment process, once needs have been defined, is to review all the resumes and applications that are on file. This pool of potential candidates can reduce additional costs in advertising and preliminary screening.

6. NEW EMPLOYEE ORIENTATION

In order for the employee and the company to start out well together, it is imperative that a proper orientation program be established. Specific objectives of this program should be—

- Making the employee comfortable in the new work environment.
- Developing and maintaining a positive attitude on the part of the employee toward the organization, the supervisor, and the job.
- Making the employee productive in terms of quantity, quality, safety, and dependability.
- Developing an employee who will be a team player as well as an individual performer.
- Enabling the employee to work independent of close supervision as soon as possible.

In order to accomplish the preceding objectives, good communication will be required from the first day of employment. Employees will obviously need to learn more about the employer than can be communicated in an interview. They will need to know how to "sense the environment" and become aware of the political pitfalls that impact

all organizations. Much is being written about "coaching" or "mentoring." It is a time-tested way to ensure that all new employees are trained in the culture of the organization as well as in the technical aspects of the job. According to the AICPA's *Management of an Accounting Practice Handbook*, "The firm is the biggest winner in a mentoring program." Three parties are involved in any such program—the protege, the mentor, and the firm. While all parties grow, the firm benefits in very tangible ways.

It is essential that an organization have a checklist specifically designed to cover the necessary aspects that all new employees will be expected to learn. Appendix 10 (also see the *Accountant's Business Manual Toolkit CD-ROM*) contains a sample orientation checklist.

Appendix 19, "Sample Employee Personal Information Update," on the *Accountant's Business Manual Toolkit CD-ROM,* illustrates a form that can be used at a later time to update personal information of the employee originally obtained at the time of employee orientation.

7. PERFORMANCE EVALUATIONS

Each employee has a right to know how he or she is performing. Likewise, each business has an obligation to inform employees of their performance. This becomes more important not only at the time of salary or promotion determination, but also at the time of the potential discharge of an employee. As such, performance evaluations need only be as long as required to outline an employee's responsiveness to the requirements of the job. All performance evaluations should be documented, dated, and signed by the employee and respective supervisor. Appendix 20, "Sample Professional Development Appraisal," on the *Accountant's Business Manual Toolkit CD-ROM,* is a sample form designed to document and assist in the evaluation and career planning process.

Similarly, it is important that employees being transferred or promoted into a new department or a new function be given an orientation to that area. All too often, employers take for granted that transferred employees know all about the company and all its departments. However, new supervisors, colleagues, and responsibilities should all be introduced to the transferred employee by means of an informal period of orientation.

8. COMPENSATION

8.1 Compensation Objectives

The fundamental objective of a salary administration plan is to ensure that employees are paid in relation to the value of the work they perform.

The company should receive a fair return on its salary investments and, in turn, individual employees should receive a fair compensation for their abilities and efforts.

The specific objectives of any plan should be—

- To pay competitive salaries as an attraction to superior people and motivation for them to do their best.
- To establish and maintain a logical, consistent scheme of value relationships among positions that represent an objective analysis of the division of responsibility.
- To pay individuals fairly according to their relative contribution to the effectiveness of operations, the objective measurement of which is considered to be the relative value of the work each individual performs and the results achieved.
- To establish and maintain a competitive, sound salary structure—one that provides strong inducement to individuals to advance and to assume greater responsibilities.
- To establish and maintain salary ranges for the respective salary grades that afford ample latitude for recognizing and rewarding performance improvement and superior performance.

(Text continued on page 19)

- To establish and maintain logical earnings relationships between supervisors and their subordinates.
- To maintain a competitive compensation structure that is applied subject to various economic pressures such as inflation, salaries at other companies, and the profitability of the organization.
- To establish meaningful differentials in compensation between individuals performing at significantly different levels and administer adjustments so as to recognize these differentials.
- To comply fully with provisions of all government regulations regarding compensation.
- To plan and implement all compensation expenditures through the budget system.
- To communicate to all employees the compensation policy and the methods of administering this policy.

8.2 Job Analysis—Job Descriptions

The advantage of having carefully prepared, properly used job descriptions should be obvious to anyone in the management field. But because so many organizations have not prepared and used their job descriptions properly, many of these benefits have been lost or overlooked. Consider the following:

1. Job descriptions clarify who is responsible for what within the organization. They also help define relationships between individuals and between departments. When used to advantage, they can settle grievances, nip conflicts in the bud, and improve communications.
2. Job descriptions help the jobholder understand the responsibilities of the position. This not only enables the employee to assess the relative importance of everything he or she is accountable for, but also provides a sense of where the job fits into the larger responsibilities of the organization as a whole.
3. Job descriptions are helpful to job applicants, to employees, to supervisors, and to human resources staff at every stage in the employment relationship, from recruitment to retirement. They provide information about the knowledge, training, education, and skills needed for each job. They prevent unnecessary misunderstandings about responsibilities and duties. They can guide both a new employee who may have forgotten or misunderstood some aspects of the job, and a supervisor who may think the new hire does not fully understand the job. Best of all, they provide this information in a completely objective and impersonal manner.

4. Job descriptions help management analyze and improve the organization's structure. They reveal whether all company responsibilities are adequately covered and where these responsibilities should be reallocated to achieve a better balance.
5. Accurate job descriptions provide a basis for job evaluation, wage and salary surveys, and an equitable wage and salary structure. (Job descriptions can be used to either support or discredit comparable worth and other job description complaints, and for this reason they should reflect only the truth about the job in question.)

Despite these and many other potential benefits, job descriptions have traditionally suffered a poor reputation among managers and supervisors. In fact, even companies that have spent a great deal of time and money preparing job descriptions often end up ignoring or underutilizing them. Exhibit 2 depicts uses of the position descriptions.

8.2.1 How are job descriptions used

One of the reasons that so many organizations have job descriptions that are not used is that they are simply unaware of their many uses. Many employers think of job descriptions only in terms of wage and salary administration, or as a necessary evil in complying with certain employment laws. But these are only two of the many practical uses for job descriptions, most of which can be grouped under the following four headings.

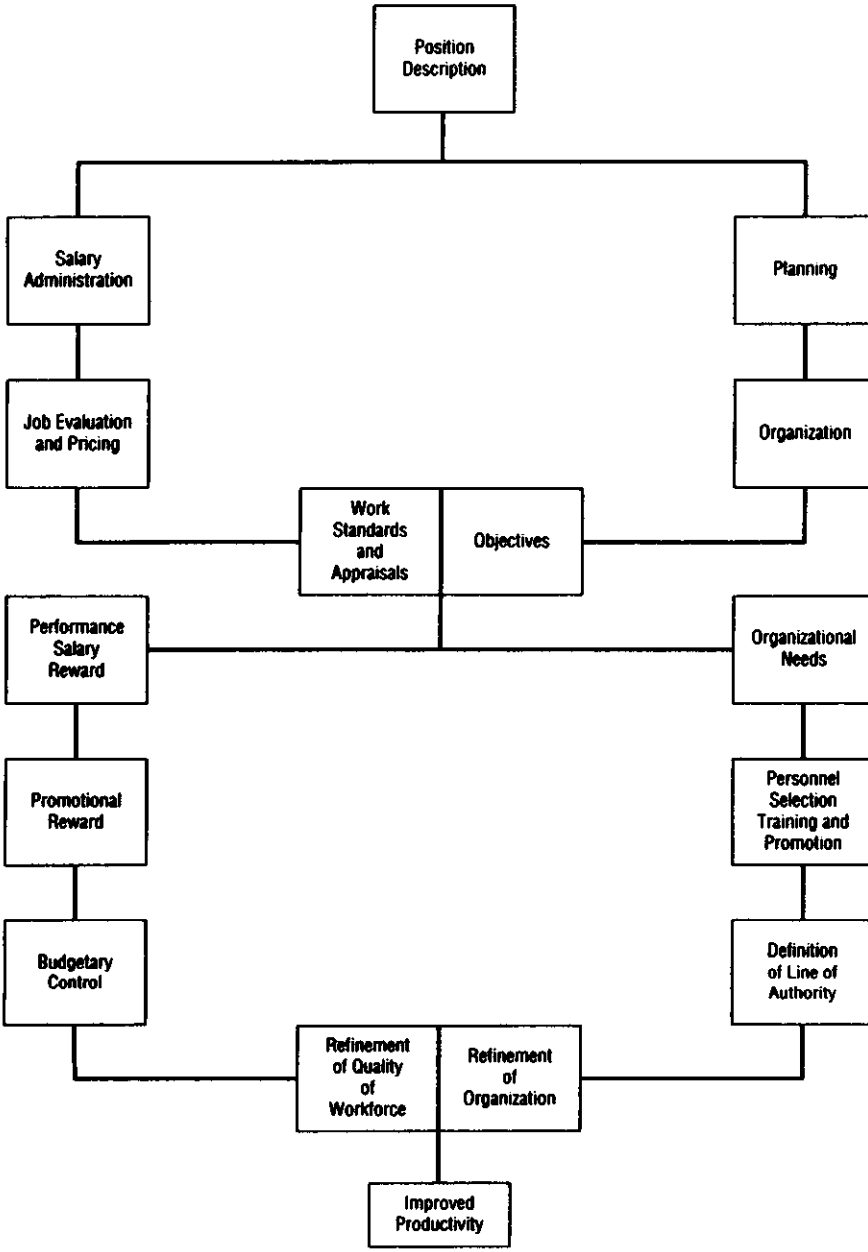
1. **Personnel Administration.** There is probably no better tool when it comes to human resource planning than a well-written set of job descriptions. Consider their usefulness in the following areas:

— Responsibility planning
— Recruitment and screening
— Hiring and replacement
— Orientation
— Training and development
— Career ladders

2. **Wage and Salary Administration.** Any compensation system requires that jobs be classified and evaluated in terms that make comparisons possible. This is where good job descriptions come in. They are especially valuable in the following compensation-related activities:

— Job evaluation
— Job classification
— Wage and salary surveys

Exhibit 2: Use of the Position Description



— Pay structure

— Performance appraisal

3. **Legal Guidance.** Changes in employment legislation have been frequent in recent years, and new issues—such as comparable worth—are always being tested in the courts. Job descriptions are important in complying with a number of the major pieces of government legislation, including the following:

— Fair Labor Standards Act

— Equal Pay Act

— Title VII of the Civil Rights Act of 1964

— Occupational Safety and Health Act

— Age Discrimination in Employment Act

— Employment Security Act

4. **Collective Bargaining.** The issue of varying pay rates for similar work has often been raised by unions, who may point to job descriptions as a basis for standardizing these pay rates. Job descriptions have also been used by employers to defend themselves against what they believe are unjustified union demands for uniform rates. Good job descriptions can clarify which jobs are truly similar, and which jobs warrant different pay levels because they require different levels of skill, knowledge, or responsibility, or because they contribute to the organization goals in different ways.

8.2.2 Responsibility planning

Actually, the process of preparing job descriptions serves a useful purpose in itself, particularly if it starts at the upper levels of the organizational hierarchy. The preliminary drafts of managerial and executive job descriptions can be used as a basis for productive group discussion in which managers and executives get together to talk about each other's responsibilities. Such discussions often reveal areas in which overlapping responsibilities or confusion about the limits of responsibility are a problem, or where the organizational structure is faulty. When these problems have been solved, each manager can then repeat the process with his or her own subordinates in reviewing and discussing their job descriptions. A side benefit of this approach is that managers and supervisors are more likely to feel committed to supporting a system that they have helped to create. They are also more likely to use job descriptions for a number of the purposes outlined above, rather than letting them collect dust in a drawer.

Other uses for job descriptions are the following:

— Job posting
— Management by objective programs
— Grievance procedures
— Work flow analysis
— Organizational studies

See Appendix 11 (also see the *Accountant's Business Manual Toolkit CD-ROM*) for job description preparation forms.

8.3 Job Evaluation

By definition, job evaluation is the consistent, logical, and equitable analysis and measurement of job responsibilities and duties. The emphasis is put on the *job* since the focus is on duties and responsibilities relative to the firm's goals—*not* on the employees currently holding the job.

The objectives of job evaluation are to—

— Eliminate or decrease wage and salary inequities.
— Provide accurate data for hiring new employees.
— Assist supervisors in determining which employees qualify for promotion.
— Determine whether employees are qualified for their current jobs.
— Help train supervisors to counsel employees in order to improve job performance.

To properly introduce a job evaluation program, it is important that the details and objectives be communicated first to the managerial and supervisory group and then to the employees whose positions will be evaluated. This communication should be written and should carry the endorsement of top management.

There are various kinds of evaluation plans or systems in use in industry today. The most popular plan is termed "the point factor technique." For the sake of brevity, this chapter only comments on the following three predominant evaluation techniques:

— Point factor
— Factor comparison
— Ranking

The point factor evaluation is based on well-defined factors or so-called common denominators that apply to the group of jobs being evaluated.

The factor of education, for example, is important in determining job worth for any position. Education, as it is commonly used in job evaluation, measures the trade-training or formal knowledge (in terms of years of education) required to perform the job duties under normal supervision. This may have been acquired by education, by outside study, or by training received on jobs of lesser rank. Under this factor are varying degrees, numerically cited, that indicate the levels of education required. Under the point factor plan, when a job is rated on education, a specific numerical score is applied to indicate the required job education. The same procedure is followed in reviewing other factors required by the job as rated.

The factor comparison evaluation technique compares jobs by making judgments concerning which jobs contain more of certain appropriate factors than others. Jobs are compared to one another, one factor at a time. In one such factor comparison plan, certain *universal factors* are used: mental requirements, physical requirements, skill requirements, responsibility, and working conditions. This technique is similar to that of point factor, except that no numerical scores are used. This may prove to be a potential disadvantage because more guesswork is involved.

The third evaluation technique used is that of ranking. Under this technique, jobs are ranked without regard either to factors or to point values. Usually, the determination of job rank is based on its worth to the organization. To assist an organization wishing to rank its jobs, key or benchmark jobs are first ranked. These key jobs are ones that are common throughout industry and are more readily understood by the members involved—jobs, such as janitor, punch-press operator, or clerk/typist.

8.3.1 Internal equity

The objectives of establishing a pay structure are to maintain competitive rates of pay and to maintain differentials between jobs within the organization. This ladder is often called internal equity.

Job evaluation, which has already been discussed, has as its objective the establishment of proper job differentials. The next step then is to analyze and apply competitive pay rates to these jobs—referred to as external competitiveness.

8.3.2 External competitiveness

The approach usually taken is to make a wage or salary survey of the organization's industry and area of operation by benchmark jobs. Benchmark jobs are those that are similar enough in content to allow similar industry comparisons. In making a survey of this kind, it is very

important that the comparison be made not on the basis of job title alone, but on careful consideration of job responsibilities as well.

There are many wage and salary surveys available. Employers' associations, chambers of commerce, trade associations, and consulting organizations make such surveys on a periodic basis.

Once an external comparison is completed and compared to the worth in which the evaluation measured the internal equity, a salary range can be developed.

8.4 Salary Ranges

A salary range is established to allow an individual room for growth within a job classification based on job performance over the years. Each individual range moves on an annual basis. Employee performance should be evaluated to be consistent with the company's ability to pay an appropriate salary that is commensurate with performance and that moves the individual up the salary range of the position. The ultimate goal is to ensure that a solid, competent performer is maintained at or near the average (midpoint) of a salary range that is both internally equitable and externally competitive.

8.5 Performance Reviews

The need for emphasis on performance appraisals has already been discussed. Performance appraisals serve more day-to-day purposes outside the human resources function than is generally recognized. For purposes of compensation, the performance appraisal system should help employees and managers set goals for themselves and for the organization. Goals should be measurable and should be reassessed throughout the year, as summarized in the following sections.

8.5.1 Setting goals with subordinates

Identify goals that are commonly set within the organizational unit for the upcoming budget period. Such goals often relate to profitability, competitive position, and productivity. In addition, the goals can be educational devices to encourage and promote staff development in the following areas:

— Technological leadership

— Employee development

— Public responsibility

— Employee relations

Working organization charts should be prepared that illustrate titles, duties, relationships, and impending changes. As objectives are set for the next budget year with each person, the following should be completed:

— Subordinates should be asked to make notes on their objectives for the coming year. These objectives should cover routine duties, problem-solving goals, creative goals, and personal goals.

— Lists should be prepared of the objectives that subordinates should include, noting innovations and improvements that are needed in each function.

— In personal conferences, subordinates' objectives should be reviewed in detail, and suggestions or changes should be offered.

— Three copies of the employees' objectives should be prepared: one for the employee, one for the firm's records, one for the supervisor.

— Working from the final document, supervisors should ask what they can do to help employees accomplish their goals. Suggestions should be kept with the supervisor's copy of the goals, becoming part of the supervisor's goals.

During the year, each subordinate's goals should be checked as promised milestones are reached.

— Is the employee meeting targets?

— Should the targets be amended?

— Is the supervisor helping the subordinate?

— Use jointly agreed upon goals as tools for coaching, developing, and improving the subordinate's performance on a continuous basis. Reenforce good results by feedback of success.

8.5.2 Measure results against goals

— Near the end of a budget year, subordinates should be asked to prepare a brief statement of performance against budget using their copies of the performance budget as a guide, supplying relevant figures where applicable. Individuals should give reasons for variances and list additional accomplishments not budgeted for.

— A date should be set to go over reports in detail with subordinates.

— The evaluator and subordinate should reach agreement on just how good job performance was, and where improvement should be made.

— Other concerns may be covered at this time—job, opportunity, job-related personal problems.

— Following evaluation, the stage is set for establishing the performance budget for the next year.

8.6 Merit Guides

Since the fundamental concept of the salary program is that individual pay should be based on progress and performance improvement, the performance evaluation becomes a salary recommendation or discussion. Certainly for this philosophy to be meaningful, the individual salary decisions must be appropriately related to judgments about employee performance results. The responsibility for successful achievement of this key relationship, both in actuality and as perceived by employees, rests with the immediate supervisor.

Once an employee's performance results have been measured, the next step is to select the appropriate merit treatment for that person. To assist the supervisor in this decision, a set of percentage and frequency guides should be established for each job classification. The term *guide* is used to distinguish these from rules. The indicated percentages and frequencies are intended to provide a guide for management discretion, not to establish rules within which supervisors must operate. Guides are never the reason for giving or not giving an increase.

Increase guides cannot be effectively applied simply on the basis of performance and the position of the current salary in the range. One additional piece of information is needed—the employee's rate of performance progress. This factor is important in determining when an increase should be given.

The appropriate use of any guide links performance judgments to individual salary progression. The progression through the salary range should be emphasized as a rate, and the individual's position in the salary range should depend on performance.

Those employees who consistently far exceed performance expectations progress to the upper portions of their salary range, while employees who make steady performance improvement generally retain their position within their salary range. According to this philosophy, it is necessary for the supervisor to determine each employee's performance relative to their peers in addition to their performance results against the established job standard and agreed-upon objectives. These two ingredients will determine precisely the position in the salary range to which an employee will progress and how long it will take the employee to get there. Individual salary increase decisions made by the employee's supervisor will reflect that result.

9. BENEFIT PROGRAMS

9.1 Objectives of a Benefits Plan

Employees provide valuable skills and knowledge that are essential to help a firm grow and prosper. For that work, employees are compensated not only with salary but also with a total benefits program.

The objective of a total benefits program should be able to give employees and their families three things:

1. Protection in time of financial need
2. Security to help them build their personal savings
3. An opportunity to grow in their careers and enjoy a richer life while they are away from their jobs

9.2 What You Can Afford

All payments made to employees for time not worked, along with additions to pay for the employees' benefit, are termed "benefits" or "fringe benefits." In the past, these benefits accounted for only a small part of total compensation—less than 5 percent. In recent years, benefits have become a popular means of attracting and retaining good workers. This development, along with the increase in collective bargaining activity and the advantageous treatment given to benefits under federal tax laws, has gradually given rise to an employment picture in which certain benefits are now almost universally taken for granted. Benefit costs now account for more than one-third of payroll outlays.

There are many misconceptions in the marketplace today relative to what companies must provide by way of benefits to its employees. Social Security and Medicare payments, unemployment insurance, and workers' compensation (mandated by the individual states), serve as the only required benefits. Recent legislation relative to the American with Disabilities Act and the Family Medical Leave Act stipulates certain policies relative to the granting of time off for employees, but since these are leaves "without pay," they are not considered benefits.

There are basically three types of cost considerations in structuring an employee benefit plan. The most important consideration with respect to profitability is the cost to the organization. There are also two employee-related costs. There are costs to the employee in terms of the payroll deductions required for participation in benefit programs and the amount of other out-of-pocket costs the employee incurs to purchase coverages that are not provided in the benefit and service package. Also, there is the important consideration of the value to the

employee. Any benefit program will be a waste of money if the employees perceive no usefulness from the benefits and services offered.

Any benefit program will have to include the mandatory costs of legislated programs such as social security, unemployment compensation, and workers' compensation. Nevertheless, these programs should be carefully considered to avoid any overlap in coverage. Private plans can be tailored to supplement public assistance and as the latter is increased, some reduction in organization benefits can be considered. Pension plans can be integrated with Social Security benefits. Health insurance can carve out Medicare eligibles. Disability insurance can be integrated with workers' compensation. Educational assistance can be made conditional upon the use of available veterans assistance.

A benefit plan should also be cost-effective in terms of employee contributions. This would entail the standard practice of having deductibles for health insurance coverage and schedules of maximum payments and copayments for certain coverages. In other areas, educational assistance can require that the courses taken have some relation to job duties. Also, it may not be economical to provide a standard amount of life insurance for all employees. Younger employees or single workers may not need coverage as extensive as that required by workers with families or older employees.

One way to make sure that benefits are cost-effective is to provide the benefits and services most valued by employees. Benefits systems have tended to grow and change in response to outside events rather than for the purpose of meeting changed employee needs or improving organizational effectiveness. The most frequent example of this error in thinking is illustrated by similar organizations attempting to duplicate each other's benefit packages. What is good for one company may not always hold true for the next organization.

9.3 Cafeteria Plans

According to a number of surveys, employers are offering increased flexibility to make what are termed "cafeteria plans" more valuable to employees. The cafeteria approach to employee compensation is a method of providing a flexible benefits and services program. Employees receive a specific value for the amount of benefits they may choose from a menu of different items. Usually, there is a core of benefits that the employee must accept. For most other benefits, the employee may pick and choose—or take the cash. The employee picks what benefits he or she wants, provided that the maximum dollar amount allocated to the individual is not exceeded. Some benefits, such as pensions, must be kept in the core of the mandatory benefits because the law requires it.

The advantage of the cafeteria or flexible benefits approach for meeting the demands of a changing workforce is apparent. The established, career-minded employee may be interested in pensions; the traditional one-worker family with two children may not want a lot of group health insurance; one-half of a two-worker family may not be interested in any group insurance at all; the single person may want extra vacation time.

The cafeteria-style benefit plan is highly touted among small businesses today because it enables the employees to participate by purchasing medical, dental, and optical benefits, as well as child care, while paying for these items with pretax dollars.

10. FLEXIBLE WORK ARRANGEMENTS

The objective of any benefit program is to create more satisfied employees, thereby improving performance and positively affecting the bottom line. It is short-sighted to view the costs of providing flexible work arrangements without weighing in the many benefits to the company.

These benefits include managing diversity, enhancing the work-family-life balance, improving the level of staff retention, gaining a recruitment advantage, managing seasonality, improving client services, improving productivity, facilitating education, reducing office space and capital requirements, reducing absenteeism, and enhancing morale.

10.1 Types of Flex Arrangements

Flexible work arrangements don't mean the same thing for every employer. As the name implies, they should create a win-win arrangement which meets the needs of both employer and employee. In each situation this may result in flextime, compressed workweeks, regular part-time, job sharing, work sharing, telecommuting, or sabbaticals.

Given an increasingly diverse workforce, different flex arrangements may be provided to different employees without being discriminatory. In reality, many employees prefer the structure of a regular schedule in an office environment. Both men and women have benefited from such arrangements, particularly in solving child-care or elder-care problems. Flexible arrangements also work in positions of responsibility and generally are not disruptive if managed well. Supervision of flexible work arrangements requires a new kind of management style that emphasizes results rather than oversight, an approach that is necessary to compete in the twenty-first century.

10.2 Flextime

Flextime allows employees to choose their starting and quitting times within limits set by management. A "core time" may be established during which all employees are expected to be present with all other time identified as "flexhours." This requires trust and is a means of empowering staff. The business needs of the company, however, are paramount. Flex programs may need curtailing during busy seasons. Open communication is necessary to ensure that some employees are not overburdened by another's flex schedule.

10.3 Compressed Workweeks

A compressed workweek is a standard workweek that is compressed into fewer than five days. Organizations need to determine if such a schedule would be implemented on an individual basis, within a department, or company-wide. Demographics of the workforce is an important consideration as significantly longer workdays may present problems for parents with younger children or older employees.

Federal and state labor laws should be closely reviewed. The Fair Labor Standards Act requires most employers to pay overtime after forty hours. In certain states overtime must be paid for hours worked in excess of eight a day. Companies requiring full-service coverage over five days may overlap shifts or stagger schedules so that all positions remain covered each day. It is important to ensure that such schedules coincide with transit system and public transportation availability. Compressed schedules may also require companies to revise vacation and holiday policies in terms of hours rather than days off.

10.4 Job Sharing

Job-sharing and work-sharing arrangements require regular part-time personnel who are part of the core work force and routinely work less than a normal workweek. For most, a part-time arrangement is transitory—allowing them to balance work with some other aspect of their life. Policies should clearly define the circumstances for returning to full-time status in the future and the effect part-time status has on the company's fringe benefit plans.

Job sharing splits the responsibilities of a full-time position. This requires a team approach and good communication. It can also provide valuable mentoring and cross-training of skills as job sharers tend to supervise each other's work. These attributes improve quality assurance and encourage self-empowerment and self-supervision.

10.5 Telecommuting

Flexplace, or telecommuting, refers to staff working in a remote location (generally at home) part of the time. Telecommuting is advantageous where some types of work can be done more effectively outside the office environment with its ringing telephones, distractions, and interruptions.

Telecommuting requires an employee be self-motivated and disciplined. Employees need to evaluate their own strengths and weaknesses and decide if lack of interaction with others enhances or detracts from job productivity and satisfaction. Such arrangements should only be considered after employees are experienced in their duties and familiar with policies and procedures.

Employers should consider the confidentiality of company and customer data kept off-site and whether additional insurance coverage may be needed. Remote locations generally need an investment in technology and office furnishings and policies should address who is responsible for these costs. Technology may include computer, modem, specific software, printer, scanner/fax/copier, additional phone lines, and courier services. Using appendix 21, "Checklist for an Office at Home" (on the *Accountant's Business Manual Toolkit CD-ROM*), is a good way to establish basic home office criteria.

10.6 Leaves and Sabbaticals

Leaves and sabbaticals are authorized paid or unpaid periods of time away from work without loss of employment rights. In many cases, the Family and Medical Leave Act now mandates unpaid leave rights for the birth or placement for adoption or foster care of a child, or for a serious health condition of any family member. Sabbaticals may also be granted to long-time employees to restore vitality and prevent burnout and stress-related illnesses. Employers need to consider how to cover an employee's work during a leave and what positions will be available when an employee is prepared to return full-time.

11. TERMINATION

11.1 Performance Evaluation and Documentation

Measurement of performance is one of the most crucial tasks performed by managers and supervisors. Although performance evaluation may seem to be directly related only to discussions that occur at salary

evaluations, it is a topic relevant to many other day-to-day activities in the workplace. Performance evaluation is actually an ongoing communication effort, beginning with the initial job interview, and continuing throughout the employment cycle.

An employee's history of not meeting performance requirements is often the cause for termination. Failure to communicate performance requirements fully is often the underlying problem if a company is faced with employment-related litigation. Inability to meet performance standards must be fully documented in order to support a termination decision. In order to reduce the potential for any future problems, it is essential that performance requirements, and the employee's record of meeting or not meeting those requirements, be communicated at the time an employee is hired, regularly during employment, and again at employment termination.

11.2 Guidelines for Termination

Prior to terminating an employee, the company should consider several questions:

- Does the organization have options other than termination?
- Should management seek a voluntary resignation instead of a termination accompanied by the employee's signed release of all claims?
- How should the grounds for dismissal be worded in order to avoid any potential discrimination lawsuit?
- Should a peer review board or committee be instituted to resolve disputes over potential terminations?
- What individual within the organization should notify the employee of the impending termination?
- When should a terminated employee be physically released from the organization?
- How are inquiries from the outside handled and by whom?
- What impact will a termination have on the company image, operations, and remaining employee morale?
- What sorts of severance benefits, if any, should be offered the terminee, and under what circumstances?
- What formula should be developed and used to compute the severance and compensation package?
- What company benefits are to continue after the termination and for how long?
- Should job outplacement be considered for the terminated employee?

11.3 Prior to Finalizing a Termination Decision

If termination is being considered due to a violation of company policy, it is imperative that the company adhere to the procedures listed below. Following these procedures will help to protect the company's position if the employee were to sue for wrongful discharge.

— Document all pertinent facts. Documentation of policy infractions is the basis for a "good cause" defense. This documentation should begin at the time infractions, and related disciplinary actions, present the possibility of dismissal. Every violation of policy, regardless of how trivial, should be recorded in the employee's personnel file. All records of violations should fully indicate the resulting disciplinary action, whether formal or informal.

— Use progressive discipline. Establish formal, written guidelines for discipline and follow them rigorously. Under a typical progressive discipline system, an employee will be given an oral warning for the first offense, a written warning for the second, and suspension or termination for the third. If a suspension procedure is implemented, termination would not normally occur until the fourth offense. The system should also provide for immediate dismissal under certain conditions, such as gross unprofessional conduct, or other activities that management deems highly inappropriate or damaging.

If termination is considered due to repeated poor performance, the performance evaluation process must be scrutinized. In order to defend its position, management should be able to answer the following questions based upon the company's performance evaluation process as it relates to the terminated employee:

— Is it obvious what activity/job/position is being evaluated?

— Are the performance objectives explicit, fair, and realistic?

— Is the evaluation objective, fair, and unbiased as to sex, race, religion, handicap, and national origin?

— Was the employee told of the performance evaluation and notified of the functional areas where performance needed improvement?

— What performance standards are used to evaluate the employee's performance?

— Are the performance criteria and/or performance standards ever changed? If so, the following questions must also be addressed:
  — Are the changes explicitly and formally communicated to the affected employee?
  — Are copies of these communications permanently maintained?

— Are performance standards based on the job analysis?

— Are the same job performance standards applied to all employees holding similar jobs?

— Were the evaluations consistent with sound personnel practices?

— Were the evaluations done by a person thoroughly familiar with the terminated employee's performance?

— Has the employee been given appropriate assistance and guidance toward reaching objectives?

— Were the necessary resources made available to reach the established objectives and standards?

— Does the company provide necessary training to enable the employee to keep relevant knowledge up-to-date?

— Were unsatisfactory performance issues discussed with the employee at reasonable intervals?

— Was the employee advised of the consequences of continued unsatisfactory performance?

— Were deadlines provided for remedial actions?

— Is the company's performance evaluation program formal and has it been formally communicated to employees?

— Have employees ever been evaluated as satisfactory even though the performance was poor, unsatisfactory, or marginally satisfactory?

— Is a complete and accurate file of each employee's performance evaluations maintained? If so, also address the following:

— Does this file support the termination?

Answers to these questions should enable management to assess its position in potential termination based on poor or unsatisfactory performance. Questions that cannot be answered positively and explicitly must alert management to reevaluate its stand on a discharge on grounds of unsatisfactory performance. Appendix 12 gives an example of a predischarge checklist that may be used to document management's review.

11.4 After the Decision to Terminate has been Finalized

After the termination decision has been made, several steps should be taken to prepare for the termination interview:

- Check whether there is any employment contract for a definite term.
- Carefully review each provision in the employee handbook.

- Make sure that an impartial third party has reviewed all facts.
- Determine the reason that is to be given for the termination.
- Draft the termination letter.
- Keep a record of the termination notice and all termination-related documents.
- Notify those who are likely to be affected by the termination.
- Employees who could potentially be harmful to the company must be asked, and should be asked, to leave the premises soon after termination notice is given. Compensation in lieu of advanced notice should be arranged.
- Exercise extreme confidentiality in handling terminations.
- Be prepared to ensure a replacement for the terminated employee if the position is not being abolished.
- Scrutinize the details of the severance package.
- Be sensitive to the time in which the employee is notified.

11.5 During the Termination Interview

During the termination interview, several important steps should be followed:

- Come to the point within the first two to three minutes.
- Outline and put into a logical order all the relevant reasons for the termination.
- Keep the termination interview brief and businesslike.
- Determine the terms to be used for the employee's departure.
- Preferably, conduct the exit in a neutral territory.
- Inform the employee of the "bad news" in a way that will alleviate trauma.
- Do not try to compensate the terminated employee for the "psychological shock" of losing the job.
- Offer assistance in helping this person find another job.

11.6 After the Termination Interview

Once the termination interview is complete, be sure the following additional steps are completed:

- Notify all the departments within your organization that are apt to be affected by the employee's departure.
- Have the employee return all company property and make sure that the employee's financial obligations to the firm are cleared.
- Find out whether the employee has any vested rights to the pension, profit sharing, or other related plans.
- Inform the departing employee the kind of contact the company will allow from them after he or she leaves.
- Inform the employee what to expect in terms of future references.
- If you are to assist with outplacement, stay in contact and follow through accordingly.

Perform an exit interview, if possible. See appendixes 13 through 15 (also see the *Accountant's Business Manual Toolkit CD-ROM*) for examples of exit interview and related termination forms.

Employee terminations are an extremely serious and sensitive subject and should be treated as such by all managers, executives, and owners. Whether a termination results in a potential lawsuit for wrongful discharge will often depend on how the termination process is handled. Lawsuits are not only expensive, but are embarrassing to both the terminating organization and the terminated employee. Every effort should be made to ensure that terminations, when inevitable, have been properly handled by management.

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APPENDIX 1: Sample Firm Hiring Policy

It is the policy of the Firm to be an equal opportunity employer and to hire individuals solely upon the basis of their qualifications for the job for which they have applied. Every effort is made to hire new employees for positions that make the best use of their abilities and in which they will be able to achieve personal satisfaction. In no event shall the hiring of an employee be considered a contractual relationship between the employee and the Firm; and, unless otherwise provided in writing, employment shall be at will, so that either party may terminate the relationship at any time and for any lawful reason.

1. PURPOSE

The purpose of this policy is to provide a controlled procedure for manpower staffing and utilization. Two general programs are outlined below: a) The hours budget system and staff plans that control staffing levels, and b) Procedures governing all personnel actions that affect staff utilization.

2. HOURS BUDGET SYSTEM AND STAFF PLAN

The hours budget and staff plan are established by employees and their supervisors and approved by shareholders during the budgeting process. Changes to the hours budget and staff plan require approval of the managing partner and director of administration.

The hours budget is maintained by the director of administration. The staff level plan is maintained by the director of administration and is distributed for shareholder review as appropriate. Specifically, it is a listing of all budgeted approved hours, whether part-time, full time, or temporary, and any additions/deletions to the original budget. Similarly, information on actual hours is provided and the differences between actual versus budgeted planned levels are explained. Supervisors are accountable for reviewing the staff level plan and reporting any changes or discrepancies to the director of administration.

The staff level plan is used as a method of communicating employment activity but primarily to control staff levels and hours. Any changes, either additions or deletions to the plan, are initiated by the supervisors through the appropriate shareholders and approved by the managing partner and director of administration. Personnel action on any change in the budgeted plan cannot begin until approval has been received.

The use of temporary additions or deletions to the staff plan will require approval and will be reflected in the staff plan.

As a supplement to the plan, an organization chart that depicts staff levels, job titles, and employee names is distributed to all employees on an as-needed basis. Any organizational chart changes should be reported to the director of administration.

3. PERSONNEL ACTION PROCEDURES

Job descriptions. Job descriptions are of key importance in successful personnel action. Supervisors are responsible for maintaining up-to-date descriptions for all jobs in their area of responsibility, with the assistance of the director of administration. Changes in job duties or requirements should be reflected in a revision of the job description and possible changes in the job title. The creation of a new job requires the completion of a new job description. Job descriptions are the basis both of an employee's position determination and performance evaluation and should be given careful consideration.

Hiring. Supervisors requiring a new employee, whether for replacement or a staff addition should—

- Insure that an accurate and current job description is in existence for the job. If the position is a new job, the supervisor should contact the director of administration for assistance in writing the job description and for job evaluation.
- Complete a personnel requisition form requesting aid for additional staff. Indicate in the comments section of the form the hours to be worked and the special conditions of employment required. For replacements, the form should be signed by the supervisor and the shareholder under whose direction this new employee would report and be forwarded to the director of administration.

Outlined below is the usual selection procedure to be followed for external recruitment.

- The director of administration or designate will screen all applicants and refer the most qualified to the supervisor for consideration.
- The director of administration or designate will check references when possible for the candidate selected by the supervisor.
- The director of administration or shareholder will extend an offer to the prospective employee and arrange a starting date.

- The director of administration will follow up with a confirmation letter to the prospective new employee officially offering the position to said employee.
- The director of administration will initiate a "Personnel Action form" for new hires which will be sent to the data processing area for payroll input purposes.
- Either prior to, or on the first day of employment, the new employee will report to the director of administration or designate to fill out new hire information and benefits orientation.

Information and Procedures

- Where qualified applicants are available internally, it is the Firm's preference to fill job openings by promoting from within. If applicants for employment are recruited from outside the organization, all available sources of qualified personnel shall be utilized. Before recruiting applicants from outside the Firm, the director of administration shall give consideration to any qualified individuals who are on layoff status.
- The Firm will accept applications for employment only for specific jobs in which openings exist.
- The Firm will not pay any employment agency fees for unsolicited referrals of individuals to fill job openings. However, for certain designated hard-to-fill professional jobs approved by the director of administration, the Firm will pay for recruiting assistance from selected employment agencies and professional recruiters.
- When a shareholder or other manager determines that there is a requirement for one or more new employees, the individual shall submit an employment requisition to the director of administration. Requisitions to fill existing jobs that are being permanently vacated will be processed routinely. All other requisitions will be reviewed by the director of administration before approval.
- To aid the process of selecting those most qualified for the job, the Firm may use employment tests as a part of normal hiring procedures for certain positions.
- If job openings are to be filled from within the Firm, the openings will be posted in accordance with the posting procedures. The director of administration will arrange interviews between the applicants and the shareholder, and the decision to accept an applicant will be made by the shareholder.
- All representatives of the Firm should be aware that employment with the Firm is at will and should exercise great care not to make any representations otherwise. Therefore, during the recruitment,

hiring, and orientation process, no statement shall be made promising permanent or guaranteed employment; and no document shall be called a contract unless, in fact, an employment contract is to be used.

- The Firm will employ a relative or cohabitant of an employee provided the individual possesses the usual qualifications for employment. However, those persons will not be given work assignments that require one to direct, review, or process the work of the other, or which permit one to have access to the personnel records of the other.
- If employees marry one another, or if two employees become cohabitants, both may retain their positions if they do not work in the same department, are not under the direct or indirect supervision of each other, and neither occupies a position of influence over the other's employment, promotion, salary administration, and other related management or personnel considerations.
- The Firm is taking affirmative action to employ, and advance in employment, qualified disabled veterans, veterans of the Vietnam era, and qualified handicapped individuals. The Firm is also taking affirmative action to employ and advance in employment qualified individuals without regard to race, sex, religion, or national origin.
- Former employees who left the Firm in good standing may be considered for re-employment. Former employees who resigned without adequate notice or who were dismissed for cause will not be considered for re-employment. A previously terminated employee who is re-employed will be considered a new employee from the date of re-employment unless the break-in service is less than thirty days, in which case the employee shall retain accumulated seniority. Length of service for the purposes of benefits is governed by the terms of each benefit plan. Employees who retire may be eligible, in certain circumstances, to be considered for rehire.

APPENDIX 2: Sample Personnel Requisition

STAFFING REQUISITION

Please type. Leave all shaded areas blank. Send form intact to Human Resources.

FROM	DATE NEEDED	_NEW POSITION _REPLACEMENT	IF REPLACEMENT, FOR WHOM & EFFECTIVE DATE
DIVISION/DEPARTMENT NAME	DIV./DEPT. CODE	DEPT. INTERVIEWER AND EXT	LEAVING BECAUSE OF: _Promotion _Resignation _Transfer _Release

LOCATION	BUDGETED SALARY THIS YEAR	IS THIS JOB INCLUDED IN YOUR BUDGET FOR THIS YEAR? _YES _NO	IF NOT, WHAT IMPACT WILL IT HAVE ON YOUR BUDGET FOR THE YEAR?

Sal. Admin. only JOB CODE	JOB TITLE	GRADE	HIRING SALARY RANGE	FT PT TEMP _ _ _	Incentive _Yes _No

Pay Freq. H.R. only	Pay Code	LEVEL 6	EXEMPT? _Yes _No	Emp. Code	HOURS PER WEEK 35 37½ 40 _ _ _	_Bi-Wkly _Wkly	_8:40-4:50 OR _____	Estimated Part Time	Overtime Required? _Yes _No	OUTSIDE ADVERT APPROVAL _YES _NO

JOB RESPONSIBILITIES:

JOB REQUIREMENTS/EDUCATION/SPECIAL SKILLS AND/OR TRAINING:

USUAL JOB PROGRESSION AND/OR ADVANCEMENT OPPORTUNITIES:

DEPT. HEAD SIGNATURE AND DATE	SALARY ADMINISTRATION	HUMAN RESOURCES
DIVISION HEAD SIGNATURE AND DATE	ADDITIONAL APPROVALS	

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APPENDIX 3: Sample Job Descriptions

JOB DESCRIPTION

TITLE: Controller
DEPARTMENT: Accounting and Finance
CLASSIFICATION: Full-Time, Exempt

REPORTS TO: CEO
SUPERVISES: Assistant Controller

Summary of Responsibilities

The controller provides accurate and timely financial information to the chief executive officer (CEO) for decision-making purposes. The controller also serves as liaison between staff and management, and outside parties and management.

Essential Functions

1. Meet with the CEO weekly to provide financial reports and advise on financial matters.
2. Establish and maintain good banking relations, and arrange and monitor lines of credit weekly.
3. Meet with company accountants and attorneys on an as-needed basis, and advise the CEO of relative legal and financial matters.
4. Oversee the preparation of reports for the annual year-end audit, and ensure that reports are available for the outside accountants.
5. Supervise the assistant controller, and review accounting reports as needed.
6. Approve and sign checks, as needed.
7. Prepare annual budgets, monthly cash flow analyses, and monthly and annual projections of jobs in progress and cash flow.

Other Functions

Prepare other reports and projects as requested from time to time by the officers of the corporation.

Required Experience

Normally, at least five years' experience as a controller or chief financial officer (CFO) for a construction-related business is required.

Educational Requirements

1. The position requires a bachelor's degree in accounting or finance or equivalent work experience.
2. Forty hours of continuing professional education is required each year.

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Required Licenses, Certificates or Knowledge
A current and valid certified public accountant's (CPA's) license is desired, but not required.

Working Conditions
1. Occasional same day, out of town travel for meetings and conferences using a personal vehicle or company vehicle.
2. Occasional overtime work required throughout the year. Heavy overtime work required at end of fiscal year for preparation of year end audit.

Safety Hazards of the Job
Minimal hazards. General office working conditions.

This job description does not list all the duties of the job. You may be asked by supervisors or managers to perform other instructions and duties. You will be evaluated in part based upon your performance of the tasks listed in this job description.

Management has the right to revise this job description at any time. The job description is not a contract for employment, and either you or the employer may terminate employment at any time, for any reason.

Dated prepared _____ Approved by _____

JOB DESCRIPTION

TITLE: Assistant Controller
DEPARTMENT: Accounting and Finance
CLASSIFICATION: Full-Time, Exempt

REPORTS TO: Controller
SUPERVISES: Accounting Staff

Summary of Responsibilities

The assistant controller helps the controller prepare financial reports and forecasts; manages the computerized accounting system; and serves as a liaison between the accounting staff and the controller.

Essential Functions

1. Prepare monthly financial statements (including job cost definition) by the 25th of each month, using a computer software program.
2. Coordinate annual year end audit with outside auditors, and oversee the preparation of appropriate schedules and reports.
3. Handle daily accounting mail, including notices and disbursements.
4. Prepare union, labor, minority and workers' compensation reports each month.
5. Prepare special reports on an as-needed basis.
6. Prepare budgets and forecasts as directed by the controller.
7. Monitor medical insurance and 401(k) plans.
8. Prepare payroll tax returns each quarter.
9. Prepare annual W-2 reports.
10. Supervise accounting staff.

Other Functions

Other duties as assigned by the controller or the CEO.

Required Experience

1. Normally, three to five years' experience working as a full charge bookkeeper or assistant controller in a construction-related business.
2. Experience preparing financial statements and job costing reports.
3. Experience with and understanding of computer software programs.

Educational Requirements

At least two years of college level courses in accounting are desired.

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Required Licenses and Certificates
None required.

Working Conditions
1. Job involves in-office work, performing various tasks concurrently.
2. Moderate to low overtime required throughout the year. High level of overtime required at year end to complete year-end audit.

Safety Hazards
Minimal hazards. General office working conditions.

This job description does not list all the duties of the job. You may be asked by supervisors or managers to perform other instructions and duties. You will be evaluated in part based upon your performance of the tasks listed in this job description.

Management has the right to revise this job description at any time. The job description is not a contract for employment, and either you or the employer may terminate employment at any time, for any reason.

Dated prepared _____ Approved by _____

APPENDIX 4: Sample Job Posting Request

JOB POSTING REQUEST

(Nonbargaining Unit) Date _____

Position Title _____ Department _____

This is a: New Job _____ or/Additional Job _____

or/Replacement for: _____
(Person)

Payroll: Pink _____

Crew 90 _____

Starting Date _____ Block No. _____

Exempt/Nonexempt _____

Minimum Qualifications:

Other Requirements:

Final Selection To Be Made By _____

Requested By _____ Approved _____
(Department Head)

Distribution: White—Personnel Department

Yellow—Department Submitting

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APPENDIX 5: Sample Application for Employment

[This application is presented for illustrative purposes only. Because employment regulations vary by state and locality, any employment application the business uses should be approved by an attorney experienced in employment law.]

APPLICATION FOR EMPLOYMENT

The following information is requested to help us make the best possible placement of employees within the company. Complete all portions of this application pertaining to you. We appreciate the time you spend completing this application. The employer, in accordance with state and federal laws, does not discriminate on the basis of age, race, religion, color, sex, national origin, ancestry, mental or physical disability, or any other characteristic protected by law.

PLEASE PRINT

NAME (Last)	(First)	(Middle)
ADDRESS (Street)	(City)	(Zip)
(Home Phone)	(Message Phones)	

If hired, can you show proof of legal authorization to work in the United States? ____Yes ____No

Are you at least 18 years of age? ____Yes ____No

If under 18 years of age, can you produce a work permit upon hire? ____Yes ____No

If you are hired, when can you begin work? _____

The hours for this job are regularly 8:00 A.M. to 5:00 P.M., Monday through Friday. Are you able to comply with this job's attendance schedule? ____Yes ____No

Have you had any convictions as an adult? A conviction will not necessarily disqualify you from employment. ____Yes ____No

---

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EDUCATION: Do not complete the EDUCATION section unless this box is checked: ☐

	SCHOOL	NUMBER OF YEARS ATTENDED	DEGREE	MAJOR
HIGH				
COLLEGE				
OTHER				

EMPLOYMENT RECORD: Please account for all time over the past ten years, listing the most recent job first. Use the back of this page if additional space is necessary.

DATE OF EMPLOYMENT (Month/Year)	NAME/ADDRESS OF EMPLOYER AND NAME OF SUPERVISOR	JOB TITLE AND RESPONSIBILITY	REASON FOR LEAVING
From _____ To _____ Phone _____	1.		
From _____ To _____ Phone _____	2.		
From _____ To _____ Phone _____	3.		
From _____ To _____ Phone _____	4.		
From _____ To _____ Phone _____	5.		

Please indicate by number the employers we may NOT contact: _____

And the reason: _____

_____

_____

List special training, certificates, or licenses you have relative to the job for which you are applying: _____

_____

_____

List any job-related professional associations in which you participate. DO NOT INCLUDE ANY ASSOCIATIONS THAT WOULD IDENTIFY AGE, RACE, COLOR, SEX, NATIONAL ORIGIN, CITIZENSHIP, RELIGION, VETERAN'S STATUS, OR DISABILITIES: _____

_____

_____

PLEASE READ ALL OF THE FOLLOWING BEFORE SIGNING

I certify that the information shown on this application is correct and complete to the best of my knowledge, and that I have not knowingly withheld any fact or circumstance. I understand that falsifying or omitting information on this form may cause me to be disqualified from further consideration or dismissed from employment if hired.

All employment offers are made contingent upon satisfactory proof of legal authorization to work in the United States according to the law. I understand that failure to provide satisfactory proof of identity and authorization to work in the United States will disqualify me from employment.

I understand that, if hired, my status will be that of an employee at will, with no contractual right, express or implied, to remain employed. In consideration of my employment, I specifically agree that my employment may be terminated, with or without cause or notice, at any time, at the option of either the employer or myself. I understand that no one, other than the President of the Company, in writing, may enter any agreement for employment on my behalf or make any agreement contrary to the foregoing.

I understand that, if hired, I may be required to undergo a physical examination and drug and alcohol screening test either: If I should become involved in an accident while on duty, on company premises, on job sites, or in a company vehicle; or if a reasonable suspicion of drug or alcohol use exists based on my performance, appearance, and/or behavior. The examination and the test will be performed at the employer's expense, by the employer's choice of physician.

I authorize the employer to investigate, confirm, and supplement any information contained on this application and to contact former employers unless otherwise stated.

Applicant Signature: _____

Date: _____

APPENDIX 6: Standard Interview Questions Form

INTERVIEW QUESTIONS

Instructions: A firm may use this form to list the interview questions that all candidates will be uniformly asked. This form promotes, and documents the consistent treatment of all candidates. One copy of this form should be kept in the job search file.

Candidate: _____ Date: _____ Job: _____

Interviewer: _____

REQUIREMENT	QUESTIONS AND NOTES
_____	1. _____
_____	2. _____
_____	3. _____
_____	4. _____
_____	5. _____
_____	6. _____
_____	7. _____
_____	8. _____
_____	9. _____
_____	10. _____

APPENDIX 7: Interview Rating Reports

INTERVIEW REPORT FORM

Applicant _____ **Interviewer** _____

Date _____ **For Position** _____

Initial Impression	Favorable 1 2 3 4 5 Unfavorable
Appearance	
Manner	
Self-expression	
Responsiveness	

Work Experience	Favorable 1 2 3 4 5 Unfavorable
Relevance of work	
Sufficiency of work	
Skill and competence	
Adaptability	
Productivity	
Motivation	
Interpersonal relations	
Leadership	
Growth and development	

Education	Favorable 1 2 3 4 5 Unfavorable
Relevance of schooling	
Sufficiency of schooling	
Intellectual abilities	
Versatility	
Breadth and depth of knowledge	
Level of accomplishment	
Motivation, interests	
Reaction to authority	
Leadership	
Teamwork	

Early Years (Optional)	Favorable 1 2 3 4 5 Unfavorable
Socio-economic status Parental examples Attitudes toward achievement, work and people Emotional and social adjustment Basic values and goals Self-image	

Present Activities and Interests	Favorable 1 2 3 4 5 Unfavorable
Vitality Management of time, energy and money Maturity and judgment Intellectual growth Cultural breadth Diversity of interests Social interests Social skills Leadership Basic values and goals	

Summary **Plus (+) and Minus (–)**	**STRENGTHS**	**WEAKNESSES**
Talents, skills Knowledge Energy Motivation Interests Personal qualities Social effectiveness Character Situational factors		

Overall Summary and Recommendations	Favorable 1 2 3 4 5 Unfavorable

INTERVIEWER'S EVALUATION

Candidate name: _____ Position applied for: _____

1. Job Knowledge: How knowledgeable is the candidate about basic components of the job?

   __Very knowledgeable __Has basic job knowledge
   __Requires special training __Insufficient knowledge to succeed

   Comments: _____

   _____

2. Education: Has the candidate completed necessary educational requirements for the position?

   __Yes __No __Is currently attending school

   Comments: _____

   _____

3. Prior Work History: Has there been evidence of successful work assignments?

   __Yes __No

   Comments: _____

   _____

4. Goal Orientation:
   a. Evaluate the candidate's basic drive to succeed. Consider whether this position will satisfy his/her need for job satisfaction, or will the candidate become dissatisfied quickly?

      __Excellent __Very Good

      Comments: _____

      _____

   b. Consider what the candidate has done to prepare himself/herself for a career in this area.

      __Excellent preparation (education & experience)
      __Good preparation (education & experience)
      __No preparation for this position

      Comments: _____

      _____

5. Considering the minimum qualifications necessary to do this job, is the candidate qualified for this position?

   __Yes __No

   To what extent?

   __Minimally __Moderately __Extremely __Not at all

   Comments: _____

   _____

6. Recommendation:

   __Hire __Reject __Hold

   Why? _____

   _____

   _____

Signature: _____ Date: _____

APPENDIX 8: Reference Check

TELEPHONE REFERENCE CHECK FORM

Applicant's name: _____

Reference name: _____

Position: _____ Company: _____

Date called: _____ Dates of employment: from _____ to _____

Starting position: _____ Last position: _____

Starting salary: _____ Ending salary: _____

Duties of last position: _____

Ask each reference to rank the prospective employee on a scale of 1 to 10 in each category:

_____

Technical ability: _____

Motivation/Attitude: _____

Ability to work with others (if relevant to position): _____

Attendance Record

Tardiness: _____ Absenteeism: _____

Reason for leaving: _____

Would you rehire? _____ Explain: _____

_____

Greatest strength: _____

_____

Greatest weakness: _____

_____

Other pertinent information/comments: _____

_____

_____

Reference checked by: _____

APPENDIX 9: Job Offers and Rejections

SAMPLE JOB OFFER LETTER

Date

Dear _____,

I enjoyed our phone conversation and reiterate that we are impressed with your background. I'd like to take this opportunity to offer you a position as an _____ at *Name of Company* at a starting annualized salary of $_____. We will review that salary consistent with our Firm-wide salary range change effective July 1, 19____, to ensure internal equity and external competitiveness.

Name of Company is proud of the service we offer our clients and we feel that this is a direct reflection on our staff. We feel that you would make a significant contribution as a member of our team.

As for benefits, the policy administration, and the day-to-day operating procedures, I can go into these in much more detail when you have time. I will be available to answer any questions you may have.

For our mutual benefit, we would like you to begin employment on _____. However, if our workload demands an earlier start date, we'll be in touch to see how your schedule could possibly accommodate such.

I would appreciate hearing from you at your earliest convenience as to the acceptability of our terms.

Sincerely,

NAME OF COMPANY
A Professional Association
Certified Public Accountants

Name
Director of Administration

SAMPLE REJECTION LETTER

Date

Dear _____,

Our selection process for the _____ position has been completed.

We received many resumes and after careful evaluation of the many qualified candidates, we have selected an individual who, in our judgment, meets the current and projected needs of our accounting firm. This is by no means a negative reflection on your fine achievements as we spoke of in the interview. Rather, it speaks to our current and future needs.

I appreciated the time you spent with me, and I wish you every success in your search for a challenging career opportunity and express my sincere appreciation for your interest in *Name of Company.*

Sincerely,

NAME OF COMPANY
A Professional Association
Certified Public Accountants

Name
Director of Administration

APPENDIX 10: Orientation Checklist

NEW EMPLOYEE ORIENTATION CHECKLIST

Name _____ Position _____

Address _____

Person to contact in case of emergency _____

Phone _____

Date of Birth _____

Date _____ Orientation done by _____

__ Full-time __ Part-time __ Temporary Date employed _____

SS# _____

A. Supply employment forms and materials

___ Tax forms (federal, state, etc.)
___ Independence questionnaire (refer to Sec. 8, pages 810:1–810:18 of Personnel Manual)
___ Assign Employee Number ( )
___ Verify that the following is in new associate personnel file: application form, transcripts (if any), resume, reference letter/reference check(s), office interview forms (if any) and correspondence (if any).

B. Employee benefits (explain and issue brochures and applications)

___ Group disability
___ Group life insurance
___ Group medical insurance
___ Cafeteria plan
___ 401(k)

C. Issue personnel manual and explain

___ Office hours
___ Payroll procedures
___ Vacation, personal time, disability and sick policy
___ Travel reimbursement policy
___ Meal reimbursement policy
___ Staff evaluation policy
___ Time and expense reporting policy
___ Scheduling procedures
___ Telephone procedures (long distance calls)
___ Mailing procedures
___ File room procedures
___ Library and periodicals
___ Supplies

D. Firm membership policies

___ AICPA and state society memberships
___ Other civic organizations

E. Education policy

___ CPA exam policies
___ Responsibility of a professional to keep knowledge current (state law and firm policy)
___ Review CPE timekeeping responsibilities (firm and individual)

F. Miscellaneous items

___ Confidential nature of client affairs
___ Policy on outside work
___ Firm social activities
___ Organizational structure (organization chart)

G. Introduction to office

___ Tour of office
___ Lunchroom
___ Introduction to partners/associates
___ Show where to obtain supplies
___ Show libraries and briefly explain usage and available publications

H. Notify the following departments of employment

___ Administrative manager
___ Data processing manager

I. New employee package

___ Accounting and auditing manual (if applicable)
___ Audit staff reference manual (if applicable)
___ Personnel manual to read
___ Quality control procedures manual (if applicable)
___ Master tax guide (if applicable)
___ Accounting standards—current text
___ Office floor plan
___ Insurance forms
___ Database information
___ Employment agreement
___ Personnel manual signature page

APPENDIX 11: Job Description Outline

JOB DESCRIPTION OUTLINE

Instructions: The Company may use this form as an outline when preparing job descriptions.

Job Title: _____
Department: _____
Reports to: _____
Supervises: _____
Salary Range: _____

FLSA exempt/nonexempt status (attach support for exemption): ____

Primary Purpose of the Job: _____
_____
_____

Essential duties of the job, frequency, and percentage of time on the job:

	%		%
1 _____	/ _____	2 _____	/ _____
3 _____	/ _____	4 _____	/ _____
5 _____	/ _____	6 _____	/ _____

Non-essential duties of the job, their frequency, and percentage of time on the job:

	%		%
1 _____	/ _____	2 _____	/ _____
3 _____	/ _____	4 _____	/ _____
5 _____	/ _____	6 _____	/ _____

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Required Skills, Abilities, Licenses, Knowledge, or Experience: _____

_____

Working Conditions of the Job: _____

_____

Safety Hazards of the Job: _____

_____

Prepared by: _____ Date: _____
Reviewed by: _____ Date: _____
Approved by: _____ Date: _____

Justification of Jobs

After identifying the job tasks and requirements, the business has an opportunity to rethink the reason for the job's existence. Competitive businesses are constantly examining the rationale behind their jobs.

A job justification can consist of two parts:

- Examining the financial or business reasons to establish or maintain a job.
- Stating succinctly the job's essential purpose, its basic reason for existence.

The end of the job description process is an effective time to examine a job's justification because not until then does the business have updated descriptions of the jobs tasks and requirements.

Typically, job justification is done, if ever, during business "downsizings," rapid growth, or restructurings. However, when vacancies in jobs occur, businesses should conduct a job justification. The business also should examine jobs on a period schedule (say, every two years) to consider how new technologies and work arrangements could benefit the company.

Reasons to Establish or Continue a Job

No objective score "proves" a job is or is not justified. Many justifications are intangible, so the decision to add another job isn't just a matter of dollars and cents. While subjective, this process is still useful.

The creation or continuation of most jobs is justified by a combination of two reasons:

- Strategic business needs. Strategic business needs are pervasive business objectives, as determined by management. Strategic business needs often are less connected to the job's specific actions than to the job's consequences for the firm's levels of performance, working conditions, and competitive standing. For example, one firm may justify internal manufacturing jobs by citing the unacceptable consequences to sales from shortages of component parts. Another may feel that security over its mailing list justifies hiring workers to maintain it, rather than contracting the work out.
- Financial efficiency. Financial efficiency occurs when money is saved by having an employee perform the work, compared to alternatives. Consequently, the decision maker should know the costs of both the worker and the alternatives.

The form on the following page may be used to examine the reasons to establish or maintain a job position.

Instructions: The Company may use the following questions to examine the reasons to establish or maintain a job. Employers should answer each of the following questions with specific, supported reasons based upon business strategy or financial efficiency.

Job: _____

Preparer's Name: _____ Date: _____

QUESTION	JUSTIFICATION
1. Why can't the work just remain undone, or as currently handled?	
2. Why can't the work be performed by changing existing procedures or forms, or by delegating authority?	
3. Why can't the work be performed by using technological improvements?	
4. Why can't the work be performed by other companies or individuals outside the company?	
5. Why can't the work be assigned to existing employees in that area?	
6. Why can't the work be assigned to existing employees in other departments who either precede or follow in the work flow?	
7. Why can't temporary employees perform the work?	
8. Why can't employees working part-time, on flexible hours, or at home perform the work?	

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APPENDIX 12: Predischarge Checklist

Instructions: The Company may use this form as a checklist to help the business assess its documentation and defense in anticipation of a contemplated discharge. "No" answers indicate an area of potential weakness that may require discussion with an experienced employment trial attorney. The Company may record additional explanations in the "Comment" column.

Employee Name: _____ Job Position Held: _____

Reason Discharge Contemplated: _____

Prepared by: _____ Date: _____

QUESTION	YES	NO	COMMENTS
1. Did the employee sign an agreement that employment was at will?			
2. Has the business avoided any written, oral, or implied representations limiting employment at will?			
3. Was the relevant rule or performance standard documented before the fact?			
4. Does the documentation show that the worker knew, or should have known, the rule or performance standard?			
5. Can the business necessity for the rule be easily explained?			
6. Did the employee have adequate opportunities to state a case before any decisions or actions were taken?			
7. Was the employee's point of view put in writing?			
8. Were employee's comments and other evidence reviewed by an impartial party?			
9. Does the business have more than a vague suspicion of misconduct or poor performance?			
10. Were warnings, counseling, or training given before termination, and were those actions documented?			
11. Do personnel evaluations support the business's conclusion?			
12. Was the employee given sufficient time and opportunity to improve?			

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QUESTION	YES	NO	COMMENTS
13. Did the employer meet all the employee's reasonable requests for assistance or accommodation?			
14. Has a neutral manager reviewed the personnel file and decided that discharge is appropriate?			
15. After reviewing the personnel file, will a reasonable person conclude the employee's action is either part of a pattern or a willful and deliberate act?			
16. Was treatment of the employee consistent with company policies?			
17. Was treatment consistent with previous similar cases?			
18. Can the business demonstrate that neither discrimination, harassment, nor retribution has occurred?			
19. Can the business defend against a breach of contract, fraud, or invasion of privacy claim?			
20. Has the business complied with all internal procedures for managing the situation?			
21. Can the employer state the reasons for its decision in writing?			
22. Is the discharge timely in relation to the employee's actions?			
23. Should the business proceed with the termination without discussing the case with labor counsel?			

APPENDIX 13: Exit Interview Form (Long Form)

Instructions: Each employee, regardless of reason for termination, should have an exit interview with at least two employer representatives, usually the manager assigned personnel responsibilities and one other manager outside the employee's direct chain of command. The employer should complete Part I of this form, which should then be shown to the employee during the interview. The employee should complete Part II of this form.

Employee Name: _____ SS# _____

Last Job Title: _____ Last Salary: _____

Hire Date: _____ Termination Date: _____

Part I
To Be Completed by the Employer

1. Separation was initiated by: _____ Employee
   _____ Employer; Person's Name and Title _____
2. Reason for the separation: _____
3. Amount of final wages due: $_____ for period _____ to _____
4. Amount of vacation benefits due: $_____ for _____ hours
5. Amount of sick time benefits due: $_____ for _____ hours
6. Other benefits due: $_____ for _____
   $_____ for _____
7. If employee elects continued group health coverage:
   Employee will pay $_____ by the _____ of each month, for self
   Employee will pay $_____ by the _____ of each month, for dependents
8. Does the employee have an outstanding indebtedness with the company? _____
   If so, what are the repayment arrangements? _____
   _____
9. Is the employee in possession of company property? _____
   If so, what property? _____
10. List any other separation arrangements. _____
    _____

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Part II
To Be Completed by the Employee

1. Have you read, and do you understand, Part I of this form? _____
2. If you disagree with Part I of this form, please state why: _____
   _____
3. Please state the reason for the termination or resignation: _____
   _____
4. Do you have another job? _____
5. What information may we *not* tell the inquiring employers? _____
6. What did you like best about working for the company? _____
   _____
   What did you like least? _____
7. Do you intend to reapply for employment with this company? _____
8. Please rate the following as excellent, good, average, fair or poor:
   Quality of professional services offered by our firm _____
   Professional competence of staff and partners _____
   Opportunities for advancement _____
   Professional training and development _____
   Compensation and fringe benefits _____
9. Do you feel that you were treated fairly? _____
   Explain: _____
10. What can we do to help make your transition easier? _____
11. What is your current address and telephone number? _____
12. What should be done with mail and telephone calls? _____

Signed: Employee: _____ Date: _____

Employer: _____ Date: _____

Witness: _____ Date: _____

APPENDIX 14: Separation Interview Checklist

☐ **Final paycheck.** Prepare final paycheck and give to employee. Include accrued overtime, vacation pay, other fringe benefits, if applicable. Issue separate checks for pension plan and profit-sharing plan distributions.

☐ **W-2 wage statement.** Prepare W-2 and give to employee, if requested.

☐ **Group insurance.** Inform employee of conversion privileges, costs, and time limits involved. Supply necessary forms for conversion.

☐ **COBRA documents.** Provide departing employees with a statement of their rights under COBRA and a form to continue or waive their rights to insurance coverage.

☐ **Forwarding address.** Get a permanent forwarding address. Get new employer's name, address, and telephone number, if possible. Instruct receptionist and mailroom on how to handle calls and mail.

☐ **Firm property.** Ask the employee to return office keys, equipment keys, membership cards, briefcase, calculator and carrying case, computer and software, audit bags, personnel guide, audit guide, accounting and tax manuals, other firm property.

☐ **Timesheet.** Make sure all client work is recorded through the time of termination.

☐ **Passwords.** Change computer passwords to files containing sensitive information if the employee had access to them.

☐ **Telephone credit cards and access codes.** Cancel the employee's telephone company credit card number. If employee had access to a long-distance service, such as MCI or Sprint, change access code number. Cancel access codes to photocopy, fax, or computer network equipment.

☐ **Directories, stationery, agreements.** Remove the employee's name from employee lists, stationery, scheduling records, payroll, building directory, white and yellow pages listings, and from bank accounts and wire transfer agreements.

☐ **Desk.** Have the employee clean out desk and take personal belongings.

☐ **Parking space.** Remove employee's name from reserved parking space and reassign.

☐ **Personnel file.** Update all personnel records to date of termination. Attach copy of written resignation or documentation of steps leading to discharge.

☐ **References.** Employer and employee should agree on topics that may be discussed with references. Was a signed consent obtained for any references?

APPENDIX 15: Termination Checklist

NAME: _____ DATE: _____

RETURN OF: Audit & Accounting Manual	_____
Personnel Manual	_____
RETURN OF: Dictation Equipment	_____
Office and Desk Keys	_____
Briefcase	_____
Adding Machine or Calculator	_____
Portable PC	_____
Parking Card	_____
Name Plate	_____
Telephone Credit Card	_____
FINAL TIMESHEET AND EXPENSE REPORT (Enter Before Employee Leaves)	_____
HEALTH INSURANCE CONTINUATION (Original Form Mailed to Home)	_____
LIFE INSURANCE CONTINUATION (Original Form Mailed to Home)	_____
DISABILITY INSURANCE CONTINUATION (Original Form Mailed to Home)	_____
CAFETERIA PLAN REIMBURSEMENT INFORMATION (Original Form Mailed to Home)	_____
PROFIT SHARING AND 401(k) (Distribution Information Mailed to Home)	_____

REVIEW OF FINAL PAY ARRANGEMENTS:

START DATE xx-xx-xx
ANNUAL SALARY $ 00,000

Regular Pay	0.00 Hours	Through xx-xx	$ 0,000.00 Gross
Overtime Pay	0.00 Hours	Through xx-xx	$ 0.00 Gross
PTO Benefits	0.00 Hours		$ 0.00 Gross
Severance Pay	0.00 Hours		$ 0.00 Gross
			$ 0,000.00 Gross

Check xxxxxx; Net $ 0.00
DIRECT DEPOSIT/
CHECK ENCLOSED

Overtime Recap Week Ending:	
00-00-00	0.00 Hours
00-00-00	0.00 Hours
TOTAL	0.00 Hours

Forwarding Address:

_____

_____

_____

Phone: _____

SIGNATURES:

_____ _____
Employee Date

_____ _____
Employer Representative Date

SECURITIES REGULATION

1. INTRODUCTION

1.1 Purpose

Originally intended to protect investors by assuring that they were provided with the information necessary to make informed investment decisions, securities regulation in the United States has expanded to encompass:

— Offerings of securities in both original issuances and as secondary distributions

— The information a prospective investor is entitled to receive

— The information an investor is entitled to receive periodically and when significant events happen

— Trading in securities

— Securities exchanges

— Self-regulatory institutions active in securities matters

— Proxy solicitation

— Investment advisers and investment newsletters

— Broker-dealers

— Insider trading and trading by any person who has inside information

— Fraudulent and manipulative use of financial statements in the buying or selling of securities

1.2 Scope

In the United States, far-reaching power to regulate issuance of and trading in securities is given to a federal agency, the Securities and Exchange Commission (SEC). The SEC not only administers the statutory provisions of the federal securities acts but also wields considerable power through the rule-making prerogatives delegated to it. The federal securities acts are these:

— *The Securities Act of 1933*, which requires registration with the SEC of publicly offered securities. The act contains antifraud provisions that apply to accountants and other persons involved with the process of registration.

— *The Securities Exchange Act of 1934*, which requires registration of securities prior to their trading on an exchange as well as of certain

over-the-counter securities in which there is a significant trading interest. The act also regulates broker-dealers, the national securities exchanges, and associations of securities dealers. Its antifraud provisions apply to persons, such as accountants, involved in securities transactions carried out by use of the mail, telephones, or any instrumentality of interstate commerce.

— *The Trust Indenture Act of 1939*, which requires that an independent trustee be appointed for publicly offered debt securities.

— *The Investment Company Act of 1940*, which requires the registration of investment companies. Their financial statements must be audited by independent accountants.

— *The Investment Advisers Act of 1940*, which requires registration with the SEC of persons deemed to be investment advisers, including accountants in some cases.

Significant attention is devoted in this chapter to the three securities acts of greatest importance to accountants and to two other federal laws with potential impact on accountants:

— The Securities Act of 1933 (cited as the 1933 act)

— The Securities Exchange Act of 1934 (the 1934 act)

— The Investment Advisers Act (the Advisers act)

— The Foreign Corrupt Practices Act (FCPA)

— The Racketeer Influenced and Corrupt Organizations Act (RICO)

All state jurisdictions and Puerto Rico (but not the District of Columbia) require in some form the registration of securities. An official, whose title varies among the jurisdictions, is designated to administer these laws. Some uniformity in state law has been achieved through the adoption of major portions of the Uniform Securities Act by thirty-one jurisdictions.

2. DEFINITIONS

The following terms appear within the context of this chapter.

Accountant. The federal securities acts refer throughout to *independent public accountant*, a person who—by SEC policy—is almost always a certified public accountant.

Accounting and Auditing Enforcement Release (AAER). Since 1982, the AAERs have been the means by which the SEC announces

enforcement actions against accountants, as well as corporate officers and others.

Accounting Series Release (ASR). Accounting Series Releases were used until 1982 by the Securities and Exchange Commission to communicate matters of interest to members of the accounting community. They included matters as diverse as interpretations concerning SEC Regulation S-X and notification of disciplinary action against accountants. They were replaced by two new series: Financial Reporting Releases and Accounting and Auditing Enforcement Releases. In 1982, portions of the previously issued ASRs that retained relevance were reissued in the SEC's Codification of Financial Reporting Policies.

Accredited investor. An accredited investor is one for whom the disclosure requirements associated with registration are unnecessary in most circumstances. Because of their bargaining power and their assumed ability to access information on their own, accredited investors are expected not to need the protection afforded by the registration process. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions of Securities and Exchange Commission (SEC) Rules 505 and 506 and Section 4(6) of the 1933 act. (See section 4.5.1 of this chapter.)

Blue sky laws. State laws dealing with the regulation of securities are known as blue sky laws, a phrase that originated more than fifty years ago in a judicial comment denouncing speculative schemes that were no more tangible than "so many feet of blue sky." In this chapter *blue sky law* will be used interchangeably with *state law* to refer to the applicable laws at the state level that govern issuance and trading of securities.

Certification. In SEC-related matters, it is common to refer to the independent auditor's report as a certification and to say that the auditor has certified the statements. In other contexts, accountants themselves generally avoid these terms on the grounds that they connote too strong an endorsement of accuracy. SEC Regulation S-X defines *certified* as "examined and reported upon with an opinion expressed by an independent public or certified public accountant."

Comfort letter. The contract between a securities issuer and its underwriter commonly requires that the issuer's independent accountant provide a comfort letter to the underwriter. Underwriters request comfort letters not only to acquire information but also to show their reliance on the auditors as part of the underwriter's due diligence examination. Comfort letters are not required by the SEC or by any of the securities acts. Standards to be followed for the accountant's review

that culminates in the comfort letter are expressed in Statement on Auditing Standards No. 72, *Letters for Underwriters and Certain Other Requesting Parties,* as amended by Statement on Auditing Standards Nos. 76 and 86 (AICPA, *Professional Standards,* vol. 1, AU sec. 634).

Due diligence. Section 11(b) of the 1933 act provides a defense for public accountants and others who are charged in a civil action on account of a false registration statement. This due-diligence defense provides that no person shall be liable who shall sustain the burden of proof "that he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true. . . ." The standard for determining reasonableness is that of a prudent person in the management of his or her own property.

Electronic Data Gathering and Retrieval System (EDGAR). In its efforts to improve its review process, provide greater dissemination of information and make the filing process more efficient for filers, the SEC in 1993 began mandating electronic filing for certain filers. Additional filers were phased in on roughly a quarterly basis through 1996, after which time all filings were required to be made electronically. Generally, Form 10-K, 10-KSB, 10-Q, 10-QSB, 8-K, all registration statements, and various international filings of domestic registrants are required to be filed electronically. Effective January 1, 1998, the SEC no longer accepts paper filings that are required to be submitted electronically (unless the registrant has requested and received a hardship exemption). The general rules and regulations for electronic filings are contained in Regulation S-T.

Financial Accounting Standards Board (FASB). The board issues releases known as Statements of Financial Accounting Standards (SFAS) and interpretations thereof, both often referred to simply as FASBs. These pronouncements have explicitly been recognized by the SEC as constituting generally accepted accounting principles. In other words, financial statements submitted in filings to the SEC are expected to conform to the FASBs and to the SEC's accounting rules expressed in Regulation S-X.

Financial Reporting Releases (FRR). FRRs have replaced Accounting Series Releases as the means by which the SEC communicates its views on accounting and auditing matters that need special treatment in financial statements filed with the commission.

Foreign Corrupt Practices Act (FCPA). The FCPA prohibits payments or offerings, by companies required to report to the SEC, of "anything of value" to foreign officials, political parties, or candidates

for the purpose of influencing decisions of the foreign government. In order to facilitate the detection of illegal payments, the act requires that all companies reporting to the SEC keep their accounting records in reasonable detail and also mandates that they maintain an adequate system of internal accounting controls.

Independent public accountant. Accountants who, as auditors, provide reports on clients' financial statements that are filed with the SEC are held to a high standard of independence. The SEC looks in the first instance to whether a relationship or the provision of a service does one of the following:

- Creates a mutual or conflicting interest between the accountant and the audit client
- Places the accountant in the position of auditing his or her own work
- Results in the accountant acting as management or an employee of the audit client
- Places the accountant in a position of being an advocate for the audit client

They violate the rules of the SEC if they—

- Have any direct or material indirect financial interest in the enterprise whose statements they audit.
- Are connected with the enterprise as promoter, underwriter, voting trustee, director, officer, or employee.
- Post journal entries or perform *any* bookkeeping, accounting, or controllership functions.

These rules apply to

- All partners, shareholders, and other principals of the firm.
- Any professional employee providing any professional service to the client, its parent, subsidiary, or other affiliate.
- Any professional employee having managerial responsibilities and located in the engagement office or other office of the firm that participates in a significant portion of the audit.

These are further examples of employment relationships that impair an auditor's independence:

- A current partner of an accounting firm serves as a member of the board of directors of the audit client.
- A sibling of a covered person is employed by an audit client as the director of internal audit.

- A former professional employee of an accounting firm who resigned from the accounting firm two years ago is employed by an audit client in an accounting role and the former employee receives a pension from the firm tied to the firm's revenues or profits.
- A former partner of an accounting firm accepts the position of chief accounting officer at an audit client, and the former partner continues to maintain a capital balance with the accounting firm.
- A former director of an audit client becomes a partner of the accounting firm, and that individual participates in the audit of the financial statements of the audit client for a period during which he or she was a director of the audit client.

In 1998 the SEC created the Independence Standards Board to assist in addressing issues related to auditor independence and granted it authority to set independence standards.

A company filing financial statements with the SEC must report on Form 8-K within five business days of a change in independent accountants. No later than the date of filing with the SEC, the company must provide a copy of the 8-K form to the former accountants who must file a letter indicating agreement or disagreement with the company's report [Item 304, SEC Reg. S-K]. The company must also report whether, during the two most recent fiscal years, there were disagreements with the former accountant on a matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, if that disagreement would have caused the former accountant to make reference to the matter of the disagreement in connection with the accountant's audit report. The AICPA's practice section has adopted a requirement that member firms directly notify the SEC within five business days by copy of a letter to the former client, confirming the date that the accountant resigned, declined to stand for re-election, or was dismissed.

Insider trading. Insider trading is trading and profiting while in the possession of information unavailable to the public, referred to in SEC rules as *material, nonpublic information.* Under Section 16(b) of the 1934 act, an *insider* who purchases and sells or sells and then purchases, within a six-month period, equity securities of a company that has a class of equity securities registered under the act will incur a liability to the corporation for any profit realized.

The SEC and the courts view the term "insider" as including a broader group than directors and officers of a corporation. Others, such as lawyers, accountants, investment bankers, and stock brokers can be considered insiders in certain circumstances. The SEC brings charges when it is satisfied that the following four tests have been met:

— Does exchange surveillance indicate suspicious trading?

— Was the trading based on material, nonpublic information?

— Was the nonpublic information released by someone who had a fiduciary duty or other relationship of trust?

— Did the recipient know (or should he or she have known) that the source of information breached a duty?

SEC acts and regulations provide for sanctions in the form of disgorgement of profits, civil liability to other traders, payment of bounty to informants, and civil and criminal penalties. Independent accountants who, in the course of their professional practice, learn of significant corporate developments such as earnings reports or mergers must not communicate this information to others until *after* the developments are announced to the public. There are no definitive guidelines to determine the length of this waiting period, but the American Stock Exchange has suggested a twenty-four-hour wait after general publication of the release in a national medium or forty-eight hours when publication is less widespread.

Investment contract. See *Securities.*

Letter stock. Stock acquired by a buyer who furnished to the seller a letter stating that the buyer acquired the securities for investment and not with a view to distribution. (See section 4.6, herein, Secondary Transactions.)

Prospectus. Any offer made in writing to sell securities constitutes a prospectus and may fall within SEC jurisdiction (Sec. 2, 1933 act). As ordinarily used, the term refers to the document required by securities law to be provided to prospective buyers of securities that are the subject of a registration statement. It is unlawful to deliver securities subject to registration to a buyer through the mails or otherwise in interstate

(Text continued on page 9)

commerce without sending a prospectus along with them unless the buyer has previously received one. The prospectus must meet specifications of the 1933 act. An offering circular must be provided for filings made under Regulation A. The equivalent document under Regulation D is an abbreviated disclosure document described in Rule 502(b).

Proxy. A proxy allows someone entitled to vote on any corporate matter—for example, through ownership of common stock—to designate another party to be present and to cast the vote. Such matters as the creation of a proxy, its effective period, and means of revocation are ordinarily dealt with under state law. Proxies may be solicited by incumbent management or by some other person. By Section 14(a) of the 1934 act the SEC regulates the solicitation of proxies directed to more than ten people.

Annual reports must accompany or precede proxy solicitations, made on behalf of management, that relate to an annual meeting in which directors are to be elected. Copies of this annual report must be mailed to the SEC for its information. Rules of the New York and the American Stock Exchanges and of the National Association of Securities Dealers must be consulted concerning transmittal of proxy material to customers whose stock is held in a broker's or banker's name (street name). See appendix 7 for disclosures required in proxy solicitation.

Proxies may also be solicited for proposals made by a person who is not a member of management. The SEC's Rule 14a-8 requires management to include such proposals along with their own proxy solicitation materials, subject to compliance with conditions relating to the timeliness, ownership of securities, and the subject of the proposal. The proposal must be made 120 days in advance, by a person owning for at least a year a minimum of one percent or one thousand dollars in market value of the securities to be voted. The subject of the proposal must be, under applicable state law, a proper subject for action by shareholders, not related to ordinary business operations, and not involving the appointment of an officer or election of a director.

Racketeer Influenced and Corrupt Organizations Act (RICO). RICO, intended to protect businesses against organized crime, has turned out to have a particularly broad reach. In the years since it was enacted, however, RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants, including General Motors, American Express, Prudential Insurance, and at least two international public accounting firms. (See section 6, Other Federal Securities-Related Acts, below.)

Red Herring. Essentially a preliminary offering prospectus. Every offer in writing of securities must contain information specified in

Section 10 of the 1934 act. Some of this information may not yet be available when issuers and their underwriters desire to create interest in an upcoming issue that has been filed for registration but is not yet effective. In these circumstances, if a registration statement is on file with the SEC, a preliminary prospectus is authorized. This document includes on its face a legend stating that the registration statement has not become effective and that a formal offer to sell can only be made after the effective date of the registration. Previously, this legend was signed to be printed in red ink, thus the name "red herring." Ordinarily, information about offering price, commissions to dealers, and proceeds accruing to the issuer is excluded from this red herring prospectus. The antifraud provisions of the 1934 act require that brokers or dealers must deliver, at least forty-eight hours prior to the mailing of the sale confirmation, a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale (SEC Rule 15c-2-8).

Registration. Registration is the process of filing with the regulatory authority adequate information about securities and the company that issues them. At the federal level, registration statements are filed with the SEC. The SEC neither approves nor disapproves of the company or its securities; it passes only on the adequacy of the disclosures. State laws may also require registration. Exemptions from state registration are frequently found for companies that report to the SEC—for example, for securities senior to or substantially equivalent to securities already traded on one of the principal stock exchanges. Full registration with the state is usually unnecessary where adequate information is already available. Although registration may not be required, a filing with the state may still be required. Both the 1933 act and the 1934 act deal with federal registration.

Registration by coordination. Most state laws allow registration by coordination—considerably abbreviated state registration (or none at all)—for securities registered in compliance with the federal securities acts.

Regulations and rules. For purposes of organization, many SEC rules are grouped within regulations. For example, Regulation D contains Rules 501 through 508.

Regulation A. Ostensibly, SEC Regulation A provides an exemption from registration for security issues of less than $5 million per year. In fact, notification and disclosure requirements under this regulation make it more in the nature of a miniregistration, less complex and expensive than full registration. Financial statements included in a Regulation A filing generally need not be certified.

Regulation S-B. Regulation S-B was created by the SEC in 1992 to replace Regulation S-X and S-K as the disclosure requirements for a group of small companies, called small business issuers (SBIs). The SEC's hope was that by eliminating certain disclosure requirements and simplifying others, it would reduce the costs small companies incur in raising capital in the public markets and in complying with the periodic reporting requirements of the 1934 act. The qualification of a company as an SBI is based on its compliance with two quantitative tests:

- Annual revenues from continuing operations for the latest completed fiscal year of less than $25 million
- Public float of the company's outstanding securities held by non-affiliates of less than $25 million

Additionally, an SBI must also be a US or Canadian issuer and cannot be an investment company.

Regulation D. SEC Regulation D consists of a series of eight Rules, 501 through 508. Rules 504, 505, and 506 establish three exemptions that replace the exemptions previously available under Rules 146, 240, and 242. Details of these exemptions may be found in section 4.5, Exemptions From Registration.

Regulation S-K. This regulation contains instructions for filing forms under the securities acts of 1933 and 1934. Specifically, Regulation S-K states the requirements applicable to the content of the nonfinancial-statement portions of registration statements filed under the 1933 act and registration statements, annual reports, proxy statements, and "any other documents required to be filed" under the 1934 act.

Regulation S-X. The SEC details its accounting rules—matters of detail and presentation—in Regulation S-X. For example, Article 5 tells accountants to "State separately amounts receivable from (1) customers (trade); (2) related parties; (3) underwriters, promoters, and employees (other than related parties) which arose in other than the ordinary course of business; and (4) others." In the case of substantive accounting matters the SEC expects conformity with generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board. The SEC considers these pronouncements to have "substantial authoritative support." Regulations S-X, S-K, and S-B may be obtained at no charge from the Publications Section, Securities and Exchange Commission, Washington, D.C. 20549.

Restricted securities. According to Rule 144 of the Securities Act, any of the following can be restricted securities:

— Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering

— Securities acquired from the issuer that are subject to the resale limitations of Regulation D

— Securities that are subject to the resale limitations of Regulation D and are acquired in a transaction or chain of transactions not involving any public offering

— Securities that are acquired in a transaction or chain of transactions meeting the requirements of Rule 144A (relating to private resales to institutions)

Subsequent sales of restricted securities will ordinarily require prior filings with the SEC unless an exemption can be found by the seller. (See also section 4.6 on Secondary Transactions and Rule 144, below.)

Scienter. A term frequently used in federal securities litigation, *scienter* roughly connotes guilty intent. It can be contrasted with the lesser degree of culpability called *negligence*, which implies carelessness or fault but no intent or knowledge of a deficiency in financial statements. For public accountants to be liable under the SEC's Rule 10b-5, their scienter must be established; not so for liability under Section 11 of the 1933 securities act, which refers to a *due diligence* defense by an accountant. This defense, in effect, establishes a negligence standard. Whether or not *recklessness* or *reckless disregard of the consequences* will be held by the courts to constitute scienter is as yet unsettled.

Secondary transactions. Subsequent sales by persons who purchase from the issuer of securities are called secondary distributions (or transactions). Proceeds of secondary distributions do not benefit the issuer of the securities. In certain cases, secondary distributions must be registered with the SEC. For example, securities originally issued in an exempt transaction generally must be registered before they are resold publicly. Also, substantial blocks of securities sold by a controlling person must be registered. See also section 4.6 on Secondary Transactions and Rule 144, below.

Securities. Definitions of a security tend toward similarity in the various federal securities acts and the state blue sky laws. Since the securities laws are applicable only if a security is involved, it is imperative to know if a proposed financial transaction involves one. *Security* is defined in the 1933 act to include any

— Note, stock, treasury stock, bond, debenture, or evidence of indebtedness.

— Certificate of interest or participation in any profit-sharing agreement.

— Collateral-trust or preorganization certificate, or subscription.

— Transferable share, investment contract, voting-trust certificate, or certificate of deposit for a security.

— Fractional undivided interest in oil, gas, or other mineral rights.

— Put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities.

— Put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency.

— Any ownership interest or instrument known as a "security."

— Certificate of interest or participation, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing (Section 2(1)).

The term *investment contract,* included in the definition, has been held by the courts to encompass a broad variety of transactions, including investment interests offered for sale in

An orange grove and in other citrus and fruit trees
A condominium to be included in a rental pool
Chinchillas, mink, beavers
Franchises
Gold and silver bullion
Limited partnerships
Rights in oil, gas, and other mineral production
Purchase-money mortgages
Cemetery lots purchased for resale
Self-improvement courses
Whiskey warehouse receipts
Variable annuities and variable life insurance policies, where related to performance of a securities portfolio

Interests as a general partner in a partnership are, in most cases, not securities. The Supreme Court has also held the following, although similar to contracts that have been held to be securities, not to be securities:

— Shares in a nonprofit co-op housing corporation

— Interests in a noncontributory defined benefit pension plan

There have been apparently contradictory decisions among the different federal judicial circuits as to what constitutes a security. The

issue is frequently litigated and no fail-safe test can be applied, particularly by the nonprofessional. Some guidance can be attained by asking whether the proposed transaction contemplates (1) an association of investors in a common enterprise and (2) the realization of profits solely through the efforts of third parties. An affirmative answer to both of these questions almost surely identifies an investment contract and, thus, a security. Whenever a client proposes to solicit funds from others for the purpose of managing or investing these funds to generate earnings or profits, the astute financial adviser will recognize that a security is probably involved and securities law must be considered.

Securities and Exchange Commission (SEC). The SEC was established by the Securities Exchange Act of 1934 to administer the various securities acts. There are regional offices and regional administrators at several locations. (See section 5.2, herein.)

Securities Investor Protection Corporation (SIPC). All broker-dealers registered with the SEC are members of SIPC, a public corporation. SIPC liquidates insolvent broker-dealers and assures payment of their customers' claims up to $500,000 per account (subject to a limit of $100,000 in "free credit balances" or cash).

Shelf registration. In the process known as a shelf registration the registration statement is filed with the SEC but the securities are "put on the shelf"—that is, delayed in their issuance for as long as two years. Shelf registration benefits issuers who wish to choose the most advantageous time for the offering, giving consideration to the effect of interest rate and stock exchange fluctuations. Requirements for shelf registration are spelled out in SEC Rule 415 that, in general, restrict this type of registration to issuers having at least $150 million in voting stock outstanding or who are eligible to use Form S-3.

Small issues. The concept of small issues, particularly in relation to exemptions from federal securities registration, depends on context and does not have a definite quantification. The threshold amounts designated for exemption from registration under certain conditions are these:

— SEC Rule 504: $1 million.

— SEC Rule 505: $5 million.

— SEC Rule 506: no dollar limit if sales are to sophisticated and accredited investors.

— SEC Regulation A, which provides for simplified registration when the amount of securities offered is not over $5 million.

— The intrastate exemption (Section 3(a)(11) and Rule 147) tends to result in relatively smaller offerings.

Staff Accounting Bulletins. Staff Accounting Bulletins (SABs) are interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant. SABs are not SEC rules; instead, they are a means of documenting the SEC staff's views on certain matters relating to accounting and disclosure practices. A SAB usually deals with a specific question posed to the SEC relating to a specific situation. However, the staff has indicated that the guidance included in the SABs should be applied in all similar cases.

Staff Legal Bulletins. First published in 1997, Staff Legal Bulletins generally provide guidance on applying rules and regulations and information required in submitting requests for allowable exceptions to the regulations. Similar to SABs, they reflect the views of the SEC staff, but are not rules or regulations.

Tender offer. Although not defined in the securities acts, tender offer refers to an offer to buy, ordinarily, a significant portion of the shares of a corporation. The Williams Act added to the 1934 Act Sections 13(d), 13(e), 14(d), 14(e), and 14(f) dealing with tender offers. According to Section 13(d), any entity or individual acquiring directly or indirectly more than a 5 percent beneficial interest in an equity security must file a notification with the SEC, whether the interest is acquired by tender offer or otherwise. The term *takeover offer* more clearly specifies that control of the target corporation is desired. Any person planning such an offer for registered securities must file with the SEC, prior to the tender, copies of all advertisements and other documents to be used in the solicitation. Persons opposed to the tender must file their responses.

The SEC has suggested that the following characterize a tender offer.

— Public shareholders are actively and widely solicited.

— A substantial percentage of the issuer's stock is involved.

— The offer to purchase is made at a premium over the prevailing market price.

— The terms of the offer are firm rather than negotiable.

— The offer is contingent on a fixed number of shares, often a fixed maximum number of shares to be purchased.

— The offer is open for a limited period of time.

— The offeree is pressured to sell his stock.

— Public announcements are made of a purchasing program concerning the target company preceding or accompanying rapid accumulation of large amounts of the target's securities.

Tombstone ads. Black borders are sometimes placed around the brief advertisements authorized by SEC Rule 134. The borders and the brevity of the ads have caused them to be labeled "tombstone ads." Often they do not appear until after the effective date of the registration and sometimes after the issue is sold out. In that case they serve as testimony of the effectiveness of the underwriter in putting the issue to rest.

Underwriter. In the typical arrangement for distribution of newly issued securities, an investment banker will undertake the task of coordinating the distribution. He or she may organize a group or syndicate of underwriters to assist in the task. The underwriter may contract to take the issue for resale at his or her own risk (firm underwriting) or may promise only to use his or her best efforts. (See also section 4.2 on the Process of Registration, herein.)

3. FEDERAL SECURITIES REGULATION: OVERVIEW

The Securities and Exchange Commission (SEC) administers the five federal securities acts. The commission's principal office is in Washington, D.C., and there are five regional and six district offices. The

(Text continued on page 15)

SEC has considerable rule-making authority, which it has frequently exercised to expand upon or clarify the securities acts. Generally, the staff of the SEC has taken an expansive posture toward its role in the administration of securities law.

Distribution to the public of securities not previously traded is regulated by the Securities Act of 1933. This act together with the rules of the Securities and Exchange Commission, specifies the disclosures necessary to register a proposed new issue of securities. Unless exempted, registration is necessary to avoid penalties provided by the act. This act also regulates both the use of prospectuses and fraud in connection with public offerings of securities.

The Securities Exchange Act of 1934 requires the registration of both securities prior to listing and trading on a stock exchange and over-the-counter securities in which there is significant trading interest. Under this act there are continuing requirements to disclose significant corporate developments. This act also requires broker-dealers, national securities exchanges, and associations of securities dealers such as the National Association of Securities Dealers (NASD) to register with the Securities and Exchange Commission. It also regulates fraud in connection with the purchase and sale of securities and generally provides the mechanism with which the SEC oversees trading in securities.

The Trust Indenture Act of 1939 concerns public offerings of debt securities, for which it requires the establishment of independent trustees pursuant to trust agreements called indentures.

The Investment Company Act of 1940 requires registration of investment companies such as mutual funds and imposes conditions relating to their operation.

The Investment Advisers Act of 1940 requires registration of investment advisers who have more than fourteen clients unless their activities are exclusively intrastate.

Of particular interest to accountants will be the 1933 and 1934 securities acts and the Investment Advisers Act. These will be discussed in detail below.

4. THE SECURITIES ACT OF 1933

4.1 The Purpose of Registration Under the 1933 Act

Registration of a new issue of securities with the SEC provides potential investors with a source of information about their investment. The 1933

act provides for civil and criminal penalties to discourage misrepresentation in connection with offerings of securities. The role of the Securities and Exchange Commission is to oversee the process of registration, essentially to determine if the registration documents are complete, without passing in any way upon the suitability or safety of the investment. Purchasers of securities who have scrutinized the mandated registration documents may be foolish in their investment, but they will not have been misinformed—at least, that is the intent of the 1933 act.

4.2 The Process of Registration

When securities are offered to the public by the issuer, registration is ordinarily required—which means the federal securities acts and the rules and regulations of the Securities and Exchange Commission must be complied with. It is unlawful to use the instrumentalities of interstate commerce (including telephone and mail) to sell unregistered securities. State securities laws must also be consulted. The decision by a closely held corporation to go public is not one to be undertaken without detailed consideration of the pros and cons. Expansion of the sources of capital and national, or at least regional, recognition are partially offset by the expense of the registration process and the ongoing complexity of continuous reporting, coupled with the partial relinquishment of control to outsiders. Clients considering the desirability of going public can consult for advice:

— Commercial bankers
— Certified public accountants
— Stockbrokers
— Investment bankers
— Registered investment advisors
— Attorneys, particularly those experienced in securities law
— Entrepreneurs who have recently gone public
— Books cited in the references section of this chapter

Ordinarily, publicly offered securities will be marketed through an underwriter. Underwriters are usually stockbroker-dealer firms with investment-banking departments. Commercial banks cannot function as underwriters. A group of underwriters, headed by one or more lead underwriters, will handle big issues; the team may be supplemented by broker-dealers who act solely as sales agents. Underwriter compensation packages typically include, but are not limited to:

— Commissions

— Discounts on the securities they underwrite

— Expense allowances

— Stock purchase warrants

— Rights of first refusal on future securities issues

The reasonableness of compensation received by its members acting as underwriters is regulated by the National Association of Securities Dealers (NASD) and by state regulations. Stated as a percentage, compensation is slightly higher for smaller offerings and for best-effort underwriting; slightly lower for larger offerings.

Assuming that no exemptions from registration can be found and the abbreviated procedures of Regulation A are not applicable, the process of a firm underwriting can be visualized like this:

— The firm desiring to raise capital meets with an investment banker.

— The banker gives oral assurance (or a letter of intent) expressing interest.

— Banker, issuer, legal counsel, and independent public accountants work together to prepare a registration statement and prospectus. (Preparation of these materials is time-consuming and—because of the expertise required of many of the participants and the liability to which they expose themselves—expensive.)

— The registration statement is filed with the SEC.

— The SEC's Division of Corporation Finance may review the filings and may issue a deficiency letter, a comment letter, a stop order, or may find the filing acceptable as it is. If the filing is not reviewed, a "no-review letter" will be issued.

— A preliminary prospectus is issued, and expressions of investors' interest are sought by the underwriter.

— After the filing of any necessary amendments, the registration statement becomes effective. (Theoretically, this occurs twenty days after the original filing; however, amendments required by the SEC staff may extend the date or the issuer may take advantage of procedures to delay the effective date.)

— Underwriter and issuer sign a firm agreement for a closing date and price. The underwriter begins to accept customers' offers to buy.

— The issuer receives a check from the underwriter and sale of the securities to the public is begun by the underwriter at the effective date of the registration.

Registration is an expensive process. The issuer, the underwriter, and sometimes the independent accountant will each be represented by his or her own legal counsel. Masses of information must be accumulated concerning the issuing company—including its history, current operations, accounting policies, major customers, labor relations, affiliated companies, management background, qualification, and compensation, as well as its financial arrangements, contracts, patents, and existing or potential litigation. Requirements to be considered are those of the SEC, of the National Association of Securities Dealers, and of state blue sky laws. Only legal counsel experienced in securities matters should be relied upon for guidance through this process.

4.3 Contents of the Registration Statement

The four basic registration forms are SEC Forms S-1, S-2, S-3, and for small business issuers, Form SB-2. They differ in the amount of detail required, because the S-2 and S-3 allow other filings with the SEC to be included by reference (that is, referred to but not attached to the S-2 or S-3 filing) and the SB forms follow rule S-B which provides for simplified disclosures. Appendix 1 is a list of commonly used 1933 Act forms. Registration statements contain

— A facing page appropriate to the particular SEC form being utilized, ordinarily displaying the names of the issuer and its legal counsel and the calculation of the registration fee.

— A prospectus containing financial data and making up the bulk of the registration. (See section 4.4, herein.)

— A cross-reference sheet coordinating registration form and prospectus.

— Selected information not required in the prospectus, including expenses of the distribution and data about unregistered securities sold within three years.

— "Undertakings" appropriate to the filing form being used, as prescribed by Item 512 of Regulation S-K. (In effect, undertakings consist of promises on the part of the registrant, introduced with the clause "The undersigned registrant hereby undertakes," for example, "to deliver . . . the latest annual report that is incorporated by reference in the prospectus.")

— A signature page.

— Exhibits, including consent documents from experts named in the filings.

4.4 Contents of the Prospectus

The amount of detail required in a prospectus differs somewhat, depending on the SEC form on which the filing is made. For instance, Form S-2 allows the incorporation of financial statements by reference to those statements included in a recent Form 10-K filing (the annual filing required under the 1934 Act). This list of matters to be included in a prospectus is taken from Regulation S-K (available from the publication section of the SEC) and assumes the most detailed filing (Form S-1) is to be used. Disclosures or descriptions that must be provided include

— Audited balance sheets for two years and statements of income and changes in cash flow for three years.

— Description of the business, its markets, sources of supply, and its competitive conditions and risk factors related to the company and the offering.

— A plan of operations.

— A statement of whether it will be necessary to raise additional funds within six months.

— Use of the proceeds of the present offering.

— Plan of distribution, including names of selling security-holders and information about the underwriters.

— Revenue, operating income or loss, and identifiable assets attributable to different operating segments (as defined in FAS 131).

— Nature of dependence on a few customers.

— Amounts spent on research and development.

— Segment information by geographic area.

— Descriptions of properties.

— Legal proceedings.

— History of market prices and dividends for most recent two years.

— Number of holders of each class of equity securities.

— Description of securities to be registered.

— Selected financial data for the last five fiscal years.

— Selected quarterly financial data for quarters within last two fiscal years.

— Management's discussion and analysis of financial condition and results of operations.

— Disagreements with and changes in independent accountants.

— Quantitative and qualitative disclosures about market risk.

— Identification of directors, executive officers, significant employees and their business experience, and involvement in bankruptcy and certain other legal proceedings.

— Executive compensation, stock options, and bonuses.

— Ownership by any group of more than 5 percent of any securities.

— Transactions with or indebtedness exceeding $60,000 with directors, executive officers, and other related or selected persons.

In 1998, the SEC adopted plain English rules that require issuers to write the cover page, summary, and risk factors section of prospectuses in plain English. These requirements became effective for registration statements and post-effective amendments filed on or after October 1, 1998. The SEC published *A Plain English Handbook: How to Create Clear SEC Disclosure Documents,* which includes techniques for writing in plain English, a summary of the plain English rules (and an excerpt from the rules), as well as examples of "before" and "after" filings.

These rules do not reduce or eliminate any substantive disclosures, but provide for more easily understood language. Sections written in plain English should use the active voice, short sentences, everyday language, tabular presentation or bullet lists for complex materials if possible, no multiple negatives, and no "legalese." The specific language and format, related to certain legal warnings previously made in all capital letters and the "red herring" legend, has been replaced with a plain English format.

4.5 Exemptions From Registration

Numerous provisions eliminate, modify, or reduce the full registration filings otherwise required; a choice of exemptions may also be available. In some cases exemption applies to the securities to be issued, in other cases to a particular transaction, type of transaction, or type of buyer to whom the distribution will be targeted. Fully exempted are securities issued by religious, educational, charitable, and governmental organizations, as well as interests in railroad equipment trusts. Generally, a transaction exemption conveys no exemption from the registration procedures that might be required in the case of subsequent nonexempt resale of the same securities. The choice of exemption must be integrated with the marketing plan for distribution of the securities. The ramifications of state law must be considered. The choice of exemptions

under which to qualify will be made by the underwriter and legal counsel experienced in securities laws.

Regulation D consolidates several *limited offering exemptions* and encompasses Rules 501 through 508. The first two of these, as well as 508, define common terms and set out general conditions. Rule 503 describes the Form D filing that is required. Rules 504 through 506 describe the exemptions. Rule 507 addresses the disqualifying provision relating to exceptions under Rules 504 through 506. The following are general conditions that govern circumstances for all Regulation D exemptions:

— Attempted compliance with a rule does not create an exclusive election, and other exemptions may be asserted.

— Compliance with a rule creates no exemption from other federal securities provisions, such as antifraud and civil liabilities, or from blue sky laws.

— The exemptions apply only to transactions by the issuer of the securities, not to the securities themselves or to resales, except that resales may be made for Rule 504 securities registered under blue sky laws.

Practitioners should be alert to advise their clients that exempt transactions and issues of exempt securities are still subject to state antifraud and blue sky laws as well as to the antifraud portions of federal securities law whenever the telephone, mail, or other instrumentalities of interstate commerce are used to offer, sell, or buy securities. The relevant portions of federal regulation are Section 10b of the 1934 act and SEC Rule 10b-5, which discuss the most commonly encountered exemptions.

4.5.1 Accredited investors

Various provisions of securities regulation confer special status and treatment for potential purchasers of securities who are designated "accredited investors." For example, accredited investors do not have to be counted when determining the thirty-five-purchaser limitation referred to in Rules 505 and 506. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions under Rules 505 and 506 and Section 4(6). These institutional investors are

— Banks (including those acting as fiduciaries).

— Investment companies.

— Insurance companies.

— Small business investment companies.

— Practically all employee-benefit plans subject to Title I of ERISA.

— Tax-exempt organizations having assets exceeding $5 million.

— Savings and loan associations supervised by a state or federal authority.

— Broker-dealers registered with the SEC under the 1934 act.

— Corporations, partnerships, or business trusts with total assets exceeding $5 million, provided the entity has not been formed solely for the purchase.

— Trusts, other than business trusts, with assets that exceed $5 million and that are directed by a "sophisticated" person.

— Governmental employee benefit plans having assets exceeding $5 million.

These are also considered accredited investors:

— Directors, general partners, or executive officers of the issuer

— Natural (not corporate) persons whose net worth, individually or jointly with a spouse, exceeds $1 million or whose annual income exceeds $200,000 (individually) or $300,000 (jointly)

The Small Business Investment Incentive Act of 1980 added Section 4(6) to the 1933 act to provide exemption from registration for transactions involving offers or sales solely to accredited investors if the offering price does not exceed $5 million and there is no advertising or public solicitation. A single offer or sale to a nonaccredited investor will invalidate this exemption. Form D must be filed. This exemption appears to be equivalent to SEC Rule 506.

4.5.2 Intrastate offerings

For this exemption to apply, the issuer and all offerees (and purchasers) of the exempted securities must be residents of the same state. In the case of a corporate issuer, both its principal place of business and its incorporation must be in the state. For offerees who are noncorporate business entities, only their principal place of business need be located in the state; for individuals, their principal residence. SEC Rule 147 requires that 80 percent of the proceeds be used in the state. The exemption is lost if a resale to a nonresident takes place within nine months after the last sale made in the same state.

4.5.3 Judicially approved exchanges

A relatively narrow exemption from registration is available under the 1933 act, Section 3(a)(10), when a judicial or federal or state administrative authority approves the issuance of securities, as for example in

a reorganization. This exemption has been used for court-approved settlements of private litigation.

4.5.4 Private placements

Section 4(2) of the 1933 act exempts transactions when there is no public offering (that is, no general solicitation). Offerings relying on this exemption will be made to sophisticated institutional and private investors who have access to the kind of information that would otherwise have to be provided in the registration documents. Since the statute itself does not identify what would constitute a nonpublic offering, the benefits of this section are of less certain operation than exemption under Rule 506, which is somewhat similar in its intent. For example, resale within a short period of time of the securities that were the subject of a private placement may cause the seller to be deemed an underwriter and may relate back and destroy the private placement exemption. The SEC's Rule 144 operates to provide protection against these unintended consequences. (See section 4.6, below.)

4.5.5 Rule 506

Characteristics of the securities offerings under Rule 506 include these:

— No limit on size of offering

— No limit on sales to accredited investors

— Sales to no more than thirty-five "sophisticated" investors

— Prohibition against solicitation to the general public

— Requirement of certain disclosures, unless all sales are made to the accredited investors

— Form D filing with the SEC

The "sophisticated" investors must be of sufficient business and investment acumen to be capable of evaluating the rewards and risks of the investments. In this task they may utilize the assistance of a personal financial adviser or a purchaser representative. According to Rule 506(b), each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately before making any sale that such purchaser comes within this description.

Prior to sale of the securities, if the issuer is selling securities to any purchaser that is not an accredited investor, a disclosure document must be delivered to all prospective purchasers. Rule 506 provides a

safe harbor for offerings that satisfy its requirements. Despite failure to qualify under some provision of Rule 506, an exemption under a similar provision, for example, Section 4(2) concerning private placements, may still be available. Securities issued under Rule 506 are restricted as to resale by purchasers.

4.5.6 Small issues

To facilitate access to the capital markets by small businesses, several avenues are available to the small issuer or to the issuer of small amounts of securities. In addition to the rules discussed below, see the sections in this chapter that cover accredited investors, intrastate offerings, private placements, and simplified registration.

Rule 504. The exemption under Rule 504 carries these conditions:

— Form D must be filed with the SEC.

— Issuer cannot be an investment company, a development stage company, or any company otherwise required to report to the SEC.

— Issue is limited to $1 million offering and sale within a twelve-month period.

— General solicitation is permitted if made in states that require registration and delivery of a disclosure document.

— Disclosure document need not be distributed if no general solicitation is made, unless required by state law.

— Resale of these securities by the purchaser is not restricted. (However, the SEC has proposed a change in the rule that would make such securities restricted in subsequent resale. A final rule has not yet been adopted.)

Rule 505. The conditions for a Rule 505 exemption are

— Limitation to $5 million in a twelve-month period.

— No restrictions on number of offerees to which offering can be made so long as there is no general solicitation or advertising.

— Purchasers limited to thirty-five except for accredited investors.

— No limit to the number of purchasers who are accredited investors.

— If any sale is made to a nonaccredited investor, disclosure documents must be provided to all purchasers.

— Not available to issuers who are investment companies or to those guilty of postal or securities fraud.

— Form D must be filed with the SEC.

— Securities are restricted in subsequent resale.

Since the thirty-five nonaccredited investors have to meet no particular standards for sophistication or suitability, this exemption is popular for limited partnerships. Unless formed for the specific purpose of acquiring the offered securities, an entity such as a corporation or partnership counts as one purchaser.

4.5.7 Voluntary exchanges

When an issuer exchanges a new issue of securities exclusively with its existing security-holders, an exemption from registration is provided. Cash paid or received to effect an equivalency of value does not invalidate the exemption. This exemption is not available where

— Remuneration is paid for solicitation, promotion, or underwriting.

— The securities are exchanged in the course of a Bankruptcy Act proceeding.

Technically, such exchanges are exempt transactions (rather than exempt securities). Subsequent resales of these securities by a holder will thus require registration unless shielded by another exemption.

4.5.8 California issuers

Regulation CE provides a registration exemption for offers and sales of securities that comply with the conditions of Section 25102(n) of

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the California corporation code. The limit is $5 million for each offering. This exemption is available to California issuers and non-California issuers having more than half of their property, payroll, and sales in that state. Securities sold under this exemption are restricted securities.

4.5.9 Other exemptions

Exemptions are also available under Section 3(a) of the 1933 act for securities of the following:

— Federal, state, and local governmental bodies and organizations (including certain industrial development bonds)

— Federal Reserve banks

— Certain insurance companies

— Qualified pension, profit, and stock plans and certain Keogh partnership plans

— Notes, drafts, and bankers' acceptances with an original maturity of not more than nine months

— Building and loan associations

— Farmers cooperatives

— Bankruptcy Act certificates

— Many insurance and annuity contracts

These are not blanket exemptions, however, and the securities acts, SEC rules, and court cases may bear on a particular offering. In some cases only an experienced securities attorney can be relied upon for confirmation of the exemption. The Keogh exemption, for example, is available only to firms offering services in the investment banking, pension consulting, investment advising, legal, and accounting fields. In these fields an employer can be expected to have the requisite knowledge and experience to guard his or her own as well as employees' interests. Independent investment advice must nevertheless be secured in setting up the plan.

4.6 Secondary Transactions and Rule 144

Section 4(1) of the 1933 act exempts from registration transactions by "any person other than an issuer, underwriter, or dealer." The term *issuer* includes any person who directly or indirectly controls or is controlled by the issuer. An *underwriter* is any person who purchases from an issuer "with a view to, or offers or sells for an issuer in connection

with, the distribution of any security." Thus nonissuers and nonunderwriters can distribute securities in transactions deemed exempt under this section.

Advisers should warn their clients that institutions or individuals who purchase securities in exempt transactions and then resell the securities can unintentionally become underwriters. This outcome can ordinarily be avoided by adherence to Rule 144, which provides an exemption from registration for certain transactions. The purpose of the rule is to permit the public sale of limited quantities of securities—without prior registration—by affiliated persons and by persons who bought restricted stock from the issuer. (An affiliate is a person controlling, controlled by, or under common control of the issuer.) Six conditions are required for an exempt transaction under SEC Rule 144:

1. *Adequate public information.* This condition is ordinarily satisfied if the issuer is a reporting company under the 1934 act.
2. *Holding period.* The securities must have been beneficially owned and fully paid for by the seller for at least one year prior to this sale.
3. *Limited amount.* In any three-month period, the amount of securities sold is limited to the greater of (a) 1 percent of the outstanding shares or (b) the average weekly reported volume of trading.
4. *Manner of sale.* Sales must be made in "brokers' transactions" or in transactions with a market maker. (Brokers' transactions are those in which the broker executes orders while acting as the seller's agent.)
5. *Notice of offering.* In any three-month period, if more than 500 shares, or $10,000 of sales price, will be offered, the seller must file with the SEC a notice on Form 144.
6. *Intent to sell.* The person filing the notice on Form 144 must have a bona fide intention to sell within a reasonable time.

If the sale is made by a nonaffiliated person who has been a beneficial holder for three years, the conditions regarding amount, manner of sale, and notice are waived. Sales on behalf of a controlling person, however, can cause the seller to be deemed an underwriter, thus canceling the exemption. Rule 405 defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This undoubtedly confers "controlling person" status on top level management of a corporation even if their stock ownership is minimal. The two-year holding period referred to in Rule 144 does not create a safe harbor for a controlling person.

Rule 144A provides a safe harbor from registration requirements for the resale of unregistered securities to a *qualified institutional investor*

acting for its own account. A qualified institutional investor is one that has $100 million in securities under its discretionary management or, subject to certain conditions, is a registered securities dealer, investment company, or bank.

Considerable litigation has resulted regarding Rule 144, and at least one book of substantial length has been devoted entirely to it. Because of varying judicial interpretation, clients must be advised not to place their reliance for an exemption entirely upon the two-year holding period, particularly if they are controlling persons within the context of the SEC rules. If the exemption of a resale transaction is challenged by the SEC, it is a question of fact to be decided by the courts whether a seller of securities originally purchased them with the intent to distribute them. Despite these possible pitfalls, however, most registered broker-dealers will have worked out procedures for safely handling Rule 144 securities and clients may be counseled to rely on these procedures.

4.7 Simplified Registration

Regulation S-B provides two forms for a simplified registration. Financial statements must conform to generally accepted accounting principles but need not comply with the SEC's more stringent requirements stated in Regulation S-X.

Form SB-1 is available for most small business issuers (SBI) that have not previously registered with the SEC. The limit is $10 million of securities issued for cash in any continuous twelve-month period. SB-2 can be used for an unlimited cash issuance by an SBI. A small business issuer is a U. S. or Canadian company, other than an investment company, that has revenue of less than $25 million and a public float of securities less than $25 million. In late 1998, the SEC proposed a change to the small business issuer criteria. The proposed change eliminates the public float test and increases the revenue level to $50 million.

Regulation A provides another type of simplified registration—in effect, a miniregistration. Its features are these:

— It allows aggregate offerings, within a twelve-month period, to $5 million by the issuer, its affiliates that became such within the last two years, and its predecessors. Additionally, included in the $5 million limitation are certain secondary distributions by affiliates and other exempt securities sold under Section 3(b) of the 1933 act (Rule 504 or 505).

— It provides for lower limits for securities offered on behalf of non-affiliated persons other than the issuer. These are

$100,000 on behalf of any person; $300,000 for all such persons. $500,000 limit if offering person is an estate.

— Solicitation of investor interest allowed prior to filing of an offering statement containing the offering circular used to sell the securities.
— Filings are made with and reviewed by regional SEC offices.
— State registration will ordinarily be required.
— Financial statements need not be certified but must conform to generally accepted accounting principles.
— Financial statements must include a balance sheet prepared within ninety days of the filing and profit and loss statements for the two preceding fiscal years.
— Financial statement specifications can be found in SEC Form 1-A.
— An offering circular must be provided to prospective purchasers.

Many attorneys believe the costs of filing and the necessity for approval by the SEC, when compared to the small size of the allowed offering, argue against the use of Regulation A registration in cases where an exemption can be found within Regulation D.

4.8 Regulation FD: Fair Disclosure

Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure. The regulation provides that when an issuer, or person acting on the issuer's behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or nonintentional. For an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a nonintentional disclosure, the issuer must make public disclosure promptly. Under the regulation, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, nonexclusionary distribution of the information to the public.

5. THE SECURITIES EXCHANGE ACT OF 1934

5.1 Overview

The Securities Exchange Act of 1934, cited hereafter as the 1934 act, prescribes registration and reporting requirements for issuers of certain

securities by securities dealers, securities exchanges, and self-regulatory organizations (the only one to date being the National Association of Securities Dealers). The act in addition concerns itself with proxy solicitation, tender offers, insider profits, and manipulative and fraudulent practices. The 1934 act established the SEC.

5.2 Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934 to administer and enforce the securities acts, and therefore has extensive rule-making authority. Documents required to be filed by the securities acts are filed with the SEC. Mail can be addressed to the Securities and Exchange Commission, Washington, D.C. 20549, to make a request

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from its Publications Section. The main telephone number is (202) 942-7040. Additionally, these phone numbers within the Division of Corporation Finance have proved particularly helpful:

Office of Chief Accountant (202) 942-2960

Office of Chief Counsel (202) 942-2900

Regional and district offices of the SEC initiate investigations and enforcement proceedings and can be queried for informal advice about matters of securities regulation. The regional and district offices and their phone numbers are:

Regional Offices

Pacific Region: (213) 965-3998	Washington, Oregon, California, Arizona, Nevada, Idaho, Montana, Hawaii, Alaska, Guam
Central Region: (303) 844-1000	Utah, Wyoming, Colorado, New Mexico, North Dakota, South Dakota, Nebraska, Kansas, Oklahoma, Texas, Arkansas
Midwest Region: (312) 353-7390	Minnesota, Iowa, Missouri, Wisconsin, Illinois, Michigan, Indiana, Ohio, Kentucky
Northeast Region: (212) 748-8000	Maine, New Hampshire, Massachusetts, Rhode Island, Connecticut, Vermont, New York, Pennsylvania, New Jersey, Delaware, Virginia, West Virginia, Maryland
Southeast Region: (305) 536-4700	Tennessee, North Carolina, South Carolina, Georgia, Alabama, Mississippi, Louisiana, Florida, Puerto Rico, Virgin Islands

District Offices

San Francisco: (415) 705-2500
Fort Worth: (817) 978-3821
Salt Lake: (801) 524-5796
Boston: (617) 424-5900
Philadelphia: (215) 597-3100
Atlanta: (404) 842-7600

5.3 Registration of Brokers and Exchanges

The SEC oversees operation of the two national stock exchanges, the New York Stock Exchange and the NASDAQ/AMEX Exchange, as well as regional exchanges. (Some stocks are traded both on a national and a regional exchange.) The regional exchanges are these:

Boston Stock Exchange
Chicago Stock Exchange
Pacific Exchange
Philadelphia Stock Exchange
Spokane Stock Exchange

The largest number of stock issues are not listed for trading on an exchange but are traded over-the-counter—in direct exchange between brokers. The National Association of Securities Dealers Automated Quotation System (NASDAQ) facilitates such trades. Possible advantages of listing on an exchange include

— Exemption from registration under some state blue sky laws.
— Increased attention from securities analysts, which increases investors' interest.
— Increased visibility and prestige in the business community.
— Price stability of shares because of readily available market quotations.
— Greater acceptance of shares as collateral by lending institutions.

Disadvantages include

— Necessity for providing more information to the SEC, the stock exchange, and shareholders.
— Initiation fees and annual charges.
— Restrictions imposed by the exchange.

5.4 Registration of Securities: General Issues

All securities traded on a national exchange must be registered with the SEC. The SEC may suspend trading in any improperly registered security. Over-the-counter securities must also be registered by issuers who have a class of equity securities with 500 or more shareholders and more than $10 million in total assets. The data required are similar to those required for securities act registration; recent SEC policy has been to bring the two registration procedures into closer agreement. Following registration, reports must be filed to keep the information up-to-date.

This information is available for inspection at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549 (call 1-800-SEC-0330 for information on the operation of the room). The SEC also maintains an internet site that contains reports, proxy and

information statements, and other information regarding issuers that file electronically with the SEC (at http://www.sec.gov).

Exemptions from exchange act registration are provided for the security issues of savings and loan, not-for-profit, and cooperative associations, certain insurance companies, and certain employee stock bonus, pension, or profit-sharing plans.

The process of registration is being facilitated through a system called *integrated disclosure.* Integrated disclosure is designed to reduce the incidence of duplicative and overlapping filings required by the various securities acts. Registration statements and prospectuses will still be required to provide transaction-specific information (unless an exemption is available) for the issuance of securities. Information focusing on the registrant/issuer, however, will in most cases already be available under the periodic and continuous reporting requirements of the 1934 act (through such Forms as 10-K, 10-Q, and 8-K).

The workings of the integrated disclosure system can be observed in the alternative use of these three different registration forms:

1. Form S-1 requires the most detail and is used by first-time registrants.
2. Form S-2 demands less detail and is available for use by issuers who have reported for three or more years under the 1934 act.
3. Form S-3, exacting the least detail, is available for issuers who have reported for twelve months under the 1934 act and who have an aggregate market value of voting and nonvoting common stock held by nonaffiliates of $75 million or more but also requires as a precondition a "market following" test that assures the securities are widely held.

If a registrant qualifies for S-3 registration, no registrant-specific information is required. Instead, data about the registrant/issuer are incorporated by reference in other exchange act filings (such as 10-Ks, for example).

See appendix 2 for a list of common forms used in registrations under the 1934 act.

5.5 Registration of Over-the-Counter Securities: Specifics

Section 12(g) of the 1934 act, together with SEC Rule 12g, requires registration of the equity securities of issuers engaged in interstate commerce or in a business affecting interstate commerce or whose securities are traded by use of the mails or any means or instrumentality, if the issuer has total assets exceeding $10 million and there are 500 or more shareholders of the equity securities. Equity securities are

— Stocks or similar securities or securities convertible into stocks or similar securities.

— Any security carrying a warrant or right to purchase a stock or similar security.

— Certificate of interest or participation in a profit-sharing agreement.

— Preorganization certificate or subscription.

— Transferable share.

— Voting-trust certificate or certificate of deposit for an equity security.

— Limited partnership interest.

— Interest in a joint venture.

— Certificate of interest in a business trust.

— Any put, call, straddle, or other option or privilege of buying or selling a security to another.

For the purposes of this section, a class includes all securities of substantially similar character and those whose holders enjoy substantially similar rights. Thus common and preferred shares are not members of the same class, but common shares designated Class A and Class B might be, depending on the similarities of the rights of their holders. As to the existence of 500 shareholders, the SEC normally accepts the issuer's records on this point, even to accepting a corporation, a partnership, or street name as one holder.

Total assets are determined after deducting such allowances as those for depreciation, depletion, and bad debts. To temporarily postpone registration by staying below the threshold for registration, these techniques might be employed (after first considering their income tax consequences):

— Pay off liabilities with available assets.

— Pay dividends or purchase treasury stock from shareholders.

— Increase allowance accounts if possible to do so while maintaining conformity with generally accepted accounting principles.

— Spin off assets to shareholders.

— Any other tactic reducing assets or number of shareholders below the threshold levels.

The asset and shareholder tests are determined at the end of the company's fiscal year. This allows some maneuvering space for a potential registrant who exceeds the threshold values during the year but desires to stave off registration. Continuing use of such tactics over several years, however, might stimulate the SEC to insist on registration.

Registration, if required, must become effective within 120 days following the fiscal-year end. Normally, a registration becomes effective sixty days after its filing, although the period may be shortened at the discretion of the SEC. Accountants whose clients are approaching the threshold at midyear should be warned they may have to register with the SEC. Projections of year-end data well in advance of year end—particularly regarding total assets and number of shareholders—can provide potential registrants time to plan their response to the 1934 Act requirements.

In early 1999, the National Association of Securities Dealers (NASD), with SEC approval, revised its eligibility rules to require companies to report their financial information on a current basis. Only those companies that report current financial information to the SEC, banking, or insurance regulators will be permitted to be quoted on the Over-the-Counter (OTC) Bulletin Board. The new requirement applies immediately to any company first quoted on the OTC Bulletin Board after January 4, 1999. For securities already quoted as of that date, the rule will be phased in over the period beginning in July 1999 and continuing through June 2000.

5.6 Disclosures Required in Proxies

Independent public accountants who are concerned in proxies are required to disclose—

- Under the caption Audit Fees, the aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.
- Under the caption Financial Information Systems Design and Implementation Fees, the aggregate fees billed for the professional services described in paragraph (c)(4)(ii) of rule 2-01 of Regulation S-X (17 CFR 210.2-01(c)(4)(ii)) rendered by the principal accountant for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant; the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser); and any entity controlling, controlled by, or under common control with the adviser that provided services to the registrant.
- Under the caption All Other Fees, the aggregate fees billed for services rendered by the principal accountant, other than the services covered

in paragraphs (e)(1) and (e)(2) of this section, for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

- Whether the audit committee of the board of directors, or if there is no such committee the board of directors, has considered whether the provision of the services covered in paragraphs (e)(2) and (e)(3) of this section is compatible with maintaining the principal accountant's independence.
- The percentage of hours, if greater than 50 percent, expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

6. OTHER FEDERAL SECURITIES-RELATED ACTS

6.1 Foreign Corrupt Practices Act of 1977

The accounting provisions of the Foreign Corrupt Practices Act specify that all securities issuers who report to the SEC are required under Section 13(b)(2) of this act to

(Text continued on page 31)

(A) Make and keep books, records, and accounts, that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

(i) Transactions are executed in accordance with management's general or specific authorization;

(ii) Transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) Access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

This Act was intended to subject to audit payments that heretofore had been disguised and that were being used by U.S. corporations to bribe foreign officials. Paragraph (7) was subsequently added as an amendment to section 13(b) to clarify certain terms questioned by corporate directors and accountants desirous of complying with the act.

(7) For the purposes of paragraph (2) of this subsection, the terms 'reasonable assurances' and 'reasonable detail' mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.

Fears of overeager enforcement were further quieted by the SEC Commissioner's statements that inadvertent recordkeeping mistakes will not result in an enforcement action.

6.2 Investment Advisers Act of 1940

This act, according to a 1981 SEC staff report, may require registration as an "investment adviser" by "financial planners" and others who provide investment advice to their clients for compensation. Three exceptions from registration are provided under the act:

1. *Intrastate exception.* Section 203(b)(1) provides an exception for an investment adviser whose clients are all residents of the state within which the adviser maintains the principal office and place of business, as long as he or she does not furnish advice or issue analyses or reports about securities listed or admitted to unlisted trading privileges on any national securities exchange. (There may still be certain

state registration and reporting requirements.) An investment adviser is also subject to the act's antifraud provision. A person who is not an investment adviser (which includes the accountant's exception) is not subject to the act at all.

2. *Insurance company adviser.* This exception is for those advisers whose only clients are insurance companies. Section 203(b)(2) applies.
3. *Private investment advisers.* Section 203(b)(3) offers an exception for investment advisers who, during the course of the preceding twelve months, had fewer than fifteen clients and who neither hold themselves out generally to the public as investment advisers nor act as investment advisers to an investment company registered under the 1940 act or to a "business development company."

Accountants rendering investment advisory services may be required to register in certain circumstances. Persons or firms who engage for compensation in the business of advising others concerning securities transactions must register with the SEC. This includes advising directly or through publications or writings as to the value or advisability of purchasing or selling any security. Any "accountant whose performance of such services is solely incidental to the practice of his profession" is exempted (Section 202(a)(11)). Any form of recommendation to a client concerning a specific security made by a public account potentially could cross the "solely incidental" threshold.

6.2.1 Consequences of registering

Certain activities follow upon registration under the Investment Advisers Act.

Reporting. Reporting is done on Form ADV, which requires the adviser to give information about various practice aspects:

— The nature of the business
— Background, education, and experience of the principals and employees
— Whether there are grounds for disqualification from registration
— Amount of assets under management
— Type of clients advised
— Kinds of investment advisory services provided
— Methods of securities analysis

An annual report, Form ADV-S, is required within ninety days after the close of the adviser's fiscal year.

Record keeping. Certain records are required of registered advisers and may be inspected by the SEC:

— Journals and ledger accounts

— Memoranda or orders and instructions for purchase, sale, receipt, or delivery of securities

— Copies of certain communications received or sent

— Listings and records relating to discretionary accounts

— Copies of all written agreements

— Copies of publications and recommendations distributed to ten or more persons and information indicating the factual basis for the recommendations

— Records of certain securities transactions entered into

(Text continued on page 33)

Disclosure. The so-called "brochure rule" requires the adviser to furnish to prospective clients certain kinds of information. Generally, it is data of the sort included in Form ADV:

— Services provided

— Types of client served

— Methods of security analysis used by the adviser

— Standards of education and business background required of the adviser's principals and employees

— Descriptions of the specific backgrounds of its principals and employees

Performance fees. Although the act itself prohibits a registered investment adviser from receiving compensation based on a share of the capital appreciation in a client's account, under certain conditions this will be acceptable under a new SEC rule (SEC Investment Advisers Act Release No. 996 (November 14, 1985)).

Antifraud provisions. It is unlawful for an investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client" or to engage in any activity that operates as a fraud upon a client. Even persons excused from registration by one of the three exceptions from registration are subject to these antifraud provisions. Persons who rely on the exceptions from the definition of investment adviser, including the accountant's exception, however, are not subject to these provisions.

6.2.2 Examples of situations involving public accountants

The following cases are based on examples presented in the book, available from the American Institute of Certified Public Accountants, titled Personal Financial Planning Practice Aid No. 1: *Issues Involving Registration Under the Investment Advisers Act of 1940*:

> **Case 1.** John is a CPA with an active practice. He spends most of his time preparing and reviewing tax returns and in analyzing the tax consequences of proposed transactions for his clients. From time to time, in preparing a tax return for a particular client, John suggests the client might consider tax shelter, tax-exempt bonds, or mutual funds . . . . John will be able to rely on the accountant's exception. He will not be required to register as an investment adviser because he meets the "solely incidental" test as stated by SEC staff. His exemption arises because
>
> He is not holding himself out as an investment adviser.
>
> The investment services he is rendering appear to be related to the accounting services he provides.

He appears not to be charging a special fee for his advisory services.

Case 2. After three years with a local firm, Margaret starts her own practice. She intends to advertise "planning services" as a special service available in her accounting practice. She hopes financial planning will be the major emphasis of her practice. Margaret will do comprehensive financial planning for a fee, will give opinions on, and recommend, specific investment vehicles, IRA plans, tax shelters, and pension arrangements . . . . Margaret cannot rely on the act's accountant's exception, since she appears to be holding herself out as a financial planner who is providing investment advice.

Case 3. Fred, a CPA, holds himself out as providing personal financial planning services as well as accounting and tax services. Except in rare instances, the investment advice he provides is limited to discussing in general terms the role different sorts of investment vehicles might play in a client's overall investment plan. Although Fred is holding himself out as a financial planner, the kind of advice he is providing appears not to be of the type that would cause him to meet the definition of investment adviser. (*Warning*: The SEC staff, however, might take a contrary position if confronted with these facts.)

Case 4. Banners and Croft, CPAs, is a medium-size firm that recently established a financial planning team. The team follows a four-step approach:

1. Presenting seminars addressing goal setting, money management, tax and estate planning, insurance, and investments.
2. Collecting data from clients about their assets, liabilities, and cash flows.
3. Using computer software to project net worth, tax liability, and cash flow for several investment alternatives.
4. Reviewing annually each client's financial plan to judge whether progress is being made toward his or her goals and whether the goals should be adjusted.

Banners and Croft does not act as sales agent for any investment vehicles. Once a client indicates an interest in a particular vehicle—municipal bonds or equities, for example—the firm provides a list of local advisers and brokers who are rated by a national rating service. The issue is whether establishment of the team constitutes holding oneself out as being in the financial planning business because financial advising is not solely incidental to the firm's accounting practice (and therefore not covered by the accountant's exception). Even if the financial planning business is not covered by the accountant's exception, the firm would not need to register under the act so long as the business did not result in meeting the definition of investment adviser. The firm does not meet this definition, since

— The securities advice is general and focused on the role of securities in a client's overall plan.
— Advice is not directed toward specific securities.

6.3 Investment Company Act of 1940

An investment company is one engaged primarily in the business of investing, reinvesting, or trading in securities. The most commonly encountered example of an investment company is a mutual fund. The 1940 act requires registration of investment companies and spells out such safeguards over operations as ratification by shareholders of the selection of the independent public accountant [Sec. 32 of the act] and changes in investment policy. Unexpected consequences may derive from operation of the act: for example, an investment company that fails in its duty to register will find itself denied access to the courts if it should attempt to enforce a contract with another party. The act contains provisions for the independence of the board of directors and for separate investment advisers. Criminal penalties are set out for willful violations of the act. There are also antifraud provisions and private remedies, both of which supplement similar provisions in the 1933 and 1934 acts, which are also operative regarding investment companies.

6.4 Trust Indenture Act of 1939

The Trust Indenture Act of 1939 provides that evidences of indebtedness such as bonds may not be offered to the public unless they are issued under an agreement (called a trust indenture) that has been passed on by the SEC. Among its other provisions, this act specifies the requirements for persons who serve as trustees for the bondholders. Accountants ordinarily have no direct role in the preparation of the registration documents or the annual filings required under this act. It may be desirable, however, for the issuing debtor's public accountant to review the trust indenture to provide advice concerning covenants that impact the financial statements or operations of the issuer.

6.5 Public Utility Holding Company Act of 1935

The Public Utility Holding Company Act of 1935 requires registration of holding companies operating electric utility or retail gas businesses. Financial statements required with the registration documents and with annual reports to the SEC must be audited by independent public accountants.

6.6 Racketeer Influenced and Corrupt Organizations Act (RICO)

The Racketeer Influenced and Corrupt Organizations Act was promulgated as part of the Organized Crime Control Act of 1970 to protect

businesses against organized crime. RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants.

RICO makes it illegal to

— Use income derived directly or indirectly from a pattern of racketeering activity to acquire any interest in an enterprise.

— Acquire any interest in or control of an enterprise through a pattern of racketeering activity.

— Conduct or participate, directly or indirectly, in the affairs of an enterprise through a pattern of racketeering activity.

— Conspire to violate any of the above provisions.

A wide variety of conduct can constitute racketeering under this statute, including murder, arson, bribery, embezzlement, mail and wire fraud, securities fraud, and pornography and drug dealing. Mail fraud is a particularly broad offense, having as its essential elements the mailing of a letter while motivated by a deceitful thought. The act allows a private legal action by "any person injured in his business or property" by conduct that is punishable as a crime. Access to court is granted the injured party upon his or her allegation that the defendant committed the illegal conduct; no prior conviction need be shown. When a civil rather than a criminal remedy is sought, as for example, by an investor against a stockbrokerage firm, the civil standard of proof by a preponderance of evidence is required. This is a less rigorous standard of proof than that required in a criminal case, where the standard is proof beyond a reasonable doubt. To the successful plaintiff in a civil action, recovery of treble damages may be allowed together with costs of the suit, including attorneys' fees. Numerous states have enacted their own RICO statutes. Because RICO has been used as an entree to court against legitimate businesses, including public accountants, both the American Institute of Certified Public Accountants (AICPA) and the National Advisory Council to the Senate's Small Business Committee have urged that RICO be amended to require plaintiffs to show the defendant has been convicted of a prior criminal racketeering activity.

6.6.1 State RICO statutes

Simultaneous RICO litigation under the federal statute and one or more state statutes is possible. The federal statute clearly spells this out:

> Nothing in this title shall supersede any provision of Federal, State, or other law imposing criminal penalties or affording civil remedies in addition to those provided for in this title.

A growing number of states have enacted RICO clones. These statutes mimic to a greater or lesser extent the federal statute. The provisions of these various state acts are shown in table I.

Twenty-one state RICO statutes specifically include fraud in the purchase or sale of securities as a racketeering act. Ten identify mail or wire fraud as predicate acts. These instrumentalities of interstate commerce are beyond the scope of state regulation. However, the states that identify these types of fraud as racketeering acts do so by reference to the federal statute, making the federal racketeering acts state racketeering acts as well.

Of the twenty-one state RICO laws that include securities fraud or mail and wire fraud as predicate acts, seventeen allow private remedy. Six of these jurisdictions provide for punitive damages in addition to damages for the injury (treble or double) and the recovery of court costs and reasonable attorney's fees. This is a civil remedy that is more liberal than that provided under the federal statute. (Federal RICO allows only treble damages plus court costs and reasonable attorney's fees.) Eight of the remaining eleven jurisdictions provide a measure of damages that is equivalent to damages allowed under federal law.

Although state statutes tend to reflect or expand on the federal measure of damages, they also frequently limit the applicability of RICO. Of the thirty-one jurisdictions with RICO clones, three states (Illinois, Louisiana, and Tennessee) limit predicate acts to narcotics law violations. Eight jurisdictions limit the application of RICO by not allowing private suits. In order to initiate a private RICO action under Delaware and Mississippi law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury (action must be brought within one year of the defendant's conviction). North Carolina and Ohio require that in a private RICO action alleging securities fraud, one of the pattern acts must be an act other than fraud in the sale of securities. In a private RICO action alleging securities fraud under the Washington statute, the defendant must have been previously convicted on a criminal charge of securities fraud. Conviction for the pattern acts themselves is not required.

Fifteen jurisdictions have included in their definition of the pattern of acts the requirement that the predicate acts have the same (or similar) purposes, results, participants, victims, methods of commission, or be otherwise interrelated by distinguishing characteristics and not simply isolated events. Thus, these states have included in their statutes the continuity and relationship standard which, as result of the *Sedima* (*FPRL v. Imrex Co.*, 105 S. Ct. 3275) decision, is now being applied in federal cases. Although, as pointed out in *H.J. Inc. et al. v. Northwestern Bell Telephone Co. et al.* (U.S. Sup. Ct. No. 87-1252, 6/26/89), a pattern ". . . might encompass multiple predicates within a single scheme that

TABLE I. STATE AND TERRITORIAL RICO STATUTES

State/ Terr.	Private Remedy	Pattern of Acts			"Racketeering Acts" Include		Damages		
		No. of Acts	Similar Not Isolated Acts	Maximum Time Allowable Between Pattern Acts	Fraud in Purchase/ Sale of Securities	Mail or Wire Fraud	Treble	Punitive	Costs + Fees
AZ	Yes	1	N/A	N/A	Yes	No	Yes	No	Yes
CA	No	2	Yes	last/10 yrs. of 1st	Yes	No	N/A	N/A	N/A
CO	Yes	2	No	last/10 yrs. of 1st	Yes	Yes	Yes	No	Yes
CT	No	2	Yes	last/5 yrs. of 1st	Yes	No	N/A	N/A	N/A
DE	Yes[1]	2	No	last/10 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
FL	Yes	2	Yes	last/5 yrs. of 1st	Yes	Yes	No[2]	No	No
GA	Yes	2	Yes	last/4 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
HI	Yes	1	N/A	N/A	No	No	No[2]	No	Yes
ID	Yes	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	No	Yes
IL	Yes	2	No	last/5 yrs. of 1st	No[4]	No[4]	Yes	No	Yes
IN	Yes	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	Yes	Yes
LA	Yes	2	Yes	last/5 yrs. of 1st	No[4]	No[4]	Yes[5]	No	Yes
MN	No	3	No[6]	within 10 yrs. of criminal proceeding	No	No	N/A	N/A	N/A
MS	Yes[1]	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	Yes	Yes
NV	Yes	2	Yes	last/5 yrs. of 1st	Yes[3]	No	Yes	No	Yes
NJ	Yes	2	Yes	last/10 yrs. of 1st	Yes	Yes	Yes	No	Yes
NM	Yes	2	No	last/5 yrs. of 1st	Yes	No	Yes	No	Yes
NY	No	3	No[6]	last/10 yrs. of 1st	Yes	No	N/A	N/A	N/A

NC	Yes	2	Yes	last/4 yrs. of 1st	Yes[7]	Yes	Yes	No	Yes[8]
ND	Yes	2	No	last 10 yrs./1st	Yes	No	Yes	No	Yes
OH	Yes	2	No[6]	last/6 yrs. of 1st	Yes[7]	Yes	Yes	No	Yes
OK	No	2	No[6]	last/3 yrs. of 1st	Yes	No	N/A	N/A	N/A
OR	Yes	2	Yes	last/5 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
PA	No	2	No	no limitation	No	No	N/A	N/A	N/A
PR	No	2	N/A	last/10 yrs. 1st	No	No	N/A	N/A	N/A
RI	Yes	1	N/A	N/A	No	No	Yes	No	Yes
TN	No	2	Yes	last/2 yrs. of 1st	No[4]	No[4]	N/A	N/A	N/A
UT	Yes	3	Yes	last/5 yrs. of 1st	Yes	Yes	No[9]	No	Yes
VI	Yes	2	No[6]	last/5 yrs. of suit	No	No	Yes	No	Yes
WA	Yes	3	Yes	last/5 yrs. of 1st	Yes[10]	No	No[2]	No	Yes
WI	Yes	3	No[6]	last/7 yrs. of 1st	Yes	Yes	No[9]	Yes	Yes

[1] In order to initiate a private RICO action under Delaware law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury. Action must be brought by the plaintiff within one year of the defendant's conviction. Mississippi law also requires that the defendant was previously convicted of a RICO violation.

[2] Florida, Hawaii, and Washington limit damages to the actual loss incurred. However, Washington courts, at their discretion, may impose treble damages.

[3] Not directly defined as a racketeering activity. Nevada's statute includes within the definition of racketeering acts, "obtaining possession of money or property valued at $250 or more, or obtaining a signature by means of false pretenses."

[4] *Racketeering Acts* are limited to violations of narcotics laws.

[5] Or $10,000, whichever is greater.

[6] Minnesota, New York, Ohio, Oklahoma, and the Virgin Islands require only that the pattern acts not be isolated. Wisconsin requires only the acts to be similar.

[7] North Carolina and Ohio require that one of the pattern acts must be an act other than fraud in the sale of securities.

[8] The North Carolina statute allows recovery of fees; however, no mention is made of costs.

[9] Utah and Wisconsin limit damages to twice the actual loss incurred.

[10] In a private RICO action alleging securities fraud, the defendant must have been previously convicted on a criminal charge of securities fraud (conviction for the pattern acts themselves is not required).

SOURCE: Analysis by Ralph E. Welton, Jr., Ph.D., Associate Professor of Accounting, Clemson University.

were related and that amounted to, or threatened the likelihood of, continued criminal activity." The effect of this standard is to limit prosecution to offenders engaging in repeated criminal activity. States requiring similar, not isolated acts are identified in table I.

Another method of limiting the application of RICO is to adopt a narrower time limitation between the commission of the pattern acts. Under the federal statute, a pattern of racketeering acts is established if the time between the predicate acts does not exceed ten years. Nineteen jurisdictions have adopted time limitations that are stricter than the federal limitation. The most common reduction is to require that the last pattern act occur within five years of the first. Five states require that a pattern consists of three or more racketeering acts, allowing prosecution only when criminal intent is demonstrated through repetition. The time limitation and the number of predicate acts required to establish a pattern under each state statute is shown in table I.

However, not all states have attempted to narrow the application of RICO. Three states have cast the net wider than the federal law by defining a *pattern of racketeering* as the commission of only one prohibited act (see table I).

6.7 Securities Investor Protection Act of 1970

The Securities Investor Protection Act of 1970 requires almost all broker-dealers to be members of the Securities Investor Protection Corporation (SIPC). Through assessments of its members to create a fund of $150 million, the possibility of levying a charge on stock exchange and over-the-counter transactions, and authority to borrow up to $1 billion from the U.S. Treasury, the SIPC can advance funds to satisfy claims by customers of failed broker-dealers. SIPC coverage extends to a maximum of $500,000 for each customer, but not more than $100,000 for claims for cash held by a failed broker.

Notification to the SIPC originates with the broker-dealer, the SEC, or a self-regulatory organization such as the National Association of Securities Dealers. Customers of an SIPC member in financial difficulty have no rights, by themselves, to require the SIPC to act. Customers who suspect they may be damaged by a broker-dealer's financial difficulties should contact an attorney or the SEC. Once the SIPC determines the financial status of a broker-dealer it may apply to the courts for customers' protection under the act. The court then appoints a trustee and an attorney for the trustee who go about returning specifically identifiable property to customers, completing any open contractual commitments of the firm, selling the assets of the firm, and paying off customers and other creditors. It is a process similar to that of Chapter 10 of the bankruptcy act.

6.8 Small Business Incentive Act of 1980

The thrust of the Small Business Incentive Act of 1980 is to exempt companies that elect to qualify as business development companies from certain burdensome provisions of the Investment Company Act of 1940. Business development companies provide assistance in the form of capital and managerial expertise to small businesses, both those that are financially sound and those that are trying to regain their liquidity. Sections 54 through 65 of the Investment Company Act provide the details of qualification. Accountants who need a detailed analysis of this act should refer to Reginald L. Thomas and Paul F. Roye, "Regulation of Business Development Companies," 55 S. Cal. L. Rev. 895 (1981), an article that should be available through any law school library.

7. STATE SECURITIES REGULATION

Nearly all states register securities and broker-dealers. The wisest preliminary assumption, therefore, is that state registration will be required whenever securities are issued, although a majority allow for registration by coordination. In these states full registration may consist only of paying the fees, naming an agent, and filing with the state the same documents that are required at the federal level. When the federal registration becomes effective, so does the state's. States' antifraud statutes continue to be operative despite SEC registration (or exemption from registration). Additionally, most states' commissioners or administrators of securities (whatever the title) will retain power to suspend distribution in their states upon suspicion of fraud.

Despite the adoption of the Uniform Securities Act, or a portion of it, in a majority of states, considerable variation in detail still exists, particularly in the fifteen or so states that either have not adopted the act or have passed highly individualized versions of it. A few relatively common features can be cited. Except for the District of Columbia, all of the states and Puerto Rico require registration of securities in some circumstances. Securities already listed on the New York and American stock exchanges are exempt from further registration in most jurisdictions. Also, issuers of securities benefiting from a Regulation D exemption from SEC registration under Rule 505 or 506 will often find an equivalent exemption at the state level.

Although full enumeration of state variation would be impractical, and legal counsel must be consulted, the table in section 7.2 can be used to provide a preliminary assessment of the existence at the state level of a Regulation D exemption. The Uniform Limited Offering Exemp-

tion (ULOE) cited in the table represents a state administrator's rule, of increasing adoption, that offers a limited transaction exemption based on SEC Regulation D but with further restrictive conditions, subject to the discretion of the administrator. An annotated version of the relevant state statutes can be consulted for further detail. For comparative data on several states, refer to Commerce Clearing House's *Blue Sky Reporter.* Both sources can be found in law school libraries, lawyers' offices, county law libraries, and some public libraries.

7.1 Uniform Securities Act

The Uniform Securities Act was drafted as the result of a two-year study at Harvard Law School. It has been adopted, with minor variations, by all states, except these:

Arizona	Louisiana	Rhode Island
California	Maine	South Dakota
Florida	New York	Texas
Georgia	North Dakota	Vermont
Illinois	Ohio	

(Text continued on page 39)

Some of these states (California, Ohio, and Texas, for example) have adopted selected portions of the act. The act is divided into four parts.

Part I proscribes fraudulent practices in connection with the purchase or sale of securities and in connection with investment advisory activities. No exemptions are provided from the prohibitions against fraudulent practices.

Part II requires the registration of broker-dealers, investment advisers, and employees of securities issuers who act as agents for the issuer.

Part III requires registration, unless an exemption can be found, of issues of securities before they can be sold in the state. The process called registration by coordination allows the registration documents filed with the SEC, when also filed with the state, to fulfill the state's registration requirements. (This portion of the uniform act has been adopted by California, Texas, Ohio, and South Dakota, which otherwise have not adopted it.)

Part IV contains definitions and matters of general applicability.

7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

	Rule 504	Rule 505	Rule 506	ULOE*
ALABAMA		X	X	
ALASKA				X
ARIZONA		X	X	
ARKANSAS			X	
CALIFORNIA			X	
COLORADO[1,3]	X	X	X	
CONNECTICUT		X	X	
DELAWARE	X	X	X	
DISTRICT OF COLUMBIA[2]	X	X	X	
FLORIDA[3]		X[a]	X[ab]	
GEORGIA[3]		X	X	
HAWAII			X	
IDAHO		X	X	
ILLINOIS		X[a]	X[ab]	
INDIANA	X	X[ab]	X[a]	
IOWA		X	X	X[c]
KANSAS				
KENTUCKY		X	X	
LOUISIANA			X[b]	

Table 7.2 (*Continued*)

	Rule 504	Rule 505	Rule 506	ULOE*
MAINE			X	
MARYLAND		X	X	
MASSACHUSETTS				X[e]
MICHIGAN		X	X	X[c]
MINNESOTA		X	X[b]	X[c]
MISSISSIPPI		X[a]	X[ab]	
MISSOURI		X	X	
MONTANA		X	X	
NEBRASKA		X	X	
NEVADA[1,3]	X	X	X	
NEW HAMPSHIRE				X[d]
NEW JERSEY [1,3]	X	X	X	
NEW MEXICO				X[d]
NEW YORK[1,3]	X	X	X	
NORTH CAROLINA			X	
NORTH DAKOTA				X[e]
OHIO			X	
OKLAHOMA	X	X	X	
OREGON	X	X	X	
PENNSYLVANIA		X	X	X[c]
RHODE ISLAND				X[d]
SOUTH CAROLINA				X
SOUTH DAKOTA		X	X	X[ce]
TENNESSEE			X	X[c]
TEXAS			X	
UTAH		X	X	
VERMONT		X	X	
VIRGINIA		X	X	
WASHINGTON	X		X	
WEST VIRGINIA				X
WISCONSIN		X	X	
WYOMING				X

Sources of Data

Harold S. Bloomenthal, *Securities Law Handbook, 1986-1987 Edition.*

Blue Sky Reporter. Commerce Clearing House.

[a]Similar exemption existed prior to Regulation D

[b]Variations apply in connection with accredited investors

[c]Modified ULOE to count purchasers rather than offerees

[d]Exemption for isolated transactions

[e]State filing is required

[1]Only intrastate offerings are regulated

[2]Does not register securities

[3]Full SEC regulation obviates state registration

*Uniform Limited Offering Exemption drafted by the North American Association of Securities Administrations.

8. ACCOUNTANTS' LIABILITY UNDER THE FEDERAL SECURITIES ACTS

This is a complex and evolving area, and this section merely suggests a few of the issues involved. For a detailed listing of SEC releases, see appendixes 3 and 4 of this chapter. An excellent treatment, directed to certified public accountants, may be found in the book by Denzil Causey listed in this chapter's references.

8.1 Securities Act of 1933

Two sections of the 1933 act deal with the independent public accountant's liability, Section 11 and Section 12. Section 11(a) provides that any person may sue "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement." To establish a case, the plaintiff must allege that

— The financial statements were misleading because of a misstatement or omission.

— The misstatement or omission was material.

— The security was purchased within a time period during which the law presumes that purchase was made in reliance on the statements.

— A loss was suffered.

Legal action must be brought within one year after the error is or should have been discovered, but in no case outside a period beginning with the date of the offering and ending three years thereafter. Reliance on the statements is presumed: It is not necessary for the plaintiff to allege and prove reliance upon, or even that he or she saw, the financial statements. Among the several defenses that could be claimed by a public accountant, two are worth our discussion:

The statements are not untrue by a material amount.

The public accountant exercised due diligence.

Although materiality is a concept much discussed in accounting literature, in securities-related matters it effectively becomes a matter of fact within the context of each case. An SEC rule (12b-2) states that an item is material if "there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered." In *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (SDNY 1968), the court did not consider to be material an erroneous misstatement of earnings from $.65 to $.75 per share but did hold that an error in the current ratio, incorrectly inflating it from 1.6 to 1.9, was material. Although generalizations are difficult, it is

probably safe to say that the threshold of materiality in a securities case will be low enough to allow the admission to court of a case that is not perceived by the court to be otherwise deficient or trivial.

The due-diligence defense provides that no person, other than the issuer, shall be liable who shall sustain the burden of proof that he or she had, "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true . . ." (Section 11(b)(3)). The act goes on to say that the standard of reasonableness shall be that of a prudent person in the management of his or her own property. Liability under Section 11 extends to the effective date of the registration statement, so it behooves a public accountant to exercise due diligence by reviewing events until as close to this date as is practicable. In the appropriate circumstances resignation and disclaimer of all responsibility in writing to the issuer and to the SEC by the effective date should be sufficient to avoid liability.

An independent accountant who audits financial statements to be included in a registration must assure that his or her engagement is performed and the work documented

— By persons having training and proficiency as public accountants and who work under adequate supervision.

— In accordance with generally accepted auditing standards (GAAS).

SEC-related cases in which accountants have been held liable suggest that these areas should be given particular attention:

— Indications of less than complete candor on the part of management

— Any doubts whatsoever concerning management integrity

— Conflicting or unsatisfactory explanations for unusual transactions that have more than a trivial impact on the financial statements

— Nontypical patterns of sales particularly near year end, or typical patterns when economic or competitive conditions would predict the contrary

Section 12(2) imposes liability on any person who "offers or sells a security . . . by means of a prospectus or oral communication, that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading."

In other contexts it has been held that any written offer constitutes a prospectus, so any writing and any oral communication could be the basis of a legal action. Presumably, unless they become sellers or offerors of securities, certified public accountants are not likely to be charged

under this rule. Accountants, however, could be charged with aiding and abetting such a violation. The courts are split as to whether silence and inaction on the part of an accountant can lead to a charge of aiding and abetting. Within the last half-dozen years one court has stated there is no aiding nor abetting in the absence of knowledge by the accountant of a securities violation (for example, a misstatement in a financial statement) together with "substantial assistance" by the accountant (*IIT v. Cornfeld,* 619 F.2d 909 (2d Cir. 1980)). On the other hand, another court held that silence and inaction were sufficient for the charge where the defendant accountant intended to further the fraud or had an independent duty to disclose the misbehavior (*Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 97 (5th Cir. 1975)).

8.2 Securities Exchange Act of 1934 and SEC Rule 10b-5

Section 10(b) of the 1934 act and the SEC's interpretation in Rule 10b-5 create grounds for legal action against independent accountants. For our purposes the essence of the act and the rule may be stated as follows: In connection with the purchase or sale of any security, no person shall use any device to defraud; no person shall make any untrue statement of (or omit to state) a material fact; no person shall engage in any act that would operate as a fraud or deceit. Jurisdiction of the SEC through the act and rule is established if the mails or the telephone is used in any part of the scheme or if a check is cleared; thus, practically all securities transactions, including those that might appear to be intrastate and not subject to SEC jurisdiction, may be included. There is no requirement that any filing of any sort with the SEC be made or fail to have been made. Criminal actions can be brought by the Justice Department acting on the request of the SEC, or injured private parties may enter a civil suit to recover damages.

Considerable anxiety arose among certified public accountants when it appeared that the rule might be applied against them a consequence of their "mere" negligence. This fear was mitigated when the Supreme Court held that a showing of scienter was required—that is, that the CPA had acted with the intent to make a misstatement or to defraud (*Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976)). The courts have not resolved whether conduct by a CPA that could be described as "reckless," although without guilty intent, would be sufficient to fulfill the requirement for scienter.

8.3 Private Securities Litigation Reform Act

In 1995, the Private Securities Litigation Reform Act was enacted, making dramatic changes in the rules governing private lawsuits filed under the federal securities laws. Among the changes are the following:

— Establishing proportionate liability except in cases where defendants engaged in "knowing" securities fraud
— Mandating sanctions for unsupported pleadings which could require the loser of a private class action suit to pay lawyers' fees and the costs of the suit
— Preventing abusive practices by eliminating bounty payments to plaintiffs, banning payment of plaintiff referral fees, and limiting "professional plaintiffs" to five class actions every three years

The act also added Section 10A to the 1934 act, and requires auditors to perform procedures designed to identify illegal acts committed by their SEC clients. This provision does not alter the professional standards or audit procedures applied under current requirements of Statement on Auditing Standards No. 54, *Illegal Acts by Clients,* and Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit.* In 1997, the SEC adopted Rule 10A-1 which requires auditors to report certain uncorrected illegal acts to boards of directors; and, in certain circumstances, to inform the SEC about illegal activity within a company in the event the company's management does not act on the auditor's findings and its board of directors fails to advise the SEC on its own.

The auditor must directly notify the board "as soon as practicable" if he reaches the following three specified conclusions:

1. The illegal act has a material effect on the client's financial statements.
2. Senior management has not taken, and the board has not caused management to take, "timely and appropriate remedial actions" regarding the detected illegal act.
3. The failure to take any remedial action "is reasonably expected to warrant" a departure from the auditor's standard audit report or the auditor's resignation from the audit.

If the board receives such a report from the auditor, then it has one business day to notify the Office of the Chief Accountant of the SEC of the report. If the auditor does not receive a copy of the board's notification to the SEC within one day, then by the end of the next business day, the auditor is required to furnish directly to the SEC a copy of the report given to the board. Resignation from the client does not negate the auditor's obligation to furnish his report to the SEC. (Reports filed under the requirements of Section 10A are considered nonpublic information).

9. GOING PUBLIC

"Going public" means offering stock for sale to the public. The Securities Act of 1933 requires that a registration statement be filed with the

SEC before a public offering of securities is made in interstate commerce or through the mails, unless the offering qualifies for an exemption. The registration statement is available to the public from the SEC. Somewhat similar requirements are imposed by the Securities Exchange Act of 1934 for certain companies—those seeking to have their securities listed and registered for public trading on an exchange and those whose equity securities are traded over the counter, having at least $10 million in assets and at least 500 shareholders.

9.1 Registration Statement

The registration statement is a document presented in narrative form, similar to a brochure. Registration serves to provide investors with a source of information and does not constitute approval of the investment by the SEC.

The registration statement does not become effective immediately upon its filing. No sales of securities may be made until it becomes effective, although expressions of interest can be solicited from investors by showing them a preliminary prospectus called a "red herring." Only the securities subjected to the filing process are considered registered; previously issued and outstanding securities must comply with SEC regulations before being resold.

A registration statement consists of two principal parts:

1. A prospectus, or selling document, that must be furnished to all purchasers of the securities
2. A supplemental part containing information that will be available subsequently at the SEC, on the SEC's Web site, or by mail upon request and the payment of a small fee

Each of several forms tailored to the type of issuing company specifies the information required for registration. Form S-1 is the basic and most commonly used form for full registration of an initial public offering (IPO). Instructions for the financial statement portions of the forms are found in Regulation S-X. Regulation S-K gives instructions for the nonfinancial aspects of a registration. These regulations and forms are available from the publications section of the SEC. Registration statement requirements are discussed in sections 4.4, 5.4, and 5.5 of this chapter.

The company must provide whatever information is necessary to make the statement complete and not misleading. The SEC will not pass judgment on the value of the offering as an investment, but will frequently require amendments to the registration documents to improve disclosure.

9.2 Selling Securities Without Registration

Exempt transactions relate to securities sales that are technically not public offerings in that they are private or otherwise limited. As with all securities sales, antifraud laws apply and disclosures made to investors must be truthful. Despite federal exemption from registration, a "notification" must be filed with the SEC, and state securities laws may similarly require a filing. Issuing securities without registration and under an exemption may not fulfill company goals in that subsequent sales of the securities will be restricted by SEC rules.

Section 4.5 of this chapter deals with conditional exemptions under SEC Regulation A, as well as with exemptions under Regulation A, SEC Rule 147, and Section 4(6) of the 1933 Securities Act.

9.3 State Securities Laws

The term "blue sky laws" refers to laws governing securities sales in each of the fifty states. In some states, an effective federal registration fulfills all state requirements. In others, the registration statement or other disclosure document must be submitted to the state commissioner of securities. Most states have a system of merit review through which offerings are scrutinized for compliance with criteria such as the size of the underwriters' commissions and fees. Most states require that sales reports be filed after the offering is complete since fees are based on sales within the state. State securities administrators can provide information. Section 7 of this chapter discusses state securities regulation.

9.4 Advantages and Disadvantages of Going Public

9.4.1 Advantages

A company's prestige and image are usually enhanced by public sale of stock. Often greater respect will be accorded to the company and its management by customers, competitors, and associates.

CEOs report that employee morale significantly increases. Going public is an immediate wealth-builder for present owners, who could see a hundred-fold increase in documented personal wealth. Establishing a market valuation on stock makes stock options a more attractive benefit to executives and managers and is a less costly incentive than salary increases. Enhanced liquidity rewards company founders with a market

for their stock. Pledging publicly offered stock makes personal borrowing easier. Liquidity of publicly held stock aids in estate planning.

A growing company needs a strong source of capital. A higher price per share can be commanded in a public offering than in a venture capital arrangement or private placement because the promised rate of return can be lower. Alternatively, a necessary amount of capital can be raised with less ownership dilution.

Good market performance of stock issued now will make it easier to raise capital in the future. An IPO improves the debt-to-equity ratio; future borrowings can be made on more favorable terms. Finally, a company's growth through acquisitions of other companies is facilitated by exchange of publicly traded stock.

9.4.2 Disadvantages

If significant percentages of stock are sold, loss of effective control of the company could result. Entrepreneurs accustomed to running their own show may find it difficult to work with a board of directors. Management flexibility will be lost; many desirable corporate maneuvers such as mergers and acquisitions must first gain shareholder approval.

Only shares registered and issued in an offering are freely tradable. Controlling shareholders may not freely sell their shares in the market without registration except under specified conditions. Shares previously issued, for example as management compensation, or issued to accredited investors in reliance on an exemption, are "restricted" and may be resold only in conformity with SEC regulations (SEC Rule 144).

Registration of even the smallest IPO may cost several hundred thousand dollars out-of-pocket. Much of this expense will be incurred even if the public issuance is not completed, for example, as a result of adverse market conditions. Further, ongoing operating expenses will increase as a result of statutorily mandated filings with the SEC, more complex legal and auditing requirements, and the record keeping and public relations costs of dealing with public shareholders.

Public disclosures must be made of the identity, business connections, and compensation of directors, officers, and major shareholders. Major customers and products, as well as their profitability, may have to be revealed. A spotlight will be turned on decisions and actions the company founders will have become accustomed to keeping private. No longer can the company serve as a tax shelter for the owners.

The company's apparent worth—its market value—will be made visible, yet will vary subject to market conditions outside the control of management. "Bottom-line-itis" will focus pressure on short-range operating results. Long-term planning and prudent decision making may be more difficult to sustain. Lack of steady improvement in

operating results may cause public stockholders to lose confidence and to sell their stock. Depressed stock prices cancel many of the advantages of going public.

9.5 Costs of Going Public

Because costs vary so widely from offering to offering, it is difficult to estimate typical fees. Excluding the underwriter's commission, which ranges from $700,000 to $1.2 million and is deducted from the sales proceeds, a $10 million offering might incur these representative out-of-pocket costs:

Legal fees	$ 50,000–$200,000
Accounting and auditing	$ 50,000–$200,000
Printing	$ 50,000–$200,000
Filing fees (SEC, NASD, state)	$ 25,000
Transfer agent, registrar fees, other costs	$ 25,000

Accounting and auditing costs can be less for the company with good internal control, well-kept records, and a several-year history of physical inventory counts observed by an independent CPA. Legal fees vary widely and must be closely monitored. Printing costs depend upon the number of and the length of the prospectus(es); the necessity for corrections, use of drawings, photos, or maps; and the number of stock certificates. Ongoing costs for stock transfers, SEC filings, and added accounting and legal work can be estimated at $50,000 to $100,000 annually. Additionally, CEOs report that the process of registration consumes management time, significantly diverting attention from operations for six months to a year. Afterwards, many companies find they must staff an ongoing "department of stockholder relations" to act as a communications buffer between shareholders and officers.

Costs are considerably less for nonpublic sales under an exemption from registration. However, against this must be balanced the likely restrictions on subsequent public trading of the issued shares.

9.6 Deciding to Go Public

The decision to go public is best made by balancing the benefits of market valuation and liquidity against the loss of privacy in management. Underwriters report, unless a particular industry is of unusual interest to the market, that the equities market seems most receptive to IPOs having these parameters:

— An operating history of five years or more

— Annual sales of at least $20 million

— Net income of $1 million or more

— A demonstrated annual growth rate of at least 25 percent

— A justified need for at least $5 million in capital, since many of the costs of the offering itself are fixed

— Promise of a "niche" position in their industry as a result of a unique product or technological process, the value of which can be readily perceived by the investment community

— A management team having breadth and credibility, preferably with one or two executives who have been successful in taking a company public

If a public offering is made prematurely and the stock flounders because growth is not sustained, permanent damage may be done to the issuer's credibility among employees, investors, and customers. Raising capital in the public market afterward may be nearly impossible; "too public, too soon" is a refrain heard often from CEOs.

9.7 Planning and Assistance

Much work must be done before going public. Assistance to the company by several kinds of business advisers, including CPAs, will be needed to evaluate and carry out numerous steps:

— Prepare a business plan.

— Prepare a capital forecast of needs for several years.

— Calculate the effect that alternative offerings of various sizes and prices would have on earnings per share and book value.

— Improve internal accounting control to allow for efficient auditing.

— Begin audits of financial statements in anticipation of SEC requirements, keeping in mind that auditor independence is defined by SEC rules that are more stringent in one respect than those of the AICPA; independence is lost for the CPA firm when it, its partners, or its employees perform any general accounting or bookkeeping functions for the client. Advise changes to generally accepted accounting principles. (One-time changes for the purpose of going public are presented as retroactive restatements.)

— Review present shareholder records for accuracy.

— Discuss implications of related party transactions and arrangements.

— Call in loans to management and other insiders.

— Restructure contracts, particularly with insiders or other related parties, to conform to good business practices.

— Determine that significant contracts and employment agreements have been reduced to writing.

— Reevaluate existing plans or implement stock option plans that may be easier to pass before going public.

— Authorize additional shares for the public offering and future acquisitions or sales.

— Formalize record keeping of minutes of stockholders' and directors' meetings.

— Consider desirability of splitting stock, adjusting par value, retiring preferred or special classes of stock, eliminating the preemptive right, or otherwise adjusting capital accounts to create a simple and understandable capital structure.

— Combine affiliated companies to consolidate interrelated entities.

— Amend articles of incorporation and bylaws to be consistent with needs of a public company.

— Restructure the board of directors to replace family members with persons having widely recognized business credentials, such as bankers, retired executives, attorneys, and certified public accountants.

— Consider election of an outside director who has experienced the process of going public.

— Establish an audit committee of the board of directors.

— Evaluate the need for a more experienced management team.

— Begin providing information to the financial community before entering the registration pipeline, since to begin doing so during registration will violate SEC rules.

— Compromise or otherwise settle litigation, since investors will avoid "buying a lawsuit."

The assistance of a variety of professionals will be required in the course of a public offering of securities. Some of the more prominent participants in the process are discussed below.

9.7.1 Underwriters and Investment Bankers

There are three types of underwriting:

— Firm

— Best-efforts

— Standby

In a firm underwriting, the lead or managing underwriter puts together a syndicate of underwriters and a selling group of brokers and

dealers. When the registration becomes effective, the lead underwriter, backed by the members of the syndicate, presents a check to the issuing company for the securities and then undertakes to sell them to the public.

When the investment banker promises only to use his best efforts to sell the securities, the issuing company bears the risk that the securities may not sell. The issuer and the best-efforts underwriter may agree that no shares will be issued unless a minimum number or, perhaps, "all or none" are sold. This arrangement avoids the danger that too few shares will be sold for the company to benefit while being saddled with the chores and costs of public ownership. As underwriting agreements are not finalized until the day before a registration statement goes effective, even a "firm" underwriting is not "firm" until it is signed.

For large offerings, syndicates of underwriters and broker-dealers are formed by the lead underwriter to limit individual firms' risk and to assure a broad distribution of the securities. The managing underwriter determines the allocation of shares to members of the syndicate and selling group.

In a standby underwriting, the underwriter stands ready to purchase securities that have been the subject of a rights offering to existing shareholders who choose not to buy them.

Choosing an investment banker is a critical decision. Investment bankers are recommended and introductions are arranged by accountants, attorneys, officers of public companies, or commercial bankers. Several should be interviewed before the lead underwriter is chosen. The firm should be chosen for its professional reputation, its client base, and its success with similar underwritings.

The business relationship between the issuer and the banker will be a continuing one. After the successful underwriting, the investment banker will make a market in the company's securities, provide investment analysis to the financial community, and contribute ongoing advice to the company. Surveys show CEOs' dissatisfaction with an underwriter is frequently related to a lack of continuing service after the underwriting. A company planning an IPO should check out the experiences of others who have used the same underwriter.

Compensation to the underwriter is in the form of sales commissions and, sometimes, warrants for the purchase of securities and expense allowances for which no accounting is required. State securities commissioners and the National Association of Security Dealers have guidelines for reasonableness of the compensation.

9.7.2 Law Firms

Preparing the legal documents for filing with the SEC and state authorities is a highly specialized task. It should be entrusted only to a law firm

having SEC experience or able to acquire it by association. Some state bar associations establish criteria for specialization in securities law. The company's present legal counsel may give recommendations, as may the underwriter, but the final choice is the company's.

9.7.3 Financial Public Relations Firms

The company going public must have its story put before the public, but the SEC restricts publicity that may be issued during the crucial "quiet period" beginning when a preliminary understanding has been reached with the underwriter and ending 90 days after the effective date of the registration. A financial public relations firm that is knowledgeable about the registration process can create a plan to develop public recognition. Mailing lists will be utilized to get the story to business analysts and journalists. Business magazines and major newspapers in the closest metropolitan area will be solicited for interviews. Presentations will be scheduled and publicized for delivery at appropriate trade shows; for example, at COMDEX for companies in computer-related fields.

9.7.4 Certified Public Accountants

Certified public accountants occupy a unique position. According to a recent small business survey, most CEOs reported their first advice regarding going public came from their CPAs.

Audits such as those required for S-1 and S-18 filings must be performed by an independent public or independent certified public accountant. Many disciplinary proceedings have been brought by the SEC against accountants who were not in fact independent. Instances of violation of independence have been reported in these SEC releases: Financial Reporting Release (FRR) No. 1, Section 600, FRR No. 4, and in Accounting and Auditing Enforcement Releases (AAER). Accountants involved in SEC filings must familiarize themselves with the FRRs, AAERs, Regulation S-X, and the SEC's Staff Accounting Bulletins and Staff Legal Bulletins, as well as be knowledgeable concerning generally accepted accounting principles.

Major investment bankers underwriting an IPO of national scope will insist upon a CPA firm that has a national reputation.

The form and content for the auditor's opinion letter (or report) is set forth in Rule 2-02 of the SEC's Regulation S-X. Generally accepted auditing standards must be adhered to. The report contained in a Securities (1933) Act filing must not be qualified as to scope or fairness of presentation.

Opinions that contain an explanatory paragraph that addresses the uncertainty of the company's ability to recover its investment in specific

assets—for example, a significant receivable, an investment, or certain deferred costs—are prohibited. Since generally accepted accounting principles generally require such assets to be stated not in excess of their net recoverable amount, such modifications are indicative of a scope limitation (that is, the auditor was unable to determine that the asset was stated at or below net recoverable value). However, the SEC will accept a standard "going concern" explanatory paragraph if prepared in conformity with Statement on Auditing Standards No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and if the filing contains full and fair disclosure as to the company's financial difficulties and the plans to overcome them. The independent accountant's written consent for its use must accompany the registration statement.

Any filings made via EDGAR include a typed signature of the accountant. The registrant is required to keep a manually signed copy of the accountant's report in its files for five years after the filing of the document.

The accountant may assist in preparing tabular and other data contained in the registration statement aside from the audited statements, but must make it clear he or she does not assume responsibility for any matters not within his or her expertise as an accountant.

9.8 Pricing the Securities

The underwriter will seek a market price that will accomplish several objectives, the first of which is the rapid sale of the securities. Offerings are usually structured so that at least 500,000 shares can be sold at a price between $10 and $20. Prices below $10 suggest speculative stocks; shares of unusual attractiveness might be priced higher than $20. Major considerations are market conditions, the company's capital needs, and such factors as book value, return on assets and sales, and the history and likely stability of earnings growth. The banker will not recommend the highest possible price but instead a price that will be sustained once the market's initial enthusiasm wears off. Bankers try to underprice offerings slightly below the after-market price in order to reward those investors who purchase on the initial offering. This creates a loyal following for the underwriter. An often expressed goal is that the shares should increase 10 to 15 percent in market price in the 30 days following the issuance. Considerable fluctuation may be encountered, ranging from −50 to +400 percent on a representative group of IPOs in a recent six-month period.

After notifying the SEC and conforming with strict guidelines, the underwriter is allowed to stabilize the price of the newly issued stock

by entering buy orders just below the offering price. Resales of stock obtained by the underwriter through stabilization must be made below the stabilization price.

9.9 Public Trading

The following are the National Association of Securities Dealers Automated Quotation System (NASDAQ) SmallCap initial listing requirements:

— Net tangible assets (total assets, excluding goodwill, minus total liabilities) of $4 million, or market capitalization of $50 million, or net income (in the latest fiscal year or two of the last three fiscal years) of $750,000

— Public float of 1 million shares (defined as shares that are not held directly or indirectly by any officer or director of the issuer and by any other person who is the beneficial owner of more than 10 percent of the total shares outstanding)

— Market value of public float of $5 million

— Minimum bid price of $4

— Three or more market makers

— At least 300 shareholders

— Operating history of one year or market capitalization of $50 million

The following are the NASDAQ National Market initial listing requirements:

— Net tangible assets of $6 million

— Pretax income (in the latest fiscal year or two of the last three fiscal years) of $1 million

— Public float of 1.1 million shares

— Market value of public float of $8 million

— Minimum bid price of $5

— Three or more market makers

— At least 400 shareholders

The following are the New York Stock Exchange minimum listing requirements:

— At least 2000 round lot holders (number of holders of a unit of trading, generally 100 shares) or 2200 shareholders with average monthly trading volume (for the most recent six months) of 100,000

shares or 500 shareholders with average monthly trading volume (for the most recent twelve months) of 1,000,000 shares

— At least 1.1 million public shares

— Market value of public shares of $40 million

— Net tangible assets of $40 million

— Pretax income of $2.5 million in the latest fiscal year and $2 million in each of the two preceding fiscal years or aggregate pretax income for the latest three years of $6.5 million and minimum in any of the three years of $4.5 million

There are no formal requirements for listing in the pink sheets—a daily service offered by the National Quotation Bureau. Quotes in the sheets are gathered from market makers on each of about 15,000 unlisted stocks.

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APPENDIX 1: Common 1933 Act Forms for Registration of Securities

Form	*For Registration of Securities*
S-1	Used when no other form is applicable. Used primarily by first-time registrants. Requires inclusion of all specified information in the prospectus.
S-2	Available to companies that are subject to 1934 Act reporting requirements for at least three years but don't meet the float requirements to use Form S-3. Requires incorporating by reference registrant's 1934 Act reports. Must furnish to investors certain registrant-related information either by including it in the prospectus or by delivering with the prospectus the annual shareholder report and subsequent interim reports.
S-3	Available to companies that are subject to the 1934 Act reporting requirements for one year and meet the float test. Requires incorporating by reference the registrant-related information from the 1934 Act reports. Disclosure generally is limited to information about the offering.
S-4	Registration of securities to be issued in a business combination. Permits, in certain cases, incorporating by reference information included in 1934 Act filings of the issuer and the target company.
S-8	Securities offered to employees under various employee stock plans.
S-11	For certain real estate companies.

Form	*For Exemptions From Registration*
1-A (Reg A)	Available for an offering under the "small issues" exemption (Reg A). Maximum offering is $5 million (including up to $1.5 million for selling shareholders) during any twelve-month period. Offering statement to be filed with regional office containing an Offering Circular that includes financial statements, risk factors, and other information. Financial statements must comply with GAAP but not Regulation S-X. Balance sheet as of ninety days prior to filing; statements of income, cash flows, and stockholder's equity for two fiscal years. Need not be audited unless issuer filed (or was required to file) audited financial statements with the SEC during the year. There are many advantages to this type of offering.
D (Reg D)	For offerings under Regulation D (Rules 501–508). Due fifteen days *after* the first sale of securities. • Rule 504—may offer up to $1 million during any twelve-month period. Cannot be used by investment companies, by development stage companies, or by issuers subject to section 13 or 15(d) of the 1934 Act. Registration and disclosures generally are not required. • Rule 505—may offer up to $5 million during any twelve-month period. Offer limited to thirty-five non-"accredited" investors and to unlimited "accredited" investors (see definition following). • Rule 506—allows the "private placement" of securities with an unlimited number of accredited investors and up to thirty-five nonaccredited persons. However, under this rule, each nonaccredited purchaser of the issuer must reasonably believe he or she is "sophisticated" (can evaluate merits and risks of offered securities). No limit is set to the amount that may be offered.

(Form D is also used for offerings pursuant to Rule 4(6).)

Financial Statement Requirements for Regulation D Offerings

- Nonreporting companies:
  - — Offerings up to $2 million—GAAP financial statements for the last two years.
  - — Offerings up to $7.5 million—GAAP financial statements for last two years.
  - — Offerings over $7.5 million—GAAP financial statements for the last two or three years (depending on whether company follows Regulation S-B or S-X).

Note: Regardless of offering amount, if audited financial statements cannot be obtained without unreasonable effort or expense, only the balance sheet dated within 120 days of the start of the offering must be audited.

- Reporting companies: Irrespective of offering size, present either (1) Proxy statement and annual shareholders' report, or (2) Form 10-K or 10, or Part I of Form S-1 or S-11.

Distribution of Prospectus

- Offerings up to $1 million— No prospectus required for nonreporting companies and offerings to accredited investors only.
- Offerings over $1 million—If purchasers include nonaccredited investors, specific disclosures are required in an offering circular.

Definition of Accredited Investor

Includes banks; investment and insurance companies and small business investment companies; certain employee benefit plans; large tax-exempt organizations; broker-dealers; large corporations, partnerships, and trusts; directors, general partners, and executive officers of the issuer; persons with a net worth over $1 million or annual income over $200,000.

APPENDIX 2: Commonly Used 1934 Act Forms for Registration of Securities

Form	
	Annual Reports
10-K	Form used by most domestic (and Canadian) registrants for which no other form is prescribed
11-K	Employee stock purchase, saving, and similar plans
20-F	Foreign private issuers. Also used for registration under the 1940 Act
	Interim and Current Reports
10-Q	Quarterly report for each of the first three quarters of the fiscal year
8-K	Current report filed when certain significant events occur
6-K	Periodic reports by foreign issuers
	Registration of Securities Under the 1934 Act
10	Securities for which no other form is prescribed
	Other
12b-25	Notification to SEC when unable to file periodic reports on a timely basis
15	To terminate registration under the 1934 Act or suspend periodic reporting obligations
Schedule 13D	Report by any person who becomes a 5 percent equity security holder of a public company. Also used to report material changes in beneficial ownership
Schedule 13E-3	To report a going private transaction
Schedule 13E-4	To report a tender offer for one's own equity securities
Schedule 14D-1	For tender offers if offeror would end up with more than 5 percent of target company

APPENDIX 3: SEC Accounting and Reporting Requirements

Regulation S-X

Regulation S-X contains the uniform instructions for financial statements included in most SEC filings. Briefly, it states the periods for which financial statements are required, the form and content of those statements including note disclosures and supplemental schedules, and discusses the qualification of accountants' and auditors' reports. Regulation S-X should be considered a *minimum* standard. Amendments to S-X are announced in the financial reporting releases (FRRs).

Financial statement requirements for 1933 and 1934 Act filings include—

- *Audited Balance Sheets*—as of the end of each of the two latest fiscal years.
- *Audited Statements of Income, Cash Flows, and Stockholder's Equity*—for each of the three latest fiscal years.
- *Audited Financial Statement Schedules*—as applicable in support of primary financial statements. (If the registrant is inactive (Reg S-X, Rule 3-11), the financial statements may be unaudited.)

Financial statements are generally required for—

- Registrant and its consolidated subsidiaries.
- Registrant alone (parent company).
- Unconsolidated subsidiaries and 50-percent-or-less-owned persons.
- Affiliates whose securities are pledged as collateral.
- Guarantors of securities registered.

A summary of each of the Articles of Reg S-X follows.

Article	*Subject*	*Summary of Contents*
1	Application of Regulation S-X	Specifies the registration statements and reports to which Regulation S-X is applicable and defines terminology used in the Regulation.
2	Qualifications and reports of accountants	Contains the requirements as to the qualifications (independence) of accountants and the contents of their reports.
3	General instructions for financial statements	Sets forth instructions for (1) the nature of financial statements required and the persons, dates, and periods they must cover and (2) the age of interim financial statements required to be included in registration and proxy statements.
3A	Consolidated and combined financial statements	Contains the requirements for the presentation of consolidated and combined financial statements.
4	Rules of general application	Contains the rules for form, order, and terminology, and for certain of the notes required to be furnished as part of the financial statements.
5	Commercial and industrial companies	Sets forth the information to be included in balance sheet and statement of income captions for commercial and industrial companies. Also specifies the schedules that are to be filed.

Article	*Subject*	*Summary of Contents*
6	Registered investment companies	These articles set forth the information to be included in financial statements of special types of entities.
6A	Employee stock purchase, savings, and similar plans	
7	Insurance companies	
9	Bank holding companies	
10	Interim financial statements	Sets forth the form and content of interim financial statements and the period for which such statements must be presented in Form 10-Q.
11	Pro forma financial information	Specifies the form and content of pro forma financial disclosures and when such disclosures are required. Also provides guidance for the presentation of financial forecasts that may be furnished in lieu of pro forma disclosures.
12	Form and content of schedules	Sets forth the form and content of schedules required in accordance with Rule 5-04 (and certain other rules for special types of entities).

Financial Reporting Releases

In 1982 the SEC replaced the Accounting Series Releases (ASRs) with the Financial Reporting Releases (FRRs) and AAERs. FRRs serve to—

- Communicate the SEC's views on accounting, disclosure, and auditing matters, and
- Announce changes to Regulations S-X and S-K and forms.

A listing of FRRs issued to date follows.

FRR No.	*Date*	*Summary of Contents*
1	4/82	Codification of financial reporting policies.
2	6/82	Instructions for presenting and preparing pro forma financial information and requirements for financial statements of businesses acquired or to be acquired.
4	10/82	Public availability of correspondence about accountants' independence.
5	10/82	Accountants' liability for reports on unaudited supplementary financial information.
6	11/82	SEC encourages experimentation with disclosure of foreign operations and foreign currency translation effects.
7	11/82	Adoption of foreign issuer integrated disclosure system.
8	12/82	Financial statement requirements for registered investment companies.

FRR No.	*Date*	*Summary of Contents*
9	12/82	Supplemental disclosures of oil- and gas-producing activities.
10	2/83	Qualifications and reports of accountants; amendment of rules on accountants' independence relating to certain company employees.
11	3/83	Revision of financial statement requirements and industry guide disclosure for bank holding companies.
12	8/83	Accounting for costs of internally developing computer software for sale or lease to others.
13	8/83	Revision of industry guide disclosures for bank holding companies.
14	9/83	Oil and gas producers—Full cost accounting practices; amendment of rules.
15	12/83	Interpretive release on accounting for extinguishment of debt.
16	3/84	Rescission of interpretation on qualified auditors' reports in 1933 Act registration statements.
17	4/84	Oil and gas producers—Full cost accounting practices relating to revenue recognition.
18	4/85	Business combination transactions—Adoption of registration form.
19	4/85	Business combination transactions—Adoption of registration form; foreign registrants.
20	11/84	Rules and guide for disclosures concerning reserves for unpaid claims and claim-adjustment expenses of property-casualty underwriters.
21	6/85	Technical amendments to rules and forms.
22	11/85	Technical amendments to rules and forms.
23	12/85	The significance of oral guarantees to the financial reporting process.
24	1/86	Disclosure amendments to Regulation S-X regarding repurchase and reverse repurchase agreements.
25	5/86	Technical amendments to Rule 3A-02.
26	10/86	Interpretive release about disclosures of the effect of the Tax Reform Act of 1986.
27	10/86	Amendment to Industry Guide—Disclosures by Bank Holding Companies.
28	12/86	Accounting for loan losses by registrants engaged in lending activities.
29	6/87	Accounting for distribution expenses.
30	8/87	Disclosure of the effects of inflation and other changes in prices.
31	4/88	Disclosure amendments to Regulation S-K, Form 8-K, and Schedule 14A regarding changes in accountants and potential opinion-shopping situations.
32	8/88	Disclosure obligations of companies affected by the government's defense contract procurement inquiry and related issues.
33	10/88	Public availability of correspondence about accountants' independence.
34	3/89	Acceleration of the timing for filing Forms 8-K relating to changes in accountants and resignations of directors; amendments to Regulation S-K regarding changes in accountants.

FRR No.	*Date*	*Summary of Contents*
35	3/89	Amendments to reporting requirements for issuer's change of fiscal year; financial reporting changes; period to be covered by first quarterly report after effective date of initial registration statement.
36	3/89	Management's discussion and analysis of financial condition and results of operations; certain investment company disclosures.
37	7/91	SEC rejection of FFIEC proposed accounting method.
38	10/91	Adoption of Item 900 of Regulation S-K regarding roll-ups of limited partnerships or similar entities.
39	7/92	New rules and forms for small businesses, including Regulation S-B for small business issuers.
40		Rescinded by 40A.
40A	9/92	Amendments to 1933 and 1934 Act rules and forms to conform requirements to recently adopted accounting standards (for example, cash flows).
41	11/93	Amendments for age of financial statements in 1933 Act filings by foreign private issuers.
42	3/94	Disclosure obligations of municipal securities issuers.
43	12/94	Reporting currency used by foreign private issuers.
44	12/94	Eliminated requirement for certain financial statement schedules.
45	12/94	Streamlined the reconciliation to US GAAP.
46	7/95	Revised expense disclosure for registered investment companies.
47	10/96	Increased the thresholds for significance used to determine financial statement requirements for completed and probably business acquisitions.
48	4/97	Accounting policies for derivatives and quantitative and qualitative disclosure about market risk.
49	4/97	Adopted Rule 10A-1 to implement provisions of the Private Securities Litigation Reform Act of 1995.
50		Recognizes the Independence Standards Board.

Accounting and Auditing Enforcement Releases

The Accounting and Auditing Enforcement Releases (AAERs) announce SEC enforcement actions involving accountants. They discuss SEC investigations and conclusions regarding violations of GAAS and GAAP, and any disciplinary actions taken against the accountants. These matters were announced in the ASRs until 1982.

Between April 1982 and January 1998, the SEC issued 1,006 AAERs dealing with everything from elaborate frauds to major audit failures to relatively minor schemes to improve net income. While the intent of the AAERs is not to establish new policy in the areas of accounting or auditing, the actions brought by the SEC do illustrate the variety of activities that constitute financial fraud and emphasize the importance of the independence of the auditor as a means of preventing fraud and other misconduct.

Staff Accounting Bulletins

Staff Accounting Bulletins (SABs) are interpretations of and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in

administering the accounting and disclosure requirements of the federal securities laws. SABs are not official releases of the Commission and are not part of Regulation S-X, but should be considered when preparing financial statements to be included in SEC filings. A listing of SABs issued to date follows.

SAB No.	*Summary of Contents*	*Topical Listing Reference*
40	Codification of SAB Nos. 1-38 (SAB No. 39 was superseded by ASR No. 29).	various
41	Estimates by oil procedures of future net revenues.	12-A2
42	SEC concern about the application of existing accounting standards to business combinations accounted for by the purchase method involving financial institutions.	2-A3
42A	Amortization of goodwill by financial institutions upon becoming SEC registrants.	2-A4
43	Early adoption of the new rules for separate financial statements required by Regulation S-X.	6-K
44	Implementation of Accounting Series Release No. 302 (FRR No. 1, Section 213) and deletion of topics no longer relevant.	6-K
45	Presentation of pro forma financial information for a pooling of interests.	2-C
46	Requirements for interim financial reporting.	6-G1; 6-G2
47	Oil- and gas-producing activities.	2-D; 12
47A	Correction of SAB No. 47 concerning minimum property conveyances.	12-D4
48	Assets acquired from promoters and shareholders prior to an IPO, in exchange for stock, should be recorded at cost to promoter or shareholder.	5-G
49	Disclosure by bank holding companies about loans in countries experiencing liquidity problems.	11-H
49A	Additional disclosures by bank holding companies about certain foreign loans.	11-H
50	Financial statement requirements in filings involving the formation of a one-bank holding company.	1-F
51	Accounting for sales of stock by a subsidiary.	5-H
52	Deleted.	
53	Financial statement requirements in filings involving the guarantee of securities by a parent or subsidiary.	1-G; 1-H
54	Push-down basis of accounting required in certain limited circumstances.	5-J
55	Allocation of expenses and related disclosure in financial statements of subsidiaries, divisions, or lesser business components of another entity; cheap stock; 1933 Act registration statement of a subsidiary should reflect all costs incurred by parent on its behalf.	1-B; 4-D
56	Reporting of an allocated transfer risk reserve in filings under the federal securities laws.	11-I
57	(Rescinded by SAB 95.)	5-K
58	Last-in, first-out (LIFO) inventory practices.	5-L
59	Accounting for noncurrent marketable equity securities. Charge realized loss for decline below market value.	5-M

SAB No.	*Summary of Contents*	*Topical Listing Reference*
60	Financial guarantees.	11-J
61	Loan losses.	2-A5
62	Discounting by property-casualty insurance companies.	5-N
63	Research and development arrangements.	5-O
64	Applicability of guidance in Staff Accounting Bulletins; reporting of income or loss applicable to common stock; accounting for redeemable preferred stock; issuance of shares prior to an initial public offering.	6-C; 6-B; 3-C; 4-D
65	Risk sharing in pooling of interests.	2-E
66	Disclosures by certain bank holding companies regarding certain foreign loans.	11-H
67	Income statement presentation of restructuring charges.	5-P
68	Increasing rate preferred stock.	5-Q
69	Application of Article 9 and Guide 3; income statement presentation of casino-hotel activities.	11-K; 11-L
70	Accounting for nonrecourse debt collateralized by lease receivables and/or leased assets.	5-R
71	Financial statements of properties securing mortgage loans.	1-I
71A	Financial statements of properties securing mortgage loans.	1-I
72	Classification of charges for abandonments and disallowances.	10-E
73	Push-down basis of accounting required in certain limited circumstances.	5-J
74	Disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period.	11-M
75	Disclosures by bank holding companies regarding certain foreign loans.	11-H2
76	Risk sharing in pooling of interests.	2-E2
77	Debt issue costs.	2-A6
78	Quasi-reorganization.	5-S
79	Accounting for expenses or liabilities paid by principal stockholder(s).	5-T
80	Financial statements of businesses acquired or to be acquired.	1-J
81	Gain recognition on the sale of a business or operating assets to a highly leveraged entity.	5-U
82	Transfers of nonperforming assets; disclosure of the impact of financial assistance from regulators.	5-V; 11-N
83	Earnings per share computations in an initial public offering.	4-D
84	Accounting for sales of stock by a subsidiary.	5-H
85	Gross revenue method of amortizing capitalized costs.	12-F; 12-G
86	Quasi-reorganization.	5-S
87	Uncertainties concerning property and casualty loss reserves may require FASB No. 5 contingency disclosures.	5-W
88	Certain disclosures required of foreign private issues.	1-D1
89	Financial statements of acquired troubled financial institutions.	1-K

SAB No.	*Summary of Contents*	*Topical Listing Reference*
90	Specific matters relating to the bankruptcy of an accounting firm which had public company clients.	1-L
91	Accounting for income tax benefits associated with bad debts of thrifts.	5-X
92	Accounting and disclosures relating to loss contingencies.	2-A; 5-Y; 10-F
93	Accounting and disclosure regarding discontinued operations.	5-Z
94	Recognition of a gain or loss on early extinguishment of debt.	5-AA
95	Rescinds views of staff contained in SAB 57 (contingent stock purchase warrants).	5-K
96	Treasury stock acquisitions following a business combination accounted for as a pooling-of-interests.	2-F
97	Interpretations of SAB 48 (transfers of nonmonetary assets by promoters or shareholders) and APB Opinion No. 16 (business combinations).	2-A
98	Amends previous SABs to conform with FASB No. 128 on earnings per share, and FASB No. 130 Reporting Comprehensive Income.	1-B2; 1-B3; 3-A; 4-D; 6-B1; 6-G1
99	Exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.	1-M
100	Accounting for, and disclosure of, certain expenses in connection with exit activities and business combinations, including accrual of exit and employee termination costs (EITF Issue Nos. 94-3 and 95-3) and recognition of impairment charges (APB Opinion No. 17 and FASB No. 121).	2-A; 5-P; 5-BB; 5-CC
101	Applying GAAP to revenue recognition in financial statements.	13-A; 8-A

Staff Legal Bulletins

Staff Legal Bulletins (SLBs) reflect the views of the SEC staff, but are not rules or regulations. SLBs are not official releases of the SEC and are not part of Regulation S-X, but should be considered when preparing financial statements to be included in SEC filings. A listing of SLBs issued to date follows.

SLB No.	*Summary of Contents*
1	Discusses the requirements for confidential treatment of information that is otherwise required to be disclosed in a registration statement or periodic report.
2	Information the SEC staff considers when evaluating a no-action letter to modify the periodic reporting for registrants that are either reorganizing or liquidating under the provisions of the bankruptcy laws.

SLB No.	*Summary of Contents*
3	Guidance as to when issuers may rely on Section 3(a)(10) of the 1933 Act for exemption from registration where securities are not issued for cash and a court or governmental agency has approved the fairness of the transaction.
4	Addresses when a subsidiary is exempt from registering the distribution of shares to its parent company's shareholders (that is, a spin-off) under the 1933 Act.
5	Discusses the disclosure requirements related to a company's ability to process date-sensitive data after the year 2000. SLB 5 was rescinded and updated guidance provided in SEC Release No. 33-7558.
6	Discusses the disclosure obligations in connection with the euro.
7	Provides answers to commonly asked questions regarding the plain English rules that became effective on October 1, 1998.
8	Addresses the handling of customer orders by broker-dealers when circuit breakers halt exchange-based trading and the adequacy of system capacity.

(Text continued on page 69)

APPENDIX 4: SEC Industry Guides

The SEC issued several guides under the 1933 and 1934 Acts dealing with certain industry-specific disclosures. The guides are not official Commission releases but should be considered when filing registration statements and periodic reports. The guides are listed in subpart 800 of Regulation S-K.

Industry Guide No.	*1933 Act Industry Guides*
1	(Reserved).
2	Disclosure of oil and gas operations.
3	Statistical disclosure by bank holding companies.
4	Prospectuses relating to interests in oil and gas programs.
5	Preparation of registration statements relating to interests in real estate limited partnerships.
6	Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters.
7	Description of property by issuers engaged in or to be engaged in significant mining operations.

Industry Guide No.	*1934 Act Industry Guides*
1	(Reserved).
2	Disclosure of oil and gas operations.
3	Statistical disclosure by bank holding companies.
4	Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters.
7	Description of property by issuers engaged in or to be engaged in significant mining operations.

APPENDIX 5: State Securities Regulators

Alabama
Securities Commission
166 Commerce Street,
2nd floor
Montgomery, AL 36130
205/261-2984

Alaska
State of Alaska
Division of Banking and
Securities
Dept. of Commerce
P.O. Box D
Juneau, AK 99811
907/465-2521

Arizona
Securities Division
Corporation Commission
1200 W. Washington, Suite 201
Phoenix, AZ 85007
602/542-4242

Arkansas
Securities Department
201 E. Markham, 3rd floor
Heritage West Building
Little Rock, AR 72201
501/371-1011

California
Department of Corporations
1115 Eleventh St.
Sacramento, CA 95814
916/445-7205

Colorado
Division of Securities
1580 Lincoln St., Suite 420
Denver, CO 80203
303/894-2320

Connecticut
Dept. of Banking
44 Capitol Ave
Hartford, CT 06106
203/566-4560

Delaware
Department of Justice
Division of Securities
820 N. French St., 8th floor
Wilmington, DE 19801
302/571-2515

District of Columbia
Public Service Commission,
Securities Division
450 5th Street, N.W., 8th floor
Washington, DC 20001
202/626-5105

Florida
Division of Securities
Office of the Comptroller,
LL-22
The Capitol Building
Tallahassee, FL 32399-0350
904/488-9805

Georgia
Securities Division
Business Services and
Regulations
2 Martin Luther King, Jr. Dr.,
S.E., Suite 306
West Tower
Atlanta, GA 30334
404/656-2894

Hawaii
Securities Enforcement
P.O. Box 40
Honolulu, HI 96810
808/548-6134

Idaho
Securities Division
700 W. State Street
Boise, ID 83720
208/334-3313

Illinois
Secretary of State
Securities Department
900 S. Spring Street
Springfield, IL 62704
217/782-2256

Indiana
Securities Commission
1 N. Capitol Street, Suite 560
Indianapolis, IN 46204
317/232-6681

Iowa
Securities Bureau
Lucas State Office Building
Des Moines, IA 50319
515/281-4441

Kansas
Securities Commission
618 S. Kansas Ave., 2nd floor
Topeka, KS 66603-3804
913/296-3307

Kentucky
Financial Institutions Dept.
Division of Securities
911 Leawood Drive
Frankfort, KY 40601
502/564-2180

Louisiana
Securities Commission
315 Louisiana State Office Bldg.
325 Loyola Avenue
New Orleans, LA 70112-1878
504/568-5515

Maine
Bureau of Banking
Securities Division
State House Station 121
Augusta, ME 04333
207/582-8760

Maryland
Division of Securities
200 St. Paul Place, 20th floor
Baltimore, MD 21202-2020
301/576-6360

Massachusetts
Secretary of State Office
Securities Division
1 Ashburton Place, Suite 1701
Boston, MA 02108
617/727-3548

Michigan
Securities Division
Department of Commerce
6546 Mercantile
Lansing, MI 48909
517/334-6209

Minnesota
Registration and Licensing
Division
Department of Commerce
133 East Seventh St.
St. Paul, MN 55101
612/296-2594

Mississippi
Office of Secretary of State
Securities Division
P.O. Box 136
Jackson, MS 39205
601/359-1350

Missouri
Division of Securities
Office of Secretary of State
301 W. High Street
Truman Building, 8th floor
Jefferson City, MO 65102
314/751-2302

Montana
Securities Division
Office of State Auditor
P.O. Box 4009
Helena, MT 59604-4009
406/444-2040

Nebraska
Department of Banking and Finance
Securities Bureau
P.O. Box 95006
301 Centennial Mall S.
Lincoln, NB 68509-5006
402/471-3445

Nevada
Secretary of State
Securities Division
2501 E. Sahara Ave
Suite 201
Las Vegas, NV 89158
702/486-4400

New Hampshire
Office of Securities Regulation
157 Manchester Street
Concord, NH 03301
603/271-1463

New Jersey
Bureau of Securities
Department of Law and Public Safety
Two Gateway Center, 8th floor
Newark, NJ 07102
201/648-2040

New Mexico
Securities Division
725 St. Michaels Drive
Santa Fe, NM 87501
505/827-7140

New York
Department of Law
Bureau of Securities
120 Broadway, 23rd floor
New York, NY 10271
212/341-2222

North Carolina
Office of Secretary of State
Division of Securities
300 N. Salisbury St., Suite 404
Raleigh, NC 27611
919/733-3924

North Dakota
Securities Commissioner's Office
600 East Blvd., 5th floor
Bismarck, ND 58505
701/224-2910

Ohio
Division of Securities
State Office Tower Two, 22nd floor
77 South High Street
Columbus, OH 43266-0548
614/466-3001

Oklahoma
Department of Securities
P.O. Box 53595
Oklahoma City, OK 73152
405/521-2451

Oregon
Department of Insurance and Finance
Securities Section
21 Labor and Industries Bldg.
Salem, OR 97310
503/378-4387

Pennsylvania
Securities Commission
1010 North Seventh Street
Eastgate Office Building, 2nd floor
Harrisburg, PA 17102
717/787-6828

Puerto Rico
Securities Office
Office of the Commissioner of Financial Institutions
P.O. Box 70324
San Juan, PR 00936
809/751-7837

Rhode Island
Securities Division
Dept. of Business Regulation
233 Richmond Street
Suite 232
Providence, RI 02903-4232
401/277-3048

South Carolina
Secretary of State
Securities Division
Edgar Brown Building
1205 Pendleton St., Suite 501
Columbia, SC 29201
803/734-1087

South Dakota
Department of Commerce & Regulations
Division of Securities
910 East Sioux
Pierre, SD 57501
605/773-4823

Tennessee
Securities Division
Department of Commerce and Insurance
500 James Robertson Parkway
Suite 680
Nashville, TN 37243
615/741-2947

Texas
Securities Board
1800 San Jacinto Street
Austin, TX 78701
512/474-2233

Utah
Securities Commissioner's Office
The Department of Commerce
P.O. Box 45802
Salt Lake City, UT 84145-0802
801/530-6600

Vermont
Securities Division
The Department of Banking and Insurance
120 State Street
Montpelier, VT 05602
802/828-3420

Virginia
Division of Securities and Retail Franchising
State Corporation Commissioner
P.O. Box 1197
Richmond, VA 23209
804/786-7751

Virgin Islands of the U.S.
Office of the Lieutenant Governor
Division of Banking and Insurance
Kongens Gade #18
St. Thomas, VI 00802
809/774-2991

Washington
Securities Division
Department of Licensing
P.O. Box 648
Olympia, WA 98504
206/753-6928

West Virginia
Securities Division
Office of State Auditor
State Capitol, Room W-118
Charleston, WV 25305
304/348-2257

Wisconsin
Commissioner of Securities
P.O. Box 1768
Madison, WI 53701
608/266-3431

Wyoming
Securities Division
Secretary of State
State Capitol Building
Cheyenne, WY 82002
307/777-7370

Other Agencies

Exchanges

New York Stock Exchange
Arbitration Dept.
20 Broad Street, 5th floor
New York, NY 10005
212/656-2772

National Assoc. of Securities Dealers
Contact your district office or write to:
Surveillance Dept.
1735 K Street, NW
Washington, DC 20006

Chicago Board of Trade
Office of Investigation and Audit
141 W Jackson Blvd., B Level
Chicago, IL 60604
312/435-3679

American Stock Exchange
Investor Inquiries
86 Trinity Place
New York, NY 10006
212/306-1452

Chicago Board Options Exchange
Dept. of Market Regulation
400 S. LaSalle Street
Chicago, IL 60605
312/786-7705

Chicago Mercantile Exchange
Compliance Department
30 S. Wacker Drive
Chicago, IL 60606
312/930-1000

APPENDIX 6: SEC Regulation S-X (Excerpts on Accountants' Reports and General Instructions Regarding Financial Statements)

From **Rule 1.02 Article 1, Application of Regulation S-X**

Accountant's Report. The term "accountant's report," when used in regard to financial statements, means a document in which an independent public or certified public accountant indicates the scope of the audit (or examination) which he has made and sets forth his opinion regarding the financial statements taken as a whole, or an assertion to the effect that an overall opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor shall be stated.

From **Rule 2-02, Accountants' Reports**

(a) *Technical Requirements.* The accountant's report (1) shall be dated; (2) shall be signed manually; (3) shall indicate the city and State where issued; and (4) shall identify without detailed enumeration the financial statements covered by the report.

(b) *Representations as to the Audit.* The accountant's report (1) shall state whether the audit was made in accordance with generally accepted auditing standards; and (2) shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) *Opinion to be Expressed.* The accountant's report shall state clearly: (1) the opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and (2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(d) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each exception on the related financial statements given.

From **Article 2. Qualifications and Reports of Accountants**

Rule 2-01, Qualifications of Accountants

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; or (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of Rule 2-01(b), the term "member" means: (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and (iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

From **Article 3, General Instructions as to Financial Statements**

Rule 3-01, Consolidated Balance Sheets

(a) There shall be filed, for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years. If the registrant has been in existence for less than one fiscal year, there shall be filed an audited balance sheet as of a date within 135 days of the date of filing the registration statement.

(b) If the filing, other than a filing on Form 10-K or Form 10, is made within 45 days after the end of the registrant's fiscal year and audited financial statements for the most recent fiscal year are not available, the balance sheets may be as of the end of the two preceding fiscal years and the filing shall include an additional balance sheet as of an interim date at least as current as the end of the registrant's third fiscal quarter of the most recently completed fiscal year.

(c) The above instruction is also applicable to filings, other than on Form 10-K or Form 10, made after 45 days but within 90 days of the end of the registrant's fiscal year, *provided* that the following conditions are met:

(1) The registrant files annual, quarterly and other reports pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 and all reports due have been filed;

(2) For the most recent fiscal year for which audited financial statements are not yet available the registrant resonably and in good faith expects to report income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle; and

(3) For at least one of the two fiscal years immediately preceding the most recent fiscal year the registrant reported income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle.

(d) For filings made after 45 days but within 90 days of the end of the registrant's fiscal year where the above conditions are not met, the filing must include the audited balance sheets required by the first paragraph of this rule.

(e) For filings made after 134 days subsequent to the end of the registrant's most recent fiscal year the filing shall also include a balance sheet as of an interim date within 135 days of the date of filing.

(f) Any interim balance sheet provided in accordance with the requirements of this rule may be unaudited and need not be presented in greater detail than is required by Rule 10-01. Notwithstanding the requirements of this rule, the most recent interim balance sheet included in a filing shall be at least as current as the most recent balance sheet filed with the Commission on Form 10-Q.

Rule 3-02, Consolidated Statements of Income and Changes in Financial Position

(a) There shall be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements of income and changes in financial position for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed, or such shorter period as the registrant (including predecessors) has been in existence.

(b) In addition, for any interim period between the latest audited balance sheet and the date of the most recent interim balance sheet being filed, and for the corresponding period of the preceding fiscal year, statements of income and changes in financial position shall be provided. Such interim financial statements may be unaudited and need not be presented in greater detail than is required by Rule 10-01.

Rule 3-04, Changes in Other Stockholders' Equity

An analysis of the changes in each caption of other stockholders' equity presented in the balance sheets shall be given in a note or separate statement. This analysis shall be presented in the form of a reconciliation of the beginning balance to the ending balance for each period for which an income statement is required to be filed with all significant reconciling items described by appropriate captions. State separately the adjustments to the balance at the beginning of the earliest period presented for items which were retroactively applied to periods prior to that period. With respect to any dividends, state the amount per share and in the aggregate for each class of shares.

From **Rule 4-08, General Notes to Financial Statements** (Topics)

Principals of Consolidation or Combination
Assets Subject to Lien
Defaults
Preferred Shares
Restrictions Which Limit the Payment of Dividends by the Registrant
Significant Changes in Bonds, Mortgages, and Similar Debt
Summarized Financial Information of Subsidiaries not Consolidated and 50 percent-or-less owned persons
Income Tax Expense
Warrants or Rights Outstanding
Related Party Transactions Which Affect the Financial Statements
Repurchase and Reverse Repurchase Agreements
Accounting Policies for Certain Derivative Instruments

APPENDIX 7: Solicitation of Proxies

Securities Exchange Act of 1934, Regulation 14A

Rule 14a-3 of the regulation states that "no solicitation subject to this regulation shall be made unless each person solicited is concurrently furnished, or has previously been furnished, with a written proxy statement containing the information specified in Schedule 14A."

Information Required in a Proxy Statement (Schedule 14A)

- Date, time, and place information.
- Revocability of proxy.
- Dissenters' right of appraisal.
- Persons making the solicitation.
- Interest of certain persons in matters to be acted upon.
- Voting securities and principal holders thereof.
- Directors and executive officers.
- Compensation of directors and executive officers.
- Independent public accountants.
- Compensation plans.
- Authorization or issuance of securities otherwise than for exchange.
- Modification or exchange of securities.
- Financial and other information.
- Mergers, consolidations, acquisitions, and similar matters.
- Acquisition or disposition of property.
- Restatement of accounts.
- Action with respect to reports.
- Matters not required to be submitted.
- Amendment of charter, by-laws, or other documents
- Other proposed action.
- Voting procedures.
- Information required in investment company proxy statements.

FEDERAL INDIVIDUAL TAX NOTES

1. 2001 TAX ACT PROVISIONS AFFECTING 2001 FORM 1040

1.1 10 Percent Tax Bracket

The Economic Growth and Tax Relief Act of 2001 (EGTRRA) establishes a new 10 percent lower tier income tax rate bracket for a portion of taxable income that was previously taxed at 15 percent [Internal Revenue Code (IRC) Section 1(i)(1)]. The 15 percent bracket begins at the end of the new 10 percent bracket, and the upper end of the 15 percent bracket remains the same as under prior law (with annual inflation indexing). The 10 percent rate bracket is scheduled as follows:

	10 Percent Rate Bracket		
	Single/ Married Filing Separate	*Head of Household*	*Married Filing Jointly*
2002–2007	$0–$6,000	$0–$10,000	$0–$12,000
2008–2010	0– 7,000	0– 10,000	0– 14,000

For 2001, in lieu of the 10 percent tax bracket, taxpayers will receive either an advance rebate or a tax credit, as discussed in the following section.

1.2 Rebate/Credit for 2001 in Lieu of 10 Percent Rate

In lieu of providing the lower 10 percent bracket for 2001 returns, Congress enacted an advance rebate/tax credit system (Sec. 6428). This advance rebate or tax credit is calculated as 5 percent of the new lower 10 percent rate bracket amount, representing the tax savings from decreasing the rate from 15 percent to 10 percent on the first $6,000 of income for single filers, $10,000 of income for a head of household filers, or $12,000 of income for joint filers. Accordingly, the maximum rebate or credit amount is as follows:

Filing Status	*Maximum Rebate/Credit*
Single	$300
Head of household	500
Joint/surviving spouse	600

1.2.1 Advance rebate

The advance rebate checks were generally issued in July through September of 2001, based on the taxpayer's 2000 taxable income and filing status.

Under the direction of Section 6428(e), the IRS issued advance rebate checks based on the amount of 2000 taxable income that would have received the benefit of the new 10 percent bracket. However, the rebate could not exceed the actual tax incurred for 2000, reduced by any nonrefundable credits.

Observation

Taxpayers who filed their 2000 Form 1040 under extension will have received their rebates later than the normal July-to-September processing period in many cases. Further, the Treasury was directed to not issue any rebates after December 31, 2001. Taxpayers not receiving an advance rebate due to the late filing of their 2000 Form 1040 will need to claim the benefit of the 10 percent bracket through the credit system discussed below.

> *Example.* Seth, a single taxpayer, had 2000 taxable income of $25,000 and incurred $3,800 of 2000 federal income tax. Accordingly, Seth received a $300 advance rebate check in August 2001 ($6,000 of taxable income that would receive the lower 10 percent bracket multiplied by 5 percent rate savings). However, if Seth had reported only $4,000 of taxable income in 2000, his rebate would have been limited to $200 ($4,000 times 5 percent). Seth would then need to test for a possible credit in his 2001 Form 1040 to receive the complete benefit of the lower bracket for 2001.

1.2.2 Eligibility for advance rebate/credit

There are two categories of taxpayers who are ineligible for either the advance rebate based on 2000 income or the credit in the 2001 Form 1040:

1. A nonresident alien
2. Any individual with respect to whom a dependency exemption is allowable to another taxpayer

1.2.3 Credit on 2001 Form 1040

For individuals who do not receive a maximum advance rebate (typically because of insufficient 2000 Form 1040 taxable income or net tax, or because the individual was a dependent of another), a tax credit may be claimed on the 2001 Form 1040.

As with the advance rebate, the tax credit is calculated based on the amount of income that would be eligible for the lower tier 10

percent bracket (for example, $6,000 single or $12,000 of joint taxable income) multiplied by the 5 percent rate savings. However, the credit is limited to the actual tax in the return less the refundable credits.

Example. Ted was in college during the entire 2000 year and was claimed as a dependent by his parents, who provided over half of his support for the year 2000. Accordingly Ted was ineligible for an advance rebate in mid-2001. However, Ted graduated from college in May 2001, provided more than half of his own support for the year, and claims his own dependency exemption in 2001. Accordingly, assuming Ted has at least $6,000 of taxable income that would have been eligible for the lower 10 percent bracket, Ted may claim a maximum $300 credit in his 2001 Form 1040. However, if Ted only had $5,000 of taxable income in 2001, his credit would be limited to $250 ($5,000 times 5 percent).

Example. Jim and Joan filed jointly in 2000. Both were in graduate school and working part time, and their 2000 Form 1040 reported only $1,500 of federal income tax. Further, this tax was offset by $1,300 of Lifetime Learning credits, leaving a net 2000 Form 1040 tax of $200. Accordingly, their advance rebate during the summer of 2001 was limited to $200. In filing their 2001 Form 1040, Jim and Joan are eligible for up to a $400 credit ($600 maximum for joint filers less $200 advance rebate). Assuming that Jim and Joan have at least $12,000 of taxable income in 2001 and report at least $600 of actual net tax, they will be able to receive the remaining benefit of $400 as a credit.

Practice Tip

The new rate reduction credit will be claimed on page two of the 2001 Form 1040. The 2001 Form 1040 instructions will contain a worksheet for calculating this credit.

Caution

Per Section 6428(c)(3), it is clear that both the advance rebate based on 2000 filing status and the 2001 tax credit (for those not receiving the full rebate) are not available to a person eligible to be claimed as a dependent by another taxpayer. Thus, children claimed as dependents receive neither a rebate nor a credit. However, some members of Congress have indicated that this does not reflect congressional intent, as dependent children should receive the 10 percent rate benefit in 2001. Accordingly, Congress may direct the IRS to allow the rate reduction credit to dependent returns in the 2001 Form 1040.

1.2.4 Other rules regarding the advance rebates and credits

If an advance rebate is issued that is greater than the credit amount that the taxpayer would be entitled to in 2001, no repayment is required.

For example, in the case of a couple that filed jointly in the year 2000 and one of the spouses deceased in 2000, a maximum $600 rebate would have been issued based on the 2000 filing status. However, in 2001, the remaining spouse filing as a single taxpayer would normally only be entitled to a $300 credit amount. The excess advance rebate does not need to be repaid.

In the case of divorced taxpayers, the law makes the assumption that half of any advance rebate was paid to each person. Accordingly, in comparing the 2001 Form 1040 to the prior rebate, each is assumed to have received half of the joint rebate, regardless of how the actual funds were allocated or paid under the marital dissolution document.

No interest is being paid on any advance rebates.

The calculation of the advance rebate or the credit does not take into account whether any of the taxable income was eligible for the lower capital gain rate. Accordingly, lower bracket taxpayers who incur either 2000 or 2001 tax at the 10 percent capital gain rate will receive the benefit of a rebate or credit, even though there may not have been ordinary income subject to the 15 percent bracket.

Example. For the year 2000, Art, a retired taxpayer, reported $10,000 of taxable income that consisted entirely of long-term capital gain taxable at the 10 percent rate ($1,000 of tax). Because Art reported more than $6,000 of taxable income and incurred more than $300 of net tax, Art received the maximum advance rebate to a single filer of $300. This occurs even though Art in fact incurred no income at the 15 percent rate and would not have been entitled to any savings through use of an actual lower 10 percent ordinary rate bracket.

The same result would occur in the calculation of the 2001 credit for an individual who did not receive an advance rebate in 2000, due to either insufficient tax or ineligibility.

1.3 Reduction of Upper Brackets

Effective in 2001 and following years, the upper tier ordinary income brackets (that is, formerly 28 percent through 39.6 percent rates) are gradually reduced until 2006. For 2001, these brackets are each reduced .5 percent, with a similar .5 percent reduction in 2002. Each bracket is further reduced 1 percent in 2004, and another 1 percent in 2006, except for the upper tier bracket being reduced by 2.6 percent from 2005 to 2006.

The following chart summarizes the scheduled changes in each income tax bracket:

Income Tax Brackets				
2000	*2001*	*2002–2003*	*2004–2005*	*2006+*
—	*	10 %	10 %	10%
15 %	15 %	15	15	15
28	27.5	27	26	25
31	30.5	30	29	28
36	35.5	35	34	33
39.6	39.1	38.6	37.6	35

*For 2001, the 10% rate bracket is administered through the advance rebate or tax credit system of IRC Section 6428, as discussed above.

The amount of income taxed at each of these brackets will continue to be adjusted annually for inflation, other than the 10 percent bracket, which is not adjusted for inflation until after 2008.

Observation

EGTRRA has also scheduled the gradual repeal of the phase out of personal exemptions and the phase out of itemized deductions. However, the elimination of these phase outs does not begin to occur until 2006. Presently, these phase outs have the impact of increasing marginal rates for upper tier filers (typically those in the 31 percent to 36 percent ordinary brackets and above). The phase out of itemized deductions causes approximately a 1 percent increase in the marginal income tax rate, and the phase out of personal exemptions causes approximately a .8 percent per exemption marginal rate increase.

1.4 Child Tax Credit

Taxpayers with a child under age 17 at the close of the tax year are entitled to a child tax credit of $500 per child [Sec. 24(a)]. This credit phases out as modified adjusted gross income exceeds $110,000 for joint filers, $55,000 for married individuals filing separately, or $75,000 for single and head of household filers. The credit phases out at a rate of $50 of credit per $1,000 (or fraction thereof) of modified adjusted gross income (AGI) over these phase out thresholds.

In the past, this credit has been nonrefundable, except for taxpayers with three or more children, who may receive a refundable credit to the extent that the taxpayer's Social Security taxes exceed the taxpayer's earned income credit.

Effective for the 2001 tax year, the credit amount per child increases to $600. This credit amounts remains at $600 until increasing to $700 in 2005, to $800 in 2009, and $1,000 in 2010 and after.

The phase out of this credit commences at the same modified AGI amount as in the past (that is, $75,000 single and $110,000 of joint

AGI), but the increased credit amount will slightly extend the range of income over which some portion of credit will remain eligible. For example, joint filers with two children will have some portion of the credit remaining until modified AGI reaches $133,000 (formerly $129,000).

Other changes to the child tax credit include:

1. The child credit is allowable to offset both the regular income tax and the alternative minimum tax (AMT), and is made a permanent feature of the tax law.
2. The child tax credit becomes refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,000. In addition, the credit is refundable regardless of the number of children in the family (previously only those with three or more children qualified for the refundable feature).

Example. Ned and Nellie have three children under age 17. In 2001 they have earned income from wages of $22,000, and an income tax liability of $700. The $700 of income tax is fully offset by the first $700 of their $1,800 of child credit (three children under age 17 times $600 credit per child). The remaining $1,100 of child credit is refundable because it is less than 10 percent of their earned income over $10,000, or $1,200 [($22,000 minus $10,000) times 10 percent].

1.5 Alternative Minimum Tax Exemption

An individual's tentative minimum tax is calculated as 26 percent of the first $175,000 of AMT income, and 28 percent of the remaining AMT income.

An exemption amount is allowed against the AMT (married filing joint, $45,000; single and heads of household, $33,750; and married filing separately, $22,500), but this exemption amount phases out. The phase out starts at $150,000 for joint filers, $112,500 for single and head of household filers, and $75,000 for married filing separately, with the exemption phased out at the rate of 25 percent of the excess of the individual's AMT income over the start of the phase out range.

For years 2001 through 2004, the AMT exemption of Section 55(d) is increased by the following amounts:

Filing Status	*Exemption Increase*	*New Exemption Amount*
Married filing jointly	$4,000	$49,000
Single and head of household	2,000	35,750
Married filing separately	2,000	24,500

2. INDIVIDUAL INCOME DEVELOPMENTS

2.1 Extraterritorial Income Exclusion

In response to a decision of the World Trade Organization, Congress repealed the Foreign Sales Corporation (FSC) provisions in former IRC Sections 921 through 927 and substituted a new extraterritorial income exclusion for taxpayers involved in foreign sales activities. The exclusion, enacted in IRC Section 114, applies to extraterritorial income, with the related definitions enacted at IRC Sections 941 through 943 (PL 106-519, 11/15/2000).

The income exclusion applies to individuals, as well as other business entities, that have foreign sales activity, and was retroactively available to transactions occurring on or after October 1, 2000. However, existing FSCs can delay implementation until January 1, 2002. In general, the exclusion from income is the greatest of the following:

1. 1.2 percent of foreign trading gross income
2. 15 percent of foreign trade income
3. 30 percent of foreign sale and leasing income

Foreign trading gross income is defined as arising from the sale, exchange, or other disposition of qualifying foreign trade property, the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States, services related to a sale, exchange, or other disposition of qualifying foreign trade property by the taxpayer, or any lease or rental of qualifying foreign trade property for use by the tenant outside the United States, engineering or architectural services for construction projects outside the United States, or the performance of managerial services in connection with the production of foreign trading gross receipts.

If foreign trading gross receipts for the year exceed $5 million, the taxpayer must also substantiate that certain economic processes take place outside the United States. IRS Form 8873, Extraterritorial Income Exclusion, is used to calculate the amount of exempt income.

Observation

In the past, a small business, and particularly a proprietorship, received no privileges for foreign sales activities. In fact, the costs associated with establishment of an FSC often prohibited small businesses from taking advantage of the FSC provisions. However, the new income exclusion applies to all businesses that are involved in foreign sales activities, and can simply be claimed by the use of IRS Form 8873, without the need to create any separate business entity or additional compliance obstacles.

2.2 Debt Relief Income: Insolvency Definition

Under Section 61(a)(12), gross income includes income from the discharge of debt. However, Section 108 allows nonrecognition of debt relief income for several categories of taxpayers, including those that are insolvent. Insolvency is defined as the excess of liabilities over the fair market value of assets, measured immediately before the debt discharge, with the tax relief limited to the amount of the taxpayer's insolvency [Sec. 108(a)(3)].

Prior court cases, including IRS rulings, have held that insolvency is measured by excluding assets that are exempt from the claims of creditors under state law, such as a residence or a qualified retirement plan (*Cole v. Comm.*, 42 BTA 1110, 1940; *Marcus v. Comm.*, TC Memo 1975-9; *Hunt v. Comm.*, TC Memo 1989-335; PLR 9125010). However, recent IRS rulings have argued that such exempt assets should not be excluded in the measurement of insolvency (FSA 199932019; PLR 199932013).

The Tax Court has ruled that assets exempt from creditors under state law may not be ignored in measuring the insolvency of a taxpayer for §108 debt relief purposes. The court relied on the fact that the statute does not contain any definition of insolvency, and consequently there is a lack of authority for the exclusion of creditor-exempt assets. The court noted that "If Congress had intended to exclude such exempt assets from a taxpayer's assets in determining whether the taxpayer is insolvent for purposes of Section 108, Congress would have so stated" (*Carlson v. Comm.*, 116 TC No. 9, 2/23/2001).

Example. Bart invested in a real estate project that is now in financial difficulty. The property has a current market value of $300,000 and has secured debt of $450,000. As a result, the lender agrees to reduce the debt by $100,000. Bart's only other asset is a principal residence valued at $200,000. Under state law, this residence is exempt from creditors.

Under the former measurement of insolvency under Section 108, due to the exclusion of his residence, Bart had a deficit in his net worth of $150,000. Accordingly, the entire $100,000 of debt relief was not currently includable in income under Section 108 (although Bart would be required to reduce the tax attributes of his property under §1017 as a result of this debt relief). As a result of the *Carlson* Tax Court decision, Bart is not insolvent for Section 108 purposes, and the $100,000 debt discharge must be included in his income.

	Former	*Revised*
Real estate	$ 300,000	$ 300,000
Residence	—	200,000
Debt	(450,000)	(450,000)
Net worth	$(150,000)	$ (50,000)

2.3 Sale of a Principal Residence

The IRS has issued proposed regulations providing additional guidance on the $250,000 ($500,000 for joint returns) exclusion of gain on the sale of a taxpayer's principal residence (NPRM-REG 105235-99, Prop. Reg. Secs. 1.121-1 through 1.121-4, 10/10/2000). The proposed regulations cover the topics that may not have been clear from the original Section 121 statute.

2.3.1 Definition of a principal residence

The regulations clarify that a principal residence may include a houseboat, house trailer, or stock held in a cooperative housing corporation if the dwelling is occupied as a principal residence. If a taxpayer alternates between two properties, using each as a residence for successive periods, the property used a majority of the time during the year is ordinarily considered the principal residence [Prop. Reg. Sec.1.121-1(b)].

Observation

In view of the fact that a principal residence must be occupied for any two years during the five-year period ending on the date of sale to qualify for the Section 121 exclusion, some taxpayers may be able to qualify two residences as principal residences at any one point in time. For example, if a taxpayer primarily used one residence as his or her principal residence during 1999 and 2000, and then used another location as their principal residence during 2001 and 2002, the sale of either property during 2003 could qualify for the Section 121 exclusion.

2.3.2 Business use of a residence

The gain exclusion does not apply to the extent of any depreciation attributable to periods after May 6, 1997. This rule applies even if a residence has been converted entirely to personal use at the time of sale. Further, if a dwelling is used partially for residential purposes and partially for business purposes at the time of sale, only that part of gain allocable to the residence portion is excludable [Prop. Reg. Sec.1.121-1(d) and (e)].

Example. Fred owns a dwelling that was in rental status for many years. On July 1, 1999, Fred converted this property from rental status to personal use by occupying this property as his principal residence. Two years and two months later, on September 1, 2001, Fred sells the property and realizes a gain of $60,000. The depreciation claimed on the property from May 6, 1997, to July 1, 1999, was $14,000. Accordingly, $14,000 of the gain must be recognized as 25 percent rate capital gain. The balance of the gain qualifies for the principal residence exclusion because Fred has owned and used the property as his principal residence for more than two years out of the prior five years.

Example. Gayle, an attorney, uses 25 percent of her principal residence as a law office and has done so for the full four-year period preceding the sale of the property. Accordingly, the Section 121 exclusion is not available to the gain from the sale that is allocable to the law office portion of the property. Assume that Gayle has owned the home for many years, and that her total basis in the property is only $200,000 compared to the current sale price of $400,000. If Gayle claimed $5,000 of depreciation during the four years of business use, her gain calculation is as follows:

	25 Percent Business	*75 Percent Personal*	*Total*
Sale price	$ 100,000	$ 300,000	$ 400,000
Less basis	(50,000)	(150,000)	(200,000)
Add depreciation	5,000	0	5,000
Gain	$ 55,000	$ 150,000	$ 205,000
Less §121 exclusion	0	(250,000)	
Taxable gain	$ 55,000	$ 0	

Observation

In the preceding example, the taxable gain on the business portion of the residence was substantial because the residence had appreciated significantly over a long-term holding period, even though the actual business use of the property only covered four years. If a taxpayer has a potentially large gain associated with a residence before commencing business-in-home deductions, and if there is a possibility that the residence could be sold during business use (that is, rather than sold after converting the residence back to exclusively personal use for more than twenty-four months preceding a sale), tax practitioners should consider discouraging eligibility for business use of the home deductions. Generally, eligibility can be violated by failing to conform to the exclusive use test of Section 280A(c)(1).

2.3.3 Prorated exclusion

A taxpayer failing to satisfy the two-year ownership, use, or prior sale rules may qualify for a prorated exclusion based on the period of eligibility, if the sale was necessitated by a change in place of employment, health reasons, or unforeseen circumstances, to the extent provided in regulations [Prop. Reg. Sec. 1.121-3(a)].

The proposed regulations do not contain any guidance regarding the definition of "unforeseen circumstances" for which a prorated exclusion might be allowable. Both the statute and regulations make it clear that the "unforeseen circumstances" exception is only available to the extent defined by the IRS. To date, no definitions have been issued.

> *Example.* Tess, a single taxpayer, purchases a home that she uses as her principal residence. Twelve months after the purchase, Tess sells the home because her employer offers a job transfer. Tess is eligible to exclude up to $125,000 of the gain from the sale of this house (12 divided by 24, times $250,000).

2.4 Reverse Like-Kind Exchanges

2.4.1 IRS safe-harbor guidance

Section 1031 and supporting regulations have allowed a taxpayer to enter into a delayed exchange, where property is transferred to an intermediary who sells the property and uses the funds to complete the acquisition of like-kind replacement property. However, there has been no IRS authority approving reverse exchanges, in which the replacement property is acquired before the sale of the relinquished parcel.

Effective on or after September 15, 2000, the IRS has issued a safe harbor procedure under which taxpayers may enter into reverse like-kind exchanges (Rev. Proc. 2000-37, IRB No. 2000-40). The following provisions must all be met in order to qualify under this safe harbor:

1. The intermediary who facilitates the exchange, known as an exchange accommodation titleholder (EAT), is an independent party that is subject to income tax, or if a pass-through entity, more than 90 percent of the EAT's partners, members, or shareholders are subject to income tax.
2. The EAT must take legal ownership of the replacement property or the relinquished property, and at the time of transfer of property it is the clear intent of the taxpayer to qualify for a Section 1031 like-kind exchange.

3. No later than five business days after the transfer of property (typically the replacement property in a reverse exchange), the taxpayer and the EAT must enter into a written agreement to facilitate the §1031 exchange, with the EAT treated as the owner of the property.
4. No later than forty-five days after the transfer of the replacement property to the EAT, the property to be relinquished, including any alternative and multiple properties, must be identified in a manner consistent with the existing regulations at Section 1.1031(k)-1.
5. No later than 180 days after the transfer of the replacement property to the EAT, the exchange must be completed.

Observation

This safe harbor approach for reverse exchanges differs markedly from the regulations at Section 1.1031(k)-1(g)(4) affecting conventional deferred exchanges, in that the EAT in a reverse exchange must take actual title and beneficial ownership of the replacement property during the exchange process. The qualified intermediary in the traditional deferred exchange can simply facilitate the transaction without taking actual legal title. Also, the new Revenue Procedure does not address the ability of the EAT to claim depreciation during the period of ownership.

2.4.2 Failure to qualify as a reverse exchange

In a Tax Court opinion issued before the safe harbor Revenue Procedure, the court held that an individual failed to qualify a reverse transaction as a Section 1031 exchange.

The taxpayer had acquired unimproved land for use as a new business location. Subsequently, the taxpayer transferred this replacement property to the purchaser of the taxpayer's old business site. The purchaser held the land until a new building was constructed, and then conveyed it back to the taxpayer. The court found that title to the replacement property had merely been "parked" while the new building was constructed, and the taxpayer continued to hold beneficial ownership. In substance, the exchange was simply a transfer away and transfer back of the replacement property to the taxpayer, and accordingly did not qualify under Section 1031 (*DeCleene v. Comm.*, 115 TC No. 34, 11/17/2000).

2.5 New Minimum Required Distribution Rules

In January 2001, the IRS issued proposed regulations that greatly simplify the rules regarding the calculation of the required minimum

distribution from individual retirement accounts and qualified retirement plans. In addition to simplification, the rules have the effect of reducing the minimum required distribution (MRD) for virtually all taxpayers [Prop. Reg. Sec. 1.401(a)(9)-0 through -8, REG-130481-00, 1/17/2001].

The proposed regulations are drafted to be effective for MRDs for calendar years beginning on or after January 1, 2002. However, taxpayers are permitted to use the proposed regulations in calculating MRDs for calendar year 2001.

Observation

Because the new proposed regulations will result in a smaller MRD amount for most retired taxpayers, it is important that clients be informed of these new MRD rules before drawing their 2001 distribution. Use of a lower MRD amount under these tables is not binding on future distributions; a taxpayer is always permitted to draw a larger amount than the MRD table in any year without affecting the ability to return to the minimum amount in a future year.

2.5.1 Simplified MRD table

The new rules follow a single table that most taxpayers will use as a divisor to calculate the MRD amount. See Exhibit 1 for a reproduction of the new MRD table.

Practice Tip

Under the new table, it is no longer necessary to choose between the annual recalculation method and the "minus one" method, or refer to the beneficiary's actual age, as under the old rules. The new table assumes that every retired taxpayer has a beneficiary more than ten years younger, and accordingly uses the same table as per former Prop. Reg. Section 1.401(a)(9)-2. At age 70 1/2, the first year divisor under the new table is 26.2, whereas the former table for a first year MRD amount was a divisor of 16.

Under the new regulations, the age of the beneficiary is generally moot in calculating the MRD. However, if the beneficiary is the taxpayer's spouse, and that spouse is more than ten years younger than the taxpayer, a lower MRD amount may be calculated by using the joint ages of the taxpayer and spouse per Table VI in Reg. Section 1.72-9.

Example: Art is age 75, and his spouse, Alma, is age 72. In the past, Art has calculated his MRD using the annual recalculation method based on his and Alma's joint life expectancies. Under the new rules, Art calculates his MRD for 2001 solely based on his age of 75, using a divisor of 21.8. Thus, if the fair market value of Art's qualified retirement plans as of

Exhibit 1
Minimum Required Distribution Table*

Age of the Employee	*Distribution Period*
70	26.2
71	25.3
72	24.4
73	23.5
74	22.7
75	21.8
76	20.9
77	20.1
78	19.2
79	18.4
80	17.6
81	16.8
82	16.0
83	15.3
84	14.5
85	13.8
86	13.1
87	12.4
88	11.8
89	11.1
90	10.5
91	9.9
92	9.4
93	8.8
94	8.3
95	7.8
96	7.3
97	6.9
98	6.5
99	6.1
100	5.7
101	5.3
102	5.0
103	4.7
104	4.4
105	4.1
106	3.8
107	3.6
108	3.3
109	3.1
110	2.8
111	2.6
112	2.4
113	2.2
114	2.0
115	1.8

*Prop. Reg. Sec. 1.401(a)(9)-5

December 31, 2000, is $480,000, Art's MRD is $22,018 ($480,000 divided by 21.8).

If Alma is age 56 rather than 72, so that she is more than ten years younger than Art, Art's MRD amount uses the joint life table of Reg. 1.72-9. In this case, the divisor is 28.3, producing a smaller MRD amount ($480,000 divided by 28.3 equals $16,961).

Observation

Other than a spouse who is more than ten years younger than the taxpayer, the age of a beneficiary is moot in calculating the MRD amount. This is in contrast to the former regulations, under which the beneficiary as of the required beginning date of age 70½ was often a critical factor in establishing the MRD calculation.

2.5.2 Postmortem distribution rules

Where a deceased taxpayer has named a beneficiary, the new regulations permit the postmortem MRD amount to be calculated based on the life expectancy of the beneficiary [Prop. Reg. Sec. 1.401(a)(9)-5, Q&A-5]. This rule applies whether the death of the retirement plan owner occurs before or after age 70½.

For purposes of postmortem distributions, the final determination of the beneficiary is made as of the end of the year following the year of the taxpayer's death.

Observation

The final determination of the taxpayer's beneficiary at the end of the year following the year of death provides great flexibility in optimizing the MRD rules for the taxpayer's beneficiaries. For example, if the taxpayer named several children as beneficiaries, the retirement plan can be split into a separate IRA for each child, such that the child's actual age is used for calculation of the subsequent MRD amounts. Also, if a portion of a qualified plan or IRA is designated to a charitable beneficiary, the charitable beneficiary can be cashed out before December 31 of the year following death, so that only individual heirs with life expectancies remain as beneficiaries.

If a retirement plan owner dies without a designated beneficiary but after attaining the required beginning date age of 70½, the account balance is to be distributed over the taxpayer's remaining life expectancy as of the year of death. The deceased owner's life expectancy is calculated using Table V of Reg. Section 1.72-9, and is reduced by one in each subsequent year. A taxpayer who designates his or her estate as the beneficiary is given the same treatment as an owner without a designated beneficiary.

If the taxpayer dies before age 70½ and has not named a beneficiary, the former five-year minimum distribution rule applies (that is, the account balance must be distributed no later than the end of the Fifth year following the taxpayer's death).

2.6 Lease Buyout as Capital Gain

The IRS has issued a private ruling holding that the payment by a landlord to a tenant to induce the tenant to relocate early was eligible for capital gains treatment by the tenant as a sale of a leasehold interest. The tenant did not actually have a written lease in effect when the payment was made, because the property was being occupied under rent control laws that did not require a lease.

The IRS ruled that whether the leasehold was a capital asset under Section 1221 or under Section 1231, it should receive capital gain treatment, rather than ordinary income treatment, on the sale. The IRS noted that case law has previously established that the right of possession under a lease is a substantial property right that, if sold at a gain, produces capital gain (PLR 200045019, 8/10/2000).

3. INDIVIDUAL DEDUCTION DEVELOPMENTS

3.1 Passive Loss Developments

3.1.1 Self-rental passive regulation upheld

To prevent taxpayers from easily creating passive rental income in order to offset other passive losses, the IRS issued a regulation that recharacterizes net rental income as nonpassive if it is derived from property rented to a business activity in which the taxpayer materially participates [Reg. Sec. 1.469-2(f)(6)].

A taxpayer who was the sole shareholder of two C corporations challenged this regulation. The taxpayer realized a loss renting a building to one C corporation, and recognized income from leasing another building to the second C corporation, his law firm. The IRS did not permit the rental income from the law firm building to offset the passive loss from the other building based on the self-rental regulation. The Tax Court confirmed the validity of the regulation, allowing the IRS to recharacterize the rental income as nonpassive. The court also found that the lease in effect during the year of examination was a renewal rather than an extension of a pre-1988 agreement, and accordingly the

written binding contract exception protecting leases entered into before 2/19/88 was not applicable (*Krukowski v. Comm.*, 114 TC No. 25, 5/22/2000).

Similarly, an individual who leased a building to his wholly owned C corporation was required to recharacterize the net rental income as nonpassive (*Sidell v. Comm.*, 2000-2 USTC ¶50,751, CA-1, 9/22/2000, aff'g. TC Memo 1999-301).

In another case, the Tax Court held that a CPA leasing a building to his professional corporation was subject to the self-rental recharacterization regulation. The CPA argued that the original lease was executed before February 19, 1988, and accordingly was grandfathered from the self-rental regulation. However, the court noted that the agreements were entirely redrafted at each renewal date, and in addition the rent materially changed. Accordingly, under state law, the court determined that the old agreement was discharged and the new lease was not a mere extension. Therefore, the written binding contract exception was not available (*Steven D. Kucera v. Comm.*, TC Summary Opinion 2001-18, 2/27/2001).

Observation

This self-rental recharacterization rule of the passive regulations has previously been upheld in another Tax Court decision (*Schwalbach v. Comm.*, 111 TC No. 215, 1990) and by the Fifth Circuit (*Fransen v. U.S.*, 99-2 USTC ¶50,882, CA-5, 1999).

Caution

The courts have held that this self-rental recharacterization regulation also applies where one spouse leases a building to the business activity of the other spouse. In *Connor*, a wife owned an office building and leased it to her husband's personal service dental corporation. Even though she had no involvement in the dental corporation, for passive activity purposes one spouse's material participation is attributed to the other. Accordingly, the lease income was subject to the self-rental recharacterization, and this income could not offset other passive losses (*Connor v. Comm.*, 2000-2 USTC ¶50,560, CA-7, 7/5/2000, aff'g. TC Memo 1999-185).

3.1.2 Self-charged management fees

In response to direction in the Congressional Committee Report at enactment of the passive loss rules of Section 469, the IRS in 1991 issued a proposed regulation providing an exception to passive loss treatment for self-charged interest (Prop. Reg. 1.469-7). This regulation allows a passive investor making a loan to a passive activity to offset

the interest income received on the loan against the otherwise passive interest expense flowing to the investor on the Schedule K-1 from the passive activity.

A taxpayer who owned an S corporation had a similar situation, except the self-charged item involved a management fee paid to the individual by several passive partnerships. The management fee was reported as taxable income in the Form 1040, but the offsetting expense was otherwise trapped under the Section 469 passive loss limitations. The taxpayer argued that the self-charged interest rules should apply, due to an expressed intent in the committee report indicating that the regulations are to identify other situations in which netting would be appropriate on self-charged items. The IRS rebutted by arguing that the existing regulations addressed only self-charged interest. The Tax Court determined that the failure of the IRS to address other self-charged items beyond interest expense did not prevent the taxpayer from using the passive loss to offset the related nonpassive management income.

However, on appeal, the Fourth Circuit reversed the Tax Court, holding that nothing within the Section 469 statute allowed a management fee offset, and that the present proposed regulations addressed only self-charged interest items. While the Fourth Circuit stated that self-charged management fees in similar transactions should in theory receive an exemption from Section 469, the court noted that the authority for an exemption could come from only either the statute or regulations (*Hillman v. Comm.*, 2001-1 USTC ¶50,354, CA-4, 4/17/2001, rev'g. 114 TC No. 6).

3.1.3 Limited liability corporation member not a limited partner

In general, an individual prevents application of the Section 469 passive loss rules by achieving material participation in an activity under any one of seven tests set forth in Reg. Section 1.469-5T. However, if the taxpayer is a limited partner in a limited partnership, a more restrictive set of three tests applies. The regulations define a limited partner as one whose liability is limited under state law.

A federal district court has addressed the question of whether a limited liability corporation (LLC) member automatically should be treated as a limited partner for purposes of testing Section 469 material participation. The court determined that the limited partner regulation is obsolete when applied to an LLC and its members. The court noted that LLC members may participate actively in management, whereas limited partners are precluded from management involvement. Accordingly, the court allowed the LLC member to test material participation

under the wider array of seven tests of Reg. Section 1.469-5T (*Stephen A. Gregg v. U.S.*, 2001-1 USTC ¶50,169, DC, Or., 11/29/2000).

3.2 Prepaid Rent

An attorney-CPA, conducting a practice as a sole proprietor, could not deduct rent prepaid in 1992 for the years 1993 and 1994. The Tax Court noted that, in general, a cash method taxpayer may not deduct prepaid rent (*Southwest Hotel Co. v. U.S.*, CA-5, 1940; Reg. Sec. 1.162-11). However, a cash basis taxpayer may deduct prepaid items if there is a substantial business reason for the prepayment and it does not cause a material distortion in the taxpayer's income in the year of prepayment.

In this case, the court found no substantial business reason for prepaying the rent in 1992. The lease called for fixed monthly payments through July 31, 1995, and negotiations for renewal of the lease did not begin until two years after the prepayment. Further, the prepaid rent resulted in a loss in the taxpayer's Schedule C (*Howard Howe v. Comm.*, TC Memo 2000-291, 9/18/2000).

3.3 Expensing of Environmental Remediation Costs

Federal legislation has extended the Section 198 election to expense environmental remediation costs to cover expenditures paid or incurred before January 1, 2004. Previously, this election had been scheduled to expire at the end of 2001.

Qualified environmental remediation expenditures include items paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

Also, previously the election applied only to contaminated sites located in specific targeted areas (certain poverty areas and empowerment or enterprise zones). The legislation eliminated this target area requirement, allowing the election at any site containing hazardous substances if certified by the appropriate state environmental agency (other than sites identified on the national priorities list) (P.L.106-554, 12/21/2000).

3.4 50 Percent Disallowed Meals and Entertainment

IRC Section 274(n) limits the deduction for meals and entertainment expenses to 50 percent of the amount actually incurred. However,

among the exceptions allowed full deductibility are expenses for entertainment or meals made available to the general public, as well as expenses for goods or services sold by the taxpayer to customers in the ordinary course of conducting an entertainment business.

The taxpayer, a well-known horse racing track, hosted various social events, including receptions and dinners, for members of the press, racing officials, and governmental officials. Attendance was by invitation only, and the taxpayer incurred and deducted all costs of food, beverages, and entertainment. However, the Tax Court determined that these expenditures did not meet one of the exceptions to the 50 percent disallowance rule. The events were not open to the general public, and the meals and entertainment were not sold to the participants, as those attending incurred no costs (*Churchill Downs, Inc. v. Comm.*, 115 TC No. 20, 9/26/2000).

3.5 Business Expense Versus Lobbying

Section 162(e) disallows lobbying expenses and other costs incurred in an attempt to influence the general public. This restriction was used to disallow the costs incurred by a police officer attempting to change public policy regarding his ability to use a ventriloquist's dummy while on patrol. The officer used the puppet to assist him in breaking down language and cultural barriers in patrolling San Francisco's North Beach neighborhood. After police supervisors and the mayor directed the police officer to eliminate the puppet (known as Officer Brendan O'Smarty), the officer incurred over $10,000 in expenses to place the issue as a ballot proposition before local voters. The officer deducted these expenses on Schedule C, offsetting income that had been received due to the national publicity from the use of the puppet in police work. However, the IRS disallowed the balloting expenses under the prohibition against lobbying and public influence expenditures.

Both the Tax Court and the Ninth Circuit sided with the IRS in determining that the costs of placing the issue on the ballot and securing voter signatures for the proposition were not deductible because of the prohibition against deducting costs associated with attempts to influence public policy (*Geary v. Comm.*, 2001-1 USTC ¶50,162, CA-9, 12/27/2000, aff'g. TC Memo 1999-111).

3.6 Continuing Education Versus Qualifying for a New Business

Expenses incurred by an individual to maintain or improve skills in the individual's trade or business are deductible, but education that is part

of a program of study that leads to qualifying the individual for a new trade or business is not deductible (Reg. § 1.162-5).

The Tax Court has held that a self-employed golf instructor could not deduct the tuition and other expenses associated with attending a golf academy. The academy was an accredited school of business offering graduates a two-year program that awarded a specialized associate degree in business. While the court acknowledged that some of the courses taken at the academy maintained or improved skills as a golf instructor, other courses were directed toward general business education. The court concluded that the degree qualified the individual for a variety of new trades or businesses other than that of a golf instructor (*Edward Fields v. Comm.*, TC Summary Opinion 2001-35, 3/20/2001).

3.7 Expense Reimbursements

3.7.1 Trucking company per diems

A trucking company employed drivers who incurred food, lodging, and incidental expenses while away from home in their truck driving duties. The company reimbursed the drivers at 6 percent of the load revenue to cover their food, lodging, and incidental costs. The drivers were not required to turn in receipts, and received the 6 percent reimbursement even if they did not pay for lodging. The company did not report the 6 percent reimbursement as wages, but rather considered it an expense reimbursement.

At trial, a federal district court found that the trucking employer failed to show that the expense reimbursements were paid pursuant to an accountable plan, and granted summary judgment to the IRS by holding that the 6 percent reimbursement should have been considered wages. However, upon review, the Eleventh Circuit remanded the case for further consideration, noting the possibility that the substantiation or documentation requirement of an accountable plan may have been met if the 6 percent reimbursement could be construed as within the definition of a per diem allowance, and not exceeding the standard federal per diem rate (*Trucks, Inc. v. U.S.*, 2001-1 USTC ¶50,116, CA-11, 12/11/2000, rev'g. and rem'd. DC, 97-2 USTC ¶50,707).

3.7.2 Sole proprietor per diem method

An individual conducting a Schedule C proprietorship (hot air balloon rides) was not permitted to use the federal per diem method for travel and lodging expenses. According to the annual IRS Revenue Procedure authorizing the use of per diem rates, self-employed individuals are precluded from using the per diem method to substantiate lodging

expenses. The authority of the IRS to establish these rules was affirmed by the Tax Court (*William K. Starr v. Comm.*, TC Memo 2000-305, 9/27/2000).

3.8 Travel Versus Itinerant Status

In general, employees who travel away from home are allowed to deduct meals, lodging, and other incidental expenses connected with the travel. However, if a taxpayer has no regular place of business or no regular place of abode, the taxpayer is classified as an itinerant and travel expenses become nondeductible.

The IRS asserted itinerant status against two ship captains who traveled extensively, spending the majority of the year on their vessels. However, upon review, the Tax Court noted that both individuals maintained a permanent residence, incurring costs such as mortgage payments, insurance, and taxes. To avoid itinerant status, it is not necessary that the residence be at a location near where the taxpayer actually works. It is merely necessary to show that duplicate living expenses are incurred. However, the individuals were not allowed to deduct the full per diem for meals, as each employer provided meals for the taxpayers while they were away from home on business. Each individual was permitted to only claim the incidental expense portion of the federal per diem, which was several dollars per day (*Marin J. Johnson v. Comm.*, 115 TC No. 16, 9/15/2000; *Jim L. Westling v. Comm.*, TC Memo 2000-289, 9/15/2000).

3.9 Section 179 Expense Limits

The Section 179 first year bonus depreciation deduction is scheduled to increase as follows, per Section 179(b)(1):

Year	*Section 179 Limitation*
2001	24,000
2002	24,000
2003 and after	25,000

The Section 179 expense election must be claimed on the taxpayer's first income tax return for the tax year to which the election applies, whether or not the return is timely, or on an amended return filed within the time prescribed by law (including extensions) for filing the return for the year [Reg. Sec. 1.179-5(a)].

In interpreting this timely election requirement, the Tax Court has sided with the IRS by holding that the IRS had the authority to disallow a Section 179 election on items that had not been originally designated as Section 179 items within the return.

The taxpayer originally had a loss on the Schedule C and would not have benefited from the Section 179 election. However, an IRS examination subsequently made significant increases to Schedule C income, and the taxpayer sought to elect Section 179 treatment on equipment items that the IRS examiner had removed from "materials and supplies" expense and placed on the depreciation schedule. However, the Tax Court determined that the taxpayer had not met the timely election requirement for Section 179 treatment (*Patton v. Comm.*, 116 TC No. 17, 4/13/2001).

Observation

Tax practitioners must recognize that the Section 179 deduction cannot be used as a fallback position if the IRS disagrees with a decision made in an original return regarding deductibility of repair or supply items. If the IRS determines that the assets must be capitalized and depreciated, the Section 179 deduction will not be available.

3.10 Self-employed Health Insurance Deduction

The deductible percentage of health insurance costs for self-employed individuals is increased by statute as follows:

Year	*Deductible Percentage*
2001	60 percent
2002	70 percent
2003 and after	100 percent

This self-employed health insurance deduction also is available to more-than-2-percent S corporation shareholders, who are treated as self-employed partners for fringe benefit purposes [§162(l)].

3.11 Extension of Medical Savings Accounts

Self-employed individuals and employees of small businesses (fifty or fewer employees) are allowed to claim an above-the-line deduction for the funding of a Medical Savings Account (§220).

Congress has renamed the Medical Savings Account as an Archer MSA, and extended the authorization of the MSA through 2002. The limit on the number of eligible MSA accounts remains at a cap of 750,000 taxpayers (PL 106-554, 12/21/2000).

3.12 Alimony Treatment for Indirect Payments

Section 71 allows an above-the-line deduction for alimony or separate maintenance payments. The deduction extends to both direct payments to a former spouse and payments made on behalf of a spouse under a divorce or separation instrument.

The Tax Court has allowed a husband to claim deductions for indirect alimony in the form of a variety of mortgage and debt payments, homeowner insurance premiums, and various bills paid on a former spouse's behalf. Noting that Section 71(b) requires that alimony or separate maintenance payments have no liability extending beyond the death of the payee spouse, the court referred to state law to determine which of the payments to third-party creditors would have been discharged in the event of the former spouse's death (*Zinsmeister v. Comm.*, TC Memo 2000-364, 11/30/2000).

3.13 Medical Improvements to Residence

A taxpayer suffered from multiple chemical sensitivity and allergies, and at the direction of her physician constructed an expensive home made of special materials. Construction of the home began in 1993 and was completed in 1995. The IRS and the taxpayer agreed that the costs of the home related to the special features exceeded the fair market value of the home by $646,000.

However, the IRS argued that this medical deduction should have been claimed each year during construction as payments were made, whereas the taxpayer claimed the deduction entirely in the year the home was placed in service (both due to the need to determine if the home was habitable for medical purposes and to establish the fair market value of the home). The federal district court agreed with the taxpayer that 1995, the year of the completion of the property, was the proper year for deduction (*Zibkin v. U.S.*, 2000-2 USTC ¶50,863, DC, Mn., 10/18/2000).

Observation

By allowing the large deduction in a single year upon completion of the residence, the impact of the 7.5 percent offset to medical deductions was minimized.

3.14 Interest Expense on Tax Deficiencies

An individual claimed that interest paid personally as a result of partnership and S corporation tax deficiencies was deductible interest. However, the court noted that under Regulation Section 1.163-9T(b)(2), all interest on Form 1040 tax deficiencies is considered personal interest and accordingly is not deductible under Section 163(h) (*Michael Fitzmaurice v. U.S.*, 2001-1 USTC ¶50,198, SD, Tx., 1/2/2001).

Observation

Similar decisions have been issued in the Fourth Circuit (*Allen*, 99-1 USTC ¶50,470), the Sixth Circuit (*McDonnell*, 99-1 USTC ¶50,556), the Seventh Circuit (*Kikalos*, 99-2 USTC ¶50,823), the Eighth Circuit (*Miller*, 95-2 USTC ¶50,485), and the Ninth Circuit (*Redlark*, 98-1 USTC ¶50,322). In the *Fitzmaurice* opinion, the court described this as "overwhelming and persuasive authority." Accordingly, even though interest expense on a tax deficiency relates to a pass-through entity entirely conducting a business or investment activity, the interest expense is considered nondeductible.

3.15 Bargain Sale to Charity

A couple entered into a contract to sell real estate to a church for approximately $150,000 at the time the fair market value of the property was $450,000. Accordingly, they claimed a charitable contribution of approximately $300,000. The IRS denied the deduction under the argument that the gift was not complete because the church owed payments to the taxpayers under the note associated with the contract. However, the Tax Court ruled that all benefits and burdens of ownership had passed to the church at the inception of the contract for deed when possession of the property changed hands, and the taxpayers had made a completed charitable gift to the church in that year (*Musgrave v. Comm.*, TC Memo 2000-285, 9/6/2000).

Observation

If property is sold to a charity in a bargain sale, the tax basis in the property must be allocated proportionally between the sale portion and the charitable gift portion [Sec. 1011(b)]. However, in the case of a noncharitable bargain sale, such as a sale at less than full value to a family member in a gift transaction, the entire adjusted basis of the property is taken into account against the sale proceeds (and none against the gift portion) in determining the amount of the gain from the sale.

3.16 Gambling Losses

Under Section 165(d), losses from gambling transactions are allowed only to the extent of gambling income. A taxpayer who reported gambling winnings of $25,000 in one year, $49,000 in the subsequent year, and $244,000 in the third year, but also reported losing wagers of a greater amount for each of those three years, claimed that the limitation against claiming a net loss did not apply because the losses were incurred in conducting a trade or business. However, the Tax Court noted that a long line of cases had previously established that the restriction against deducting gambling net losses applied even to taxpayers that were considered to be conducting a gambling trade or business. Accordingly, the expenses were limited to the amount of gambling winnings (*William Praytor v. Comm.*, TC Memo 2000-282, 8/31/2000).

Observation

While establishing trade or business status for a gambling activity does not allow the taxpayer to overcome the limitation on claiming losses, it can be important in terms of the geography of the deductions within the Form 1040. If a trade or business activity is conducted, the income and expenses are reportable on Schedule C. However, in a nonbusiness gambling activity, the income is reported on the face of the Form 1040, while the deductions must be claimed as miscellaneous itemized deductions on Schedule A. Accordingly, AMT and other factors often come into play, as the income increases AGI but the deductions, as miscellaneous itemized deductions, may not be fully deductible because of the 2 percent floor and the prohibition against miscellaneous itemized deductions for AMT.

4. TAX CALCULATIONS, CREDITS, AND COMPLIANCE MATTERS

4.1 8 Percent and 18 Percent Capital Gain Rates

Effective in 2001, assets held for at least five years receive an 8 percent capital gain rate if reportable at the lower tax bracket and an 18 percent capital gain rate if reportable at the upper tax rates. However, the eligibility rules differ as follows:

1. For individuals reporting long-term capital gains that fall in the lowest 15 percent rate bracket, the current 10 percent capital gain

rate drops to 8 percent, provided the asset has been held more than five years before gain recognition [Sec. 1(h)(2)(A)].

2. For individuals in the upper ordinary rate brackets, the current 20 percent capital gain rate drops to 18 percent, provided the asset has been held more than five years before gain recognition *and* the asset was acquired after the year 2000 [Sec. 1(h)(2)(B)].

Observation

The fact that the 18 percent rate is only available for assets acquired after the year 2000 means that no taxpayer will use this rate until 2006. The 8 percent rate, however, is available in 2001 for assets transferred by gift to children who are in the lowest tax bracket. Assets transferred by gift receive a carryover basis and a carryover holding period from the donor.

> *Example:* Chuck, who is in the 28 percent tax bracket, sells stock on March 3, 2001, at a $10,000 capital gain. Chuck acquired the stock in 1995, and accordingly this stock has been held for five years. Chuck is required to pay a 20 percent capital gain rate on this asset sale, because the acquisition occurred before 2001. If Chuck was in the 15 percent tax bracket, the sale of the stock in 2001 would be taxed at an 8 percent capital gain rate (that is, there is no requirement at the lowest tax bracket that the acquisition of the property occur after the year 2000).

4.1.1 Election to recognize gain on January 1, 2001

A taxpayer other than a corporation may elect to treat any tradable stock (that is, stock that is readily tradable on an established securities market) or any other capital asset or Section 1231 business use property held by the taxpayer on January 1, 2001, as having been sold on that date for an amount equal to its fair market value on that date. In the case of tradable securities, the fair market value is based on the closing market price on January 2, 2001.

The asset is assumed to be reacquired on the same date, so the asset achieves a fresh basis equal to its fair market value and a new holding period. Any loss resulting from this election is not allowed for any tax year.

Observation

This election, found in the 1997 legislation that enacted the new capital gain rates [PL 105-34, Act Sec. 311(e)], is intended to allow a taxpayer to "freshen up" capital assets for purposes of the new five-year holding period requirement that applies to assets acquired after the year 2000. Under this election, a taxpayer may pay gain on an existing asset held as of January 1, 2001, at the 10 percent/20 percent capital gain rate,

for purposes of deeming the asset to be acquired as of that date for a new holding period. This allows the asset to be eligible for the 18 percent capital gain rate in the year 2006 and after. This election may be efficient where a taxpayer has a small capital gain to date, but expects the asset to appreciate significantly in the future and to be held for at least five years.

> *Example:* Art owns stock that he acquired in 1998 at a cost of $100,000. This stock is publicly traded but has performed poorly lately. As of the beginning of 2001, its market value is only $102,000. Art is one of the principal employees of this company, and believes that this stock has substantial long-term capital appreciation potential. Art intends to hold the stock until his retirement, which is fifteen years in the future. In preparing his 2001 tax return, Art could make an election to treat this stock as if sold on January 1, 2001, using the valuation of the stock as of the close of the market on January 2, 2001, to determine the deemed sale price. Art would report $2,000 of capital gain at the 20 percent rate, incurring $400 of additional capital gain tax. Art would be assumed to have reacquired this stock as of January 1, 2001, and after five years this stock would be eligible for the new 18 percent capital gain rate.

Practice Tips

1. The statute requires any gain on this election to be recognized "notwithstanding any provision of the Internal Revenue Code." Thus, a taxpayer would not be able to elect a deemed sale on a principal residence with a current gain of $400,000 and offset this gain with the Section 121 $500,000 residential exclusion.
2. Taxpayers with large capital loss carryovers will find that this election presents a significant opportunity, particularly if they own a depreciable building where a deemed sale results entirely in Section 1231 capital gain (that is, it will be possible to convert a capital loss carryover to future depreciation deductions).
3. Investors who will soon begin development of substantially appreciated land may benefit by electing to report the current appreciation as capital gain under this election. This minimizes the subsequent development profit that must be reported as ordinary income.
4. Note that any loss resulting from this election may not be deducted. Thus, it is not possible to elect deemed sale treatment for both appreciated and deflated capital assets (that is, the gains from the election are taxable but the losses are disallowed).

4.2 Capital Gain From Sale of a Pass-Through Entity

The IRS has issued final regulations, effective September 21, 2000, that provide a look-through rule for the reporting of 25 percent and 28

percent capital gains, if the taxpayer sells an interest in a pass-through entity such as a partnership, an S corporation, or a trust [Reg. Sec. 1.1(h)-1 and Reg. Sec. 1.1223-3, T.D. 8902, 9/20/2000].

A partner selling an interest in a partnership must recharacterize capital gain as 25 percent gain to the extent of the allocable gain on Section 1250 depreciable property within the partnership (S corporations and trust are not subject to this look-through rule on 25 percent rate gains). However, this rule does not apply to any transaction treated as a redemption of a partnership interest.

Owners of S corporations, partners in partnerships, and beneficiaries of trusts are subject to a look-through rule on any 28 percent collectible gain within the pass-through entity, if the individual sells an interest in the entity.

Example: Del is a 10 percent partner in a partnership, and is selling his partnership interest at a $50,000 capital gain. The partnership holds real estate that includes land and one commercial building plus appreciated stocks and mutual funds. The partnership gain on the building, if sold, would be $200,000, all of which is attributable to prior depreciation. Accordingly, Del, as a 10 percent partner, must report his gain from the sale of the partnership interest as $20,000 at a 25 percent rate ($200,000 gain allocable to the building Section 1250 depreciation at Del's 10 percent partnership interest) and $30,000 at a 20 percent rate.

4.3 Estimated Tax Payments for Higher Income Individuals

In the late 1999 extender legislation, Congress continued the recent pattern of adjusting the prior-year safe harbor estimated tax percentage for higher income individuals. Individuals with AGI exceeding $150,000 on their current year Form 1040 are required to remit quarterly tax estimates or withholding at an amount which is more than the prior-year tax liability in order to rely on the prior-year tax as a safe harbor [Sec. 6654(d)(1)(C)].

For estimated tax installments and withholding due in 2001 and subsequent years, the safe harbor percentage (to rely on the prior year tax liability if AGI and the prior year exceeded $150,000) is as follows:

Estimated Tax Year	*Safe Harbor Percentage of Prior Year Tax*
2001	110% of 2000 tax
2002	112% of 2001 tax
2003 and after	110% of prior tax

Example: Ron and Lynn have AGI in excess of $150,000 in their 2001 Form 1040 and incur $40,000 of total federal tax liability. If they wish to rely on the prior-year tax safe harbor in setting their estimated tax payments and withholding for the year 2002, Ron and Lynn need to remit timely payments of $44,800 during 2002 ($40,000 prior-year tax times 112 percent).

If Ron and Lynn again incurred $40,000 of tax in their 2002 Form 1040, the couple would need to remit tax estimates or withholding during 2003 of at least $44,000 ($40,000 times 110 percent) if they wish to rely on the prior-year tax safe harbor.

Observation

In cases where remitting 110 percent of 2001 tax would result in excessive quarterly estimates or withholding for 2002 for higher income individuals, practitioners have two alternatives for arranging quarterly estimates and withholding to avoid 2002 underpayment penalties:

1. Project the total income tax of the taxpayer for the year 2002 and remit a quarterly amount that reaches at least 90 percent of the final tax shown on the return [Sec. 6654(d)(1)(B)(i)]. This strategy applies where it is possible to reasonably predict the taxpayer's tax results for the coming year.
2. Determine year-to-date actual taxable income through each quarterly period (that is, through March, May, August, and December) to compute annualized income, with quarterly estimates calculated at 90 percent of annualized tax [Sec. 6654(d)(2)]. This alternative requires more extensive calculations completed each quarter and is necessary where taxpayer income and deductions fluctuate throughout the year without an ability to accurately project the total tax result for the coming year.

4.4 Self-Employment Tax on Self-Rental Farmland

In a 1995 opinion, a Tax Court judge found that an individual who leased farmland to his active farming partnership, at a time when the individual was also a partner in the partnership, was subject to self-employment (SE) tax on the farm rental income (*Mizell v. Comm.*, TC Memo 1995-571, 11/29/95). This court opinion represented the first interpretation of language within Section 1402 that defines certain farm rental arrangements as subject to SE tax.

In general, rentals from real estate are exempt from the definition of self-employment income. However, rental income is subject to SE tax if three criteria are met:

1. The rental income is derived under an arrangement between the owner and tenant that provides the tenant shall produce agricultural commodities on the land (that is, the lease involves farmland).
2. The arrangement calls for the material participation of the owner in the management or production of the agricultural commodities.
3. There is actual material participation by the land owner [Sec. 1402(a)(1); Reg. §1.1402(a)-4(b)(1)].

In the *Mizell* case, the individual received rent from the partnership for the lease of the land, but also received a Schedule K-1 from the partnership for active participation as a partner. The court considered the word *arrangement* in the second test above to broadly reach both the rental contract and partnership roles, such that the rental contract became subject to SE tax as a result of active participation as a partner.

4.4.1 Tax Court and Eighth Circuit cases

Subsequent to the *Mizell* opinion, three individuals who received cash rent from farmland were found to be subject to SE tax, because they also received a Form W-2 from the same farming entity that paid the rent. Two of the cases (*Bot* and *Hennen*) involved farmers' wives who both leased land to their husband's proprietorship and in addition received a W-2 for services to his farming proprietorship. The third case involved an individual who leased land to his farming corporation, and also received a W-2 from the farm corporation for labor provided to that corporate entity.

In all three cases, the Tax Court judge found that the fact pattern sufficiently followed the *Mizell* precedent and imposed SE tax on the rental income (*Vincent Bot*, TC Memo 1999-256; *John Hennen*, TC Memo 1999-306; *Michael McNamara*, TC Memo 1999-333).

These three cases were consolidated on appeal to the Eighth Circuit. In December of 2000, the Eighth Circuit reversed all three Tax Court opinions, determining that SE tax is not to be imposed on farmland self-rentals (*McNamara v. Comm.*, 2001-1 USTC ¶50,188, CA-8, 12/29/2000).

The Appellate Court focused on the argument of the taxpayers that the lessor/lessee relationship should stand on its own, apart from the employer-employee relationship. The Eighth Circuit interpreted the statutory and regulatory language as requiring material participation by the landlord in the rental arrangement itself in order to subject the lease to SE tax. The court stated, "The mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only when the payment of

those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement."

The court concluded by noting that "rents that are consistent with market rents very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an 'arrangement' for participation in agricultural production."

Observation

This Eighth Circuit opinion seems to have ended the conflicts with the IRS regarding this issue. Because of the common use of self-rental leases in agriculture, practitioners should be sure that related party rentals are at or below market value rental amounts, and should also consider using written leases that clarify that the landlord has no management or participation requirements in the agricultural production of the tenant.

4.5 FICA and FUTA on Stock Option Exercise

The IRS has issued interim guidance indicating that it will not assess FICA or FUTA tax upon the exercise of incentive stock options (ISOs) or options granted under employee stock purchase plans (ESPPs) before January 1, 2003. Further, it will not treat the disposition of stock acquired pursuant to the exercise of options as subject to withholding.

In its notice, the IRS indicates that it anticipates issuing future guidance to hold that the exercise of these stock options represents wages for FICA and FUTA tax. Also, the IRS has declared that Rev. Rul. 71-52 (holding that the exercise of a qualified stock option does not give rise to FICA, FUTA or income tax withholding) is obsolete (IRS Notice 2001-14, IRB No. 2001-6).

4.6 AMT on Gross Versus Net Reporting of Legal Awards

Taxpayers receive many legal settlements and awards for damages under contingent fee arrangements. These contingent fee arrangements provide that a portion of the settlement is due to the taxpayer's legal counsel.

A significant tax issue has arisen in the courts on the question of whether the portion of the award due to legal counsel must first be included in the gross income of the taxpayer, or whether that portion can be considered as having been assigned directly to the attorney.

If the award is includable in the taxpayer's gross income, an offsetting deduction for legal fees is allowable. However, this deduction is permitted only as an itemized miscellaneous deduction in nonbusiness litigation or in employment-related lawsuits. Because miscellaneous itemized deductions are not permitted in the alternative minimum tax (AMT) system, the taxpayer inevitably incurs AMT on the gross award and the deduction for attorney fees is effectively wasted.

Example: Fred, who files jointly, receives an employment-related legal settlement of $240,000 and incurs attorney fees of $80,000 in connection with the settlement. If Fred and his spouse have $80,000 of other income, their 2001 Form 1040 will appear as follows:

	Regular Tax	*AMT*
Wages and other income	$ 80,000	$ 80,000
Legal settlement	240,000	240,000
State and local taxes	(20,800)	—
Legal fees less 2% offset	(73,600)	—
Itemized deduction phase out	5,611	—
AMT exemption after phase out	—	(2,500)
Taxable income	$ 231,211	$ 317,500
Tax	$ 64,827	$ 85,400

The nondeductibility of the legal fees for AMT purposes has triggered approximately $20,600 in AMT in this illustration.

4.6.1 Tax Court sides with IRS

The Tax Court has held that an individual receiving an age discrimination settlement from his employer must include the entire amount in income, even though about 40 percent of the gross settlement was paid directly to his attorney under the contingent fee arrangement. As a result, the taxpayer's offsetting deduction for the legal expense was largely wasted due to the imposition of the alternative minimum tax.

The court acknowledged the divergence of authority on this question in the courts. Also, several tax court judges dissented, noting that the assignment of income doctrine should not be applied to litigation awards that were clearly contingent at the time of the contractual arrangement between the taxpayer and the attorney (*Kenseth v. Comm.*, 114 TC No. 26, 5/30/2000, aff'd. CA-7, 8/7/2001).

4.6.2 Circuit courts split

The Fifth Circuit, reversing the Tax Court, found that the laws of the taxpayer's state had granted the taxpayer's attorney an ownership

interest in his defamation claim. Accordingly, the taxpayer was not in control of the portion of the settlement due to his attorney and was not required to include this portion of the settlement in gross income (*Srivastava v. Comm.*, 2000-2 USTC ¶50,597, CA-5, 7/19/2000, rev'g. TC Memo 1998-362).

For a similar result, see *Clarks Estate v. U.S.* (2001- USTC ¶50,958 (2000)) and *Foster v. U.S.* (2001- USTC ¶50,353 (2000)).

On the other hand, the Ninth Circuit, in two decisions, has affirmed the Tax Court by holding that plaintiffs who received settlements from their employer were subject to income tax reporting on the gross amount of the court award for both compensatory and punitive damages. The Ninth Circuit viewed the attorney's contingent fee contract as not rising to the level of a party in interest in the judgment, but rather merely giving the attorney a lien on the client's prospective recovery. Further, it found nothing in state law granting legal counsel any ownership right to a client's claim (*Benci-Woodward, et al v. Comm.*, 2000-2 USTC ¶50,595, CA-9, 7/18/2000, aff'g. TC Memo 1998-395; *J.T. Sinyard*, 2001-2 USTC ¶50,645, CA-9, 9/25/2001, aff'g. TC Memo 1998-364).

Observation

These Ninth Circuit decisions follow a similar Ninth Circuit opinion issued one month earlier. In the Coady decision, the Ninth Circuit held that a taxpayer who had received an employer settlement of $373,000, and remitted $260,000 of that amount to attorneys for fees and litigation costs, must report the entire gross settlement in income. The attorney's fees and litigation costs were only deductible as miscellaneous itemized deductions and accordingly caused the AMT to apply (*Coady v. Comm.*, 2000-1 USTC ¶50,528, CA-9, 6/14/2000, aff'g. TC Memo 1998-291). Many courts have viewed this issue as hinging on the state law treatment of an attorney's contingent fee arrangement (that is, whether the attorney's contingent fee arrangement rises to the level of an ownership interest in the settlement or the full ownership remains with the plaintiff). Practitioners need to be alert to the risk of IRS assessment of AMT if they attempt to net legal fees against taxable legal settlements.

4.7 Innocent Spouse Relief

The IRS has issued proposed regulations that provide guidance on the three relief rules available to a taxpayer categorized as an innocent spouse (Prop. Reg. Secs. 1.6015-0 through 6015-9, 66 FR 3888, 1/17/2001).

These rules allow a taxpayer to file a joint return to seek relief from joint and several liability where the understatement of tax is attributable to the other spouse. The proposed regulations cover each of the three relief rules:

1. The general relief provision of Section 6015(b), relieving a spouse that can establish a lack of knowledge regarding the item giving rise to the understatement and that it would be inequitable to hold the requesting spouse liable for the tax deficiency (Prop. Reg. Sec. 1.6015-2).
2. The election under Section 6015(c) available to divorced, widowed, or separated taxpayers, or those that have not been a member of the same household with the other spouse at any time during the twelve-month period, to limit the liability of the taxpayer to the portion properly allocable to the requesting taxpayer (Prop. Reg. Sec. 1.6015-3).
3. A request for equitable relief, available to a spouse failing to qualify for relief under the first two provisions, in which case the IRS has the discretion to grant relief from the joint and several tax liability based on all of the facts and circumstances [Sec. 6015(f); Prop. Reg. Sec. 1.6015-4].

The proposed regulations clarify that innocent spouse relief is available for income taxes and self-employment taxes, including related penalties and interest, but not for other taxes reported on an income tax return, such as domestic service employment taxes. Also, in determining whether relief is available, items of income, deduction, or credit are allocated to the spouses without regard to the operation of community property laws. An erroneous item is attributed to the individual whose activities give rise to the item [Prop. Reg. Sec. 1.6015-1(f)].

4.8 Recovery of Litigation Costs

A CPA who underwent an IRS audit of his personal tax return and corporate tax return subsequently filed a petition with the Tax Court, rather than filing a protest or requesting a conference with the IRS Appeals Division. The CPA subsequently prevailed in Tax Court on all matters, and then initiated suit against the IRS seeking recovery of litigation costs under Section 7430. However, the court rejected the award of litigation costs, noting that the CPA and his corporation did not exhaust all administrative remedies because they bypassed the IRS Appeals Office (*Haas & Associates Accountancy Corporation v. Comm.*, 117 TC No. 5, 8/10/2001).

Observation

A requirement of the right to recover litigation costs from the IRS under Section 7430 is that the taxpayer must exhaust all administrative remedies prior to litigation. Bypassing the IRS Appeals Office has the cost of precluding the taxpayer from the ability to recover costs if successful in court.

FEDERAL CORPORATE TAX NOTES

1. S CORPORATION DEVELOPMENTS

1.1 Exempt Cancellation-of-Debt Income

Under Section 108, debt discharge income is not currently taxable if the debt relief meets one of several specific exemptions (that is, a discharge in bankruptcy, to the extent of the taxpayer's insolvency; qualified farm debt; or a qualified real property business exception). With respect to debt discharge received by an S corporation, the Section 108 privileges are measured at the S corporation level.

However, a variety of courts had split on the issue of whether Section 108 exempt debt relief income flowed out of the S corporation to increase shareholder stock basis. The Tax Court had sided with the government (*Mel T. Nelson v. Comm.*, 110 TC 114, 2/19/98), as well as the Sixth and Tenth Circuits (*Gaudiano*, 2000-2 USTC ¶50,559, CA-6, 2000; *Gitlitz*, 99-2 USTC ¶50,645, CA-10, 1999; *Friedman*, 2000-1 USTC ¶50,515, CA-6, 2000). On the other hand, the Third and Eleventh Circuits allowed S shareholder basis to increase for exempt debt relief income (*Farley*, 2000-1 USTC ¶50,179, CA-3, 2000; *James Pugh, Jr.*, 2000-1 USTC ¶50,514, CA-11, 2000).

1.1.1 U.S. Supreme Court decision

To resolve this conflict among the courts, the U.S. Supreme Court granted a hearing in the *Gitlitz* Tenth Circuit decision. In January 2001, the Supreme Court issued its opinion, allowing S corporation tax-exempt debt relief income to flow out of the S corporation to increase shareholder basis (*Gitlitz*, 2000-1 USTC ¶50,147; S. Ct. No. 99-1295, 1/9/01). According to this opinion, the ordering of S corporation debt discharge is as follows:

1. Under Section 108(d)(7), the eligibility for exempt debt discharge income, such as under the insolvency exemption, is measured at the S corporation level.
2. Any S corporation-excluded debt discharge income passes through to increase S shareholder stock basis under Sections 1367 and 1366.
3. This increase in stockholder basis allows any current and suspended S corporation losses to be claimed by the S shareholder, to the extent of the increase in basis.
4. Attribute reduction under Section 1017 is made after the stockholder basis adjustment. Any remaining suspended losses at the shareholder level are to be treated as the S corporation's net operating losses under Section 108(d)(7)(B) and are reduced by the excluded debt discharge income under the attribute-reduction rules of Section 1017.

Example. Failco, an S corporation, has incurred substantial losses in its real estate activities. Failco's sole shareholder, Fred, has suspended S corporation's losses, due to lack of stock basis, in the amount of $300,000. During the year, Failco negotiates $200,000 of debt discharge in a refinancing plan with the mortgage holders of its real estate. At the time of this debt discharge, Failco is insolvent by $250,000 and accordingly qualifies for the exemption from gross income for this debt relief under Section 108.

As a result of the *Gitlitz* decision, this $200,000 of S corporation's exempt debt relief income flows through as an exempt income item to Fred and increases Fred's stock basis. As a result of this $200,000 increase in stock basis, Fred may deduct $200,000 of his suspended S corporation losses. The remaining $100,000 of Fred's suspended losses are considered to become the S corporation's net operating losses, and are eliminated under the reduction of tax attributes rules of Section 1017. In addition, Failco may need to reduce any other tax attributes, such as the basis of depreciable property, to the extent of the remaining exempt debt relief income.

1.1.2 Form 8275-R disclosure

An important issue is whether Form 8275-R, *Regulation Disclosure Statement,* needs to be filed. The IRS has issued a regulation [Reg. Sec. 1.1366-1(a)(2)(viii)] that contradicts the Supreme Court's *Gitlitz* ruling. However, because the regulation was issued after the years involved in the *Gitlitz* case, the Supreme Court did not specifically rule on the validity of the regulation.

Under Section 6662, the accuracy-related penalty will not be applied if a position has "substantial authority." If substantial authority does not exist, adequate disclosure occurs only when a Form 8275 or 8275-R is filed. Here, since there is a regulation on point, it would seem that Form 8275-R should be filed if a position contrary to the regulation is taken on the return. However, a Supreme Court decision constitutes substantial authority. Further, the language in Reg. Section 1.1366-1(a)(2)(viii) mirrors the IRS arguments that the Supreme Court specifically rejected. Thus, even though *Gitlitz* did not specifically invalidate the regulation, it effectively gutted it, and therefore it is highly unlikely that the IRS will attempt to enforce the regulation.

As a result, disclosure (by way of Form 8275-R) is presumably not required to avoid a substantial understatement penalty. However, for clients seeking absolute protection against the accuracy penalty, Form 8275-R could still be filed with a reference to the *Gitlitz* case.

1.2 Shareholder Loan Guarantees

The courts continue to support the IRS position on the issue of whether an S shareholder can achieve stock basis for the personal guarantee of

corporate-level debt. The courts have consistently taken the position that an S shareholder does not increase stock basis by guaranteeing loans made by Third parties, such as banks, to the S corporation. The S corporation is viewed as the primary obligor. The S shareholder does not achieve an increase in stock basis because the shareholder has no economic outlay (*Estate of Alton Bean v. Comm.*, TC Memo 2000-355, 11/15/2000; *Frederick H. Jackson III v. Comm.*, TC Memo 2001-61, 3/13/01).

Observation

In the *Bean Estate* decision, the IRS attempted to impose a negligence penalty on the taxpayer. However, the court concluded that the S shareholders had reasonably relied on an accountant to ascertain their tax basis in their S corporation stock, and accordingly the court did not impose the penalties.

In another pro-government ruling, the Seventh Circuit upheld a Tax Court decision in finding that a shareholder's participation interest in a bank loan to a corporation, recharacterized as a loan guarantee, did not increase the shareholder's stock basis (*Grojean v. Comm.*, 2001-1 USTC ¶50,355, CA-7, 4/13/2001).

1.3 Proposed Regulations on ESBTs

Under Section 1361(e)(1), electing small business trusts (ESBTs) are allowed as eligible S corporation shareholders. Each potential current beneficiary of an ESBT is treated as an S shareholder for purposes of shareholder eligibility, except the trust itself is treated as a shareholder for any period in which there is no potential current beneficiary. The IRS has issued temporary and proposed regulations on the qualification and treatment of ESBTs [Prop. Regs. Secs. 1.641(c)-1, 1.1361-1(j)(12), 1.1361-1(m) and 1.1362-6(b)(2)(iv), TD 8915, 12/29/2000].

1.3.1 ESBT beneficiaries

The proposed regulations spell out who is an ESBT beneficiary and include any person with an interest other than a remote, contingent interest. A person with a future beneficial interest whose probability of receiving a distribution is less than 5 percent is not considered a beneficiary. Also, a person in whose favor a power of appointment may be exercised is not considered a beneficiary until the power is actually exercised.

1.3.2 Procedure for making an ESBT election

When the regulations are finalized, the rules established in IRS Notice 97-12 (IRB No. 1997-3) for making an ESBT election will be modified

and replaced. Under the proposed regulations, the trustee of an ESBT makes a single ESBT election by filing a statement with the same IRS Service Center where the ESBT files its Form 1041.

1.3.3 Conversion to or from QSST/ESBT

The final regulations will modify and replace the current procedures established in Rev. Proc. 98-23 (IRB No. 1998-10) dealing with the conversion of a qualifying sub S trust (QSST) to an ESBT or an ESBT to a QSST. The proposed regulations describe the conversion procedure as an election filed with the IRS Service Center where the trust files its Form 1041, as well as the IRS Service Center where the Form 1120S is filed.

1.3.4 Consent to S election

Under the proposed regulations, a grantor trust may elect to be an ESBT. When the ESBT is also a grantor trust, the deemed owner needs to consent to the S election because that owner is taxed on all or a portion of the S corporation income. If more than one trustee exists, all trustees authorized to legally bind the trust need to consent to the S election.

1.3.5 Revocation of ESBT election

A trust needs to obtain IRS consent to revoke an ESBT election by obtaining a private letter ruling. However, such IRS consent is automatically granted for revocations that occur because of a conversion of an ESBT to a QSST.

1.4 Suspended Passive Losses From C Corporation Years

The Tenth Circuit has reversed a Tax Court decision, determining that an S corporation that disposed of rental properties could deduct suspended passive activity losses that arose while it was a C corporation (*St. Charles Investment Company v. Comm.*, 2000-2 USTC ¶50,840, CA-10, 11/14/2000, rev'g. 110 TC 46).

The IRS had previously ruled in PLR 9628002 that the freeing up of carryover passive losses upon disposition of a passive activity does not apply when a closely held C corporation's passive losses are held by a successor S corporation that sold the activities. The full Tax Court then ruled similarly in the *St. Charles Investment Company* case. However, the Tenth Circuit has now overturned this ruling, determining that

Section 469 does not enumerate the Section 1371 restrictions on carryforwards from a C corporation year to an S corporation year, and thus the deductibility of these suspended losses are subject only to the disposition rules of Section 469.

Observation
S corporation shareholders would need to hold sufficient basis to deduct passive activity losses passed through to them upon such a disposition.

1.5 Accrual of Charitable Contributions

Under Section 170(a)(2), an accrual-basis corporation may accrue a contribution paid within twenty-two months after year end, if the contribution is properly authorized by the board of directors at any time during the taxable year. Under Section 1363(b), S corporation charitable contributions pass through as a separately stated item to shareholders and are deducted under individual income tax rules.

The IRS has now ruled that an accrual-basis S corporation may not elect to accrue a charitable contribution under Section 170(a)(2). The IRS determined that this election is not available to individuals, and because S corporation charitable contributions pass through to individual shareholders, this privilege is available for C corporations only (Rev. Rul. 2000-43, IRB No. 2000-41).

1.6 Recapture of LIFO Reserve

Section 1363(d) requires recapture of the last-in first-out (LIFO) reserve upon the conversion of a C corporation to an S corporation. In a recent Tax Court ruling, the court determined that partnerships need to be viewed as an aggregation of the partners, rather than as separate entities, for purposes of this provision. Accordingly, an S corporation that was a limited partner in each of five partnerships was deemed to own a pro-rata portion of the inventory of each partnership, and therefore required to recognize its pro-rata share of all partnership LIFO reserves. Operating as a holding company for five subsidiary corporations that operated automobile dealerships, the taxpayer elected S status under a restructuring plan. The restructuring involved the contribution of assets and liabilities to a limited partnership in exchange for a limited partnership interest, at which point the subsidiary corporations were liquidated.

The court applied the aggregate approach to partnerships, as opposed to the entity approach, which prevented the corporate taxpayer from using the LIFO method to permanently avoid gain recognition

on appreciated assets. Accordingly, the corporation was required to recapture its pro-rata share of LIFO reserves when it elected S status as part of the restructuring (Coggin Automotive Corp. v. Comm., 115 TC No. 28, 10/18/2000).

1.7 Second Class of Stock

The IRS has ruled that the issuance of nonvoting common stock did not create a Second class of stock; nor did an arrangement under which a payment of bonuses of the nonvoting stock would be made to certain key employees.

In the ruling, two shareholders wished to transfer "incentive stock" to key employees as part of a long-range plan to transfer ownership. Accordingly, the owners established nonvoting common stock for purposes of transfer as this incentive stock under the bonus arrangement. The IRS determined the arrangement was valid and did not create a Second class of stock (PLR 200118046).

1.8 Inadequate Officer Compensation

In a Tax Court Summary Opinion, the court determined the three-year statute of limitations did not bar the liability of a CPA firm for employment taxes connected to the underpayment of salary to its sole shareholder. The CPA owner had received a salary from an S corporation in the amount of $2,000 for 1994 and took no compensation in 1995 and 1996. The IRS initiated an examination of the taxpayer's employment tax liability in early 1997, and in May of 1997, the taxpayer executed Form SS-10, Consent to Extend the Time to Assess Employment Taxes. This form extended the statute for the 1994 year through July 31, 1998. In February 1998, the taxpayer then executed another Form SS-10, agreeing to extend the statute through April 15, 1999. The taxpayer later executed Form 2504, Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment, and also in December 1998 filed a Form 656, Offer in Compromise, which was signed and accepted by the IRS. This offer in compromise provided for the waiver of the statute of limitations associated with the collection matter.

When reasonable compensation was proposed by the IRS to be $45,000 for 1994, $47,500 for 1995, and $49,000 for 1996, and when employment taxes, along with interest and penalties, were assessed against the taxpayer, the taxpayer went to court, arguing that the statute of limitations barred assessment of the liabilities. The court determined that the statute was properly extended by execution of the Forms SS-10

and the Form 656. The taxpayer also argued that he was not an employee of his CPA firm employer, but the court found that because he was the only CPA who performed services for the company, and because he was an officer of the company, he was in fact a legitimate employee of the corporation. Finally, the taxpayer argued that he was eligible for relief under Section 530 of the Revenue Act of 1978, arguing that he had consistently treated himself as a nonemployee. The court found that the taxpayer did not satisfy the requirements of Section 530 and thus was not eligible for relief under that section, determining that inconsistent treatment had occurred because a Form W-2 had been issued for the $2,000 of 1994 compensation (*Wiley L. Barron, CPA, Ltd. v. Comm.*, TC Summary Opinion 2001-10, 2/7/2001).

Observation

This case is yet another decision in a long line of rulings dealing with inadequate compensation out of an S corporation (see, as an example, *Spicer Accounting, Inc., Joseph Radtke, S.C.*, and *Dunn & Clark*). What differentiates this decision is the argument of the taxpayer that the statute of limitations prevented such assessment and the attempt to use Section 530 relief.

1.9 Deductibility of Interest Expense

A taxpayer borrowed money from several sources to buy two nursing homes, later transferring ownership of the nursing homes to two S corporations he organized. The taxpayer remained personally liable for repayment of the loans on the purchase of the properties. The taxpayer also personally obtained a number of other loans over the years to operate, improve, and develop the nursing homes. The IRS attempted to disallow the interest expense, arguing that the taxpayer held the properties for investment purposes and that the interest expense was an expense of the S corporation, not of the taxpayer personally.

The Tax Court rejected both arguments and ruled that the taxpayer could deduct the interest expense on all loans, determining that the purchase of the nursing homes occurred primarily to provide employment for the taxpayer and his wife, and that personal liability remained with the taxpayer to pay the interest (*Rosser v. Comm.*, TC Memo 2001-79, 3/30/2001).

Observation

The taxpayer could have avoided the problem by having the S corporation borrow the funds to pay its operating expenses, or by having the

corporation assume the indebtedness if the debts were obtained before incorporation of the entity. Also, IRS Notice 89-35 specifically allows business interest expense treatment by an S shareholder for acquisition debt if the following three conditions exist:

1. The taxpayer materially participates in the business operations of the S corporation.
2. The S corporation's assets are used solely in conducting an active trade or business, and not for passive or portfolio activities.
3. There have been no debt-financed distributions to shareholders. In some cases, under the provisions of IRS Notice 89-35, even interest from debt used to make distributions can be treated as fully deductible business interest expense by the S shareholder.

1.10 Corporate Distribution of Acquired Stock

The Tax Court ruled that the distribution of stock held by an S corporation less than five years after acquiring control of the stock did not qualify as a tax-free spin-off under Section 355. Accordingly, the gain passed through to the shareholders of the S corporation and was taxable to them (*McLaulin v. Comm.*, 115 TC No. 18, 9/20/2000).

Observation

At the time of this transaction, an S corporation could not be a member of an affiliated group of corporations. Accordingly, if the S corporation had held the C corporation stock, its S status would have terminated. However, for taxable years beginning after 1996, S corporations are allowed to have more-than-80-percent-controlled C corporation subsidiaries.

2. DEPRECIATION AND AMORTIZATION

2.1 Modification of Section 179 Election Disallowed

The Tax Court sided with the IRS in determining that the IRS had the authority to refuse to allow a taxpayer to change a Section 179 election to expense items that had not originally been elected under Section 179. The taxpayer originally had a loss on his Schedule C and thus was unable to benefit from the Section 179 election. However, upon later IRS examination, significant adjustments were made that resulted in

additional Schedule C income. At this point, the taxpayer sought the permission of the IRS to use Section 179 against the positive income. Although the IRS has the authority to consent to a late election, Reg. Section 1.179-5(b) indicates that such consent is to be used "only in extraordinary circumstances."

One of the major factors working against the taxpayer was that he had aggressively deducted as "materials and supplies" the cost of three pieces of welding equipment that should have been placed on the depreciation schedule. Upon audit, when this equipment was reclassified by the IRS, along with a substantial increase in revenues because of unreported income, the taxpayer wanted to expense the three assets under Section 179. The court determined that the taxpayer's circumstances were of his own making, based solely on the misclassification of the very assets that the taxpayer later wanted to expense (*Patton v. Comm.*, 116 TC No. 17, 4/13/2001).

Observation

In many cases, practitioners may expense assets without using Section 179, assuming they could always later use Section 179 on these assets if the IRS disagrees with the expensing classification. However, as clearly indicated in the *Patton* case, if assets are improperly classified and later required to be capitalized by the IRS, taxpayers essentially have no opportunity to elect Section 179 at a later time.

2.2 Capitalization of Minor Cost Assets Required

The Tax Court supported the IRS in requiring a home health agency corporation to capitalize the cost of assets that cost less than $500, but that had a useful life of more than one year, despite the fact expensing was allowed under Medicare reimbursement guidelines. The court determined that the IRS has the authority to require the taxpayer to change its method of accounting to capitalize the assets, and that the taxpayer's current accounting method, calling for expensing of low cost items, did not clearly reflect income.

However, the court also found the taxpayer was not liable for the substantial understatement penalty, because the expensing policy used on the tax returns by the taxpayers was the same as had been used in previous years. The court determined the taxpayer adequately relied on its CPA firm in preparing the tax returns and had reasonable cause for expensing the assets in question (*Alacare Home Health Services, Inc. v. Comm.*, TC Memo 2001-149, 6/22/2001).

2.3 Noncompete Agreements and Partial Redemptions

The Tax Court upheld the IRS in determining that the payment by a corporation on a noncompete covenant completed in connection with the redemption of 75 percent of the corporation's outstanding stock fell under the provisions of Section 197 and its fifteen-year amortization requirement. The corporation executed a redemption agreement for 75 percent of the stock held by another corporation and also executed a five-year noncompete agreement with the seller. The taxpayer owning the other 25 percent of the stock argued that it did not really acquire an interest in a business in connection with the redemption transaction, because both before and after the transfer, the corporation was engaged in the same business and acquired no new assets in the transaction. However, the court determined that the history of Section 197 contained no evidence that any type of a purchase agreement, even a redemption, was to be excluded from the term *acquisition* and therefore the noncompete covenant fell under the provisions of Section 197 (*Frontier Chevrolet Company v. Comm.*, 116 TC No. 23, 5/14/2001).

2.4 Advanced Rulings on Leveraged Leases

The IRS has provided guidance on when it will issue advance rulings in determining whether transactions purporting to be leases of property qualify as legitimate leases for tax purposes. The guidelines apply to transactions called "leveraged leases," which are net leases with a lease term covering a substantial part of the useful life of the leased property. In these leases, the payments by the lessee to the lessor are sufficient to cover the payments of the lessor to the lender. Additionally, the IRS has defined the information and representations required to be furnished by a taxpayer in a request for advance rulings on leveraged lease transactions (Rev. Procs. 2001-28 and 2001-29, IRB No. 2001-19).

2.5 Nonallocation on Cancellation of Lease

A taxpayer with an unfavorable lease on property purchased the property in order to terminate the lease. The taxpayer then attempted to allocate a portion of the acquisition cost of the property to the lease termination in order to obtain a current deduction. However, the Tax Court determined that the entire cost needed to be allocated to the property under Section 167(c)(2), with depreciation being the only mechanism for recovery of this cost (*Union Carbide Foreign Sales Corp. v. Comm.*, 115 TC No. 32, 11/8/2000).

3. ACCOUNTING METHOD ISSUES

3.1 Restoration of Installment Method for Accrual Taxpayers

3.1.1 Statutory change

In late 1999 legislation, Congress added Section 453(a)(2), providing that the installment method was not available for any sale by an accrual method taxpayer, effective for dispositions occurring on or after December 17, 1999. This provision had the effect of preventing an accrual method business from selling assets, such as real estate and goodwill, under the installment method.

Subsequently, on December 28, 2000, Congress enacted the Installment Tax Correction Act to retroactively permit the use of the installment method by an accrual taxpayer. The intent was to allow use of the installment method as if the accrual method restriction had not been enacted (P.L. 106-573, 12/28/2000).

Observation

Because the bill is retroactive to the effective date of the 1999 law change, accrual method taxpayers who have already reported the entire gain on a post December 16, 1999, installment sale (that is, on a 1999 calendar-year return or a fiscal year 2000 return) should file an amended return if the taxpayer now wants to take advantage of the installment sale provisions. This represents an important refund opportunity for affected taxpayers.

3.1.2 IRS guidance on retroactive repeal

The IRS has provided guidance on this retroactive repeal of the installment method prohibition. The relief applies to an accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale without the benefit of the installment method. That taxpayer has the consent of the IRS to file an amended return for the year in which the installment sale occurred, and for any other affected tax year, in order to report the gain on the installment method (IRS Notice 2001-22, IRB No. 2001-12, 2/16/2001).

3.2 Automatic Change From Accrual to Cash for Small Businesses

In May 2000, the IRS announced that small businesses would be allowed to make an automatic change in accounting method to convert from

the accrual method to the cash method, effective for tax years ending on or after December 17, 1999. This privilege to change to the cash method was subject to the following conditions:

- The taxpayer's average annual gross receipts, measured for the prior three-year period, did not exceed $1 million.
- The taxpayer must meet a conformity requirement, under which financial statements to owners and creditors are also issued on the cash method of accounting.
- The taxpayer must hold material or merchandise costs in inventory until the goods are consumed or sold (but there is no requirement to capitalize labor or other overhead to inventory, nor do Section 263A UNICAP procedures apply).
- Eligible taxpayers are given automatic permission to accomplish a change from the accrual method to the cash method, applying the four-year spread provisions for the Section 481(a) adjustment (Rev. Proc. 2000-22, IRB No. 2000-20).

The IRS subsequently modified and restated the provisions for the automatic change from accrual to cash method (Rev. Proc. 2001-10, IRB No. 2001-2).

- The financial statement conformity requirement has been eliminated. Accordingly, a small business may switch to the cash method without any requirement that its financial statements issued to owners and Third parties use the same method of accounting.
- Entities classified as tax shelters, such as those that have had a registered offering of securities for sale, may not make the conversion from accrual to cash.
- The revised procedures clarify that inventoriable materials and supplies are to be deducted in the year in which the taxpayer sells the merchandise, or in the year in which the taxpayer actually pays for the inventoriable items, if later.

Observation

The ability to deduct merchandise costs at sale not only simplifies a taxpayer's calculations (that is, ending physical inventory determines cost of goods sold), but also allows income deferral (that is, cost of goods sold reflects some merchandise sales for which the collection of income is deferred to the next year).

- Taxpayers were given until June 15, 2001, to amend the tax return filed for the first year ending on or after December 17, 1999, to accomplish the conversion from the accrual method to the cash

method. If the change is initiated for a later tax year, the Form 3115 must accompany the taxpayer's timely filed (including extensions) original return for the year of change, under Section 6.02(2) of Rev. Proc. 99-49.

3.3 Cash Versus Accrual Developments

3.3.1 Flooring contractor

Smith Floors, an S corporation, initially limited its business activity to the installation of flooring materials. However, its business gradually evolved to include the warehousing of flooring materials that were sold in connection with installation services. The business did not store any flooring materials for resale to the general public, but rather used the flooring materials for installation jobs. During the year at issue, the business had a total of 836 jobs, of which 555 involved the purchase and resale of flooring materials and 281 involved installation-only services. The Tax Court found that the flooring materials purchased and installed by the business did not constitute merchandise because the business was inherently a service provider. The court also noted that there was no evidence the business had attempted to prepay expenses unreasonably or accumulate excess supplies at the end of its tax year. Accordingly, the court allowed the business to retain the cash method (*Edward G. Smith v. Comm.*, TC Memo 2000-353, 11/14/2000).

3.3.2 Change in IRS litigating position

In response to the *Smith* decision (above), as well as other recent decisions allowing the use of the cash method (*Jim Turin & Sons, Inc. v. Comm.* CA-9, 7/21/2000, involving an asphalt paving contractor and *RACMP Enterprises, Inc. vs. Comm.*, 114 TC No. 16, 3/30/2000, involving a concrete contractor), the IRS announced a change in its litigating position. The Office of Chief Counsel announced that it is studying the issue addressed by the courts in these cases, and, until further guidance is issued, will not assert that taxpayers in similar businesses are required to use an accrual method of accounting. This change in litigating position covers construction contractors involved in paving, painting, roofing, drywall, and landscaping. However, this interim policy does not apply to taxpayers that are resellers or manufacturers, or those that would be required to use an accrual method of accounting under Section 448 (a C corporation with gross receipts of $5 million or more) (CC-2001-010, 2/9/01).

3.4 Expensing Versus Capitalization

3.4.1 Ongoing towboat maintenance

The Tax Court has held that the owner of inland river towboats could currently deduct the cost of periodic maintenance and overhaul of towboat engines, rather than being required to capitalize the expenses. The taxpayer completed maintenance and overhaul of the towboat engines every three or four years at a cost of about $100,000 per boat. The procedure involved inspection of almost all engine parts and replacement of slightly over 20 percent of the parts. Following industry practice, the procedures maintained, but did not increase, the relative value of the towboat and did not extend the anticipated useful life. The court found that even though a buyer would be more interested in a well-maintained towboat, there was no clear evidence a buyer would pay $100,000 more for a towboat that had recently undergone maintenance (*Ingram Industries, Inc. v. Comm.*, TC Memo 2000-323, 10/18/2000).

3.4.2 Ongoing airplane maintenance

In response to its loss in *Ingram Industries,* the IRS ruled that a commercial airline that continually serviced and repaired its aircraft in order to adhere to strict governmental safety standards was allowed to deduct the costs as repairs, determining that the inspections merely kept the aircraft in ordinary operating condition and did not extend their useful life (Rev. Rul. 2001-4, IRB No. 2001-3).

Observation

The IRS had previously ruled in PLR 9618004 that the cost of Federal Aviation Association-mandated aircraft engine inspections conducted every four years by airlines at a cost of approximately $100,000 per engine needed to be capitalized.

3.4.3 Asbestos removal

The IRS has ruled that the cost of asbestos removal incident to the repair of production plants and machinery needed to be capitalized under Section 263 and was not currently deductible as an expense. The taxpayer, an electric utility company, routinely inspected and repaired production plants and machinery, often resulting in a requirement to remove asbestos insulation. The IRS deemed the asbestos insulation to be a part of the production plant and of the capitalized cost of the assets of the plant, and accordingly not currently deductible as an expense (FSA 200035021).

3.4.4 Acquisition of installment contracts

In a narrowly divided decision, with seven judges agreeing, the Tax Court ruled that an S corporation must capitalize salaries and benefits paid in connection with the acquisition of automobile financing installment contracts. The court did allow, however, current deductibility of overhead expenses, determining that they were not directly related to acquisition of the contracts. The corporation was in the business of providing alternative financing for purchasers of used automobiles who had marginal credit, and attempted to claim a current deduction for credit analysis expenses associated with the acquisition of the installment contracts. The court sided with the IRS in determining that the payments provided the taxpayer with significant future benefits in the form of income generated by the installment contracts in later years. This required capitalization of salaries and benefits incurred in connection with the acquisition of the contracts (*Lychuk v. Comm.*, 116 TC No. 27, 5/31/2001).

3.4.5 Loan acquisition fees

The IRS ruled that a corporation that acquired installment sales contracts containing loans from automobile dealers was required to capitalize the expenses paid with respect to the loans, determining that the costs provided significant future benefits beyond the year in which they were incurred (FSA 200109001).

3.4.6 Capitalization of federal bank fees

The Tax Court ruled that fees paid to a federal entity during the course of a corporate acquisition represented ordinary and necessary business expenses of the taxpayer, allowing current deductibility of all costs. During the acquisition of another financial institution, a bank needed to insure the funds of depositors of the acquired bank by paying various fees to the Federal Deposit Insurance Corporation (FDIC) amounting to approximately $500,000. The court found the taxpayer was obligated to pay the FDIC fees if it wanted the acquisition to be approved by the federal regulators and that the taxpayer had made a reasonable business decision in deciding to pay the fees. This decision minimized the overall cost of the acquisition and accordingly the fees were currently deductible as a business expense (*Metrocorp, Inc. v. Comm.*, 116 TC No. 18, 4/13/2001).

3.5 Change in Accounting Period

3.5.1 Comprehensive proposed regulations

The IRS has released a set of comprehensive proposed regulations on adopting an annual accounting period under Section 441 and receiving

IRS approval to adopt, change, or retain annual accounting periods under Section 442. The proposed regulations reorganize existing temporary regulations, and become effective for taxable years ending on or after the date they are issued as final regulations (Prop. Regs. Secs. 1.441-1, 1.441-2, 1.441-3, 1.441-4, 1.442-1, 1.706-1, 1.898-4 and 1.1378-1, REG-106917-99, 6/13/2001).

3.5.2 Nonautomatic accounting period changes

The IRS issued a notice releasing a proposed revenue procedure providing automatic procedures under Section 442 to establish a business purpose and adopt, change, or retain a partnership, S corporation, electing S corporation, or PSCs annual accounting period (IRS Notice 2001-34, IRB No. 2001-23).

3.5.3 Automatic approval for pass-throughs

The IRS issued a notice releasing a proposed revenue procedure liberalizing the procedures that partnerships, S corporations, electing S corporations, and PSCs must follow to obtain automatic approval to adopt, change, or retain their annual accounting periods (IRS Notice 2001-35, IRB No. 2001-23).

Observation

The proposed method would be the exclusive procedure for taxpayers to follow in obtaining automatic approval to make the following changes:

- A change to the required tax year of the entity, or to a fifty-two-to-fifty-three-week tax year ending with reference to the required tax year.
- A change to or retention of a natural business year by partnerships, S corporations, electing S corporations, or PSCs that satisfy the 25 percent gross receipts test.
- An S corporation's or electing S corporation's adoption, change to, or retention of its ownership tax year in which shareholders owning more than 50 percent of the issued and outstanding stock on the first day of the requested tax year have changed, or are changing to, that tax year, or a fifty-two-to-fifty-three-week tax year ending with reference to that tax year.
- A change from a fifty-two to fifty-three week tax year to a non-fifty-two-to-fifty-three-week tax year that ends on the last day of the same calendar month, and vice versa.

Observation

Contrary to earlier rules, partnerships, S corporations, and PSCs may change automatically to a natural business year that satisfies the 25

percent gross receipts test, regardless of whether that year results in a greater deferral of income. Thus, for example, a calendar year S corporation, conducting a seasonal ski business satisfying the 25 percent gross receipts test as of March 31, would be permitted to change to a March fiscal year end.

3.6 Long-Term Contracts

The IRS has issued final regulations under Section 460 addressing the definition of "unique items" specifically designed for the needs of the customer, safe harbor provisions, hybrid contracts, related-party rules, and cost allocation rules associated with long-term contracts. The regulations include numerous examples, and apply to contracts entered into on or after January 11, 2001 (Regs. Secs. 1.460-1, 1.460-2, 1.460-3, 1.460-4, 1.460-5, and 1.460-6, TD 8929, 1/11/2001).

3.7 Simplified LIFO for Auto Dealers

The IRS has released a revenue procedure providing dealers in used cars and light trucks with an alternative LIFO inventory computation method known as the used vehicle alternative LIFO method. The revenue procedure also grants automatic consent to taxpayers to make a switch to this alternative method. This new method for used vehicle inventories is designed to simplify the dollar-value LIFO computations of used vehicle dealers (Rev. Proc. 2001-23, IRB No. 2001-10).

3.8 Alternative Cost Method for Developers

Rev. Proc. 92-29 (1992-1 CB 748) describes an alternative cost method under which real estate developers are allowed to allocate estimated construction costs of future common improvements, such as a golf course and clubhouse, to the cost of the lots sold. The Tax Court allowed a real estate developer using this alternative cost method to allocate the costs of common improvements, but did not allow allocation of the estimated future period interest expense (*Hutchinson v. Comm.*, 116 TC No. 14, 3/14/2001).

3.9 Accrual of Interest on Short-Term Loans

In June of 2000, the Tenth Circuit followed the decision of the Eighth Circuit in *Security Bank Minnesota* (CA-8, 93-1 USTC ¶50,301) in

determining that a cash-method commercial bank was not required to accrue interest or OID under Section 1281 on short-term loans made to customers in the ordinary course of the banking business (*Security State Bank v. Comm*, 2000-2 USTC ¶50,549, CA-10, 6/7/2000). The IRS has now acquiesced to the decision of the Tenth Circuit (AOD CC-2001-01, 2/1/2001).

Observation

The IRS had previously announced procedures on how applications for change in accounting method can be filed by taxpayers in the Eighth Circuit who wish to follow the appellate court's decision in *Security Bank Minnesota* (IRS Notice 95-57, IRB No. 1995-45). The IRS has not yet given any indication on procedures for change in accounting method for taxpayers in the Tenth Circuit.

While the IRS indicates that it still disagrees with the holdings of the Eighth and Tenth Circuits, it did indicate in its acquiescence announcement that it will not continue to litigate the issue in any other Circuit if the issue falls strictly within the parameters of the Eighth and Tenth Circuit cases.

3.10 Reverse Like-Kind Exchanges

3.10.1 IRS safe harbor guidance

Section 1031 and supporting regulations have allowed a taxpayer to enter into a delayed exchange, where property is transferred to an intermediary who sells the property and uses the funds to complete the acquisition of like-kind replacement property. However, there has been no IRS authority approving reverse exchanges, in which the replacement property is acquired before the sale of the relinquished parcel.

Effective on or after September 15, 2000, the IRS has issued a safe harbor procedure under which taxpayers may enter into reverse like-kind exchanges (Rev. Proc. 2000-37, IRB No. 2000-40). The following provisions must all be met in order to qualify under this safe harbor:

- The intermediary who facilitates the exchange, known as an exchange accommodation titleholder (EAT), is an independent party that is subject to income tax, or if a pass-through entity, more than 90 percent of the EAT's partners, members, or shareholders are subject to income tax.
- The EAT must take legal ownership of the replacement property or the relinquished property, and at the time of transfer of property it is the clear intent of the taxpayer to qualify for a Section 1031 like-kind exchange.

- No later than five business days after the transfer of property (typically the replacement property in a reverse exchange), the taxpayer and the EAT must enter into a written agreement to facilitate the Section 1031 exchange, with the EAT treated as the owner of the property.
- No later than forty-five days after the transfer of the replacement property to the EAT, the property to be relinquished, including any alternative and multiple properties, must be identified in a manner consistent with the existing regulations at Section 1.1031(k)-1.
- No later than 180 days after the transfer of the replacement property to the EAT, the exchange must be completed.

Observation

This safe harbor approach for reverse exchanges differs markedly from the regulations at Section 1.1031(k)-1(g)(4) affecting conventional deferred exchanges, in that the EAT in a reverse exchange must take actual title and beneficial ownership of the replacement property during the exchange process. The qualified intermediary in the traditional deferred exchange can simply facilitate the transaction without taking actual legal title. Also, the new Revenue Procedure does not address the ability of the EAT to claim depreciation during the period of ownership.

3.10.2 Failure to qualify as a reverse exchange

In a Tax Court opinion issued before the safe harbor Revenue Procedure, the court held that an individual failed to qualify a reverse transaction as a Section 1031 exchange. The taxpayer had acquired unimproved land for use as a new business location. Subsequently, the taxpayer transferred this replacement property to the purchaser of the taxpayer's old business site. The purchaser held the land until a new building was constructed, and then conveyed it back to the taxpayer. The court found that title to the replacement property had merely been "parked" while the new building was constructed, and the taxpayer continued to hold beneficial ownership. In substance, the exchange was simply a transfer away and transfer back of the replacement property to the taxpayer, and accordingly did not qualify under Section 1031 (*DeCleene v. Comm.*, 115 TC No. 34, 11/17/2000).

4. COMPENSATION ISSUES

4.1 Reasonable Compensation

4.1.1 Inadequate retained earnings

The Tenth Circuit affirmed a Tax Court decision in ruling that compensation paid by a catastrophic claims adjusting company to its sole shareholder left the company with inadequate retained earnings and thus

included a substantial amount of nondeductible disguised dividends. The taxpayer's salary was $40,000 in 1988, and increased to $608,000 in 1989, $300,000 in 1990, and $190,000 in 1991. Because of a number of major catastrophes in the United States during 1992 and 1993, the taxpayer drew a salary of approximately $4.3 million in 1992 and slightly over $2 million in 1993. The Tax Court ruled that $2 million of the payment in 1992 and $1 million of the payment in 1993 were unreasonable and represented taxable dividends to the owner. One of the critical factors in the court's determination was the taxpayer determined the level of his salary at the end of each year, after the total gross receipts and overhead were known, and then withdrew virtually all of the corporation's net profits as compensation. Accordingly, the court felt that depleting almost all of the corporation's value was unreasonable and that a portion of the payments therefore represented disguised dividends (*Eberl's, Inc. v. Comm.*, 2001-1 USTC ¶50,396, CA-10, 5/4/2001).

4.1.2 Passive investor test

A real estate leasing corporation was not allowed to deduct compensation paid to its sole shareholder and the shareholder's spouse. The corporation derived its income from rental properties, and the court determined the revenue would have existed regardless of the shareholder's participation or expertise. Additionally, because of ill health, the shareholder's involvement in the corporation decreased at the very time his compensation was increasing (*Metro Leasing and Development Corp. v. Comm.*, TC Memo 2001-119, 5/18/2001).

4.1.3 Partial disallowance of family compensation

The Second Circuit has upheld a Tax Court ruling limiting the deductibility of compensation paid to the father and son shareholders of a metal fabricating business. The father, age 80, was semi-retired but drew compensation of over $350,000 for several years under examination. The son, who actively managed the business, drew compensation ranging from $450,000 to $820,000. The Tax Court had previously adjusted the annual compensation of the father to $200,000, and the son's compensation to amounts ranging from $300,000 to $440,000. The courts noted that the compensation to the owners left the corporation with only nominal operating income (*Normandie Metal Fabricators, Inc. v. Comm.*, 2001-2 USTC ¶50,467, CA-2, 5/30/2001).

4.1.4 Small salaries with large year-end bonus

The Tax Court imposed constructive dividend treatment on a portion of compensation paid to two shareholders of a construction company.

The taxpayers drew only a small salary (approximately $40,000 to $50,000 each) during the years in question, with large bonuses (often several hundred thousand dollars) paid at the end of the year. The court determined the bonuses paid at year end were based solely on the profits of the corporation, and were paid only to the two shareholders. The court also determined an independent investor would not have approved of the compensation in view of the quality of services performed by the shareholders, and the fact that return on equity of the corporation was unreasonable. Of total compensation of approximately $2.4 million paid in the two taxable years in question, the court allowed deductibility of approximately $1.3 million of this amount, with the remainder deemed to be disguised dividends (*Wagner Construction, Inc. v. Comm.*, TC Memo 2001-160, 6/29/2001).

4.2 Revised Characterization of Split-Dollar Insurance Plans

The IRS has issued interim guidance on the topic of employer-employee split-dollar life insurance arrangements. This guidance arose from two concerns on the part of the IRS with respect to existing split-dollar plans: (1) Equity split dollar arrangements, in which the employee accrues rights to the investment portion of the insurance contract, have become commonplace, but existing IRS pronouncements on split-dollar arrangements did not adequately reflect this benefit; and (2) the P.S. 58 rates (in Rev. Rul. 55-747) are based on mortality tables from 1946 that no longer clearly reflect the cost of insurance protection.

Pending the consideration of public comments and publication of further guidance, the IRS has stated that split-dollar arrangements may be characterized in several ways in the interim. Taxpayers may characterize the employer's payments as loans subject to the payment terms of Section 7872. Alternatively, the employer will be treated as owning the policy and the employee will be treated as receiving compensation equal to the annual value of the life insurance protection. In addition, the employee has compensation income to the extent of any dividends to the employee under the life insurance contract, and to the extent of any vested interest acquired in the cash surrender value of the contract. However, this compensation element is reduced by the consideration paid by the employee to the employer (IRS Notice 2001-10, IRB No. 2001-5).

- The P.S. 58 rates may continue to be used for tax years ending on or before December 31, 2001.
- A new premium rate table is set forth in the Notice, identified as Table 2001, to replace the P.S. 58 rates for determining the value of

current life insurance protection on a single life provided under a split-dollar arrangement.

- The new Table 2001 provides a significantly lower rate for the value of one-year term premiums for $1,000 of life insurance protection. For example, under P.S. 58, the one-year term premium for $1,000 of life insurance protection for a 50 year old was $9.22. Under Table 2001, that rate is $2.30.

4.3 Final Regulations on Cafeteria Plans

The IRS has adopted final regulations associated with Section 125 cafeteria plans, clarifying circumstances under which a cafeteria plan may permit an employee to change elections with respect to accident or health insurance coverage, group-term life insurance coverage, dependent care assistance, and adoption assistance during a plan year. The final regulations are generally effective for cafeteria plan years beginning on or after January 1, 2001.

The final regulations are generally consistent with proposed regulations previously issued in March 2000, modifying the rules allowing election changes in connection with a significant increase in cost and allowing election changes during a period of coverage when there is a significant decrease in the cost of a qualified benefits plan or the cost of a benefits package option. Other provisions in the final regulations deal with mid-year election changes when there is a significant improvement in coverage provided, dropping coverage when there is either an increase in cost or a loss of coverage, events treated as a loss of coverage, and changing an election in response to a change made under the plan of a spouse or dependent (Reg. §1.125-4, TD 8921, 3/2/2001).

4.4 Medical Fringe Benefits

A recent case in the Small Tax Case Division of the Tax Court threw out a spousal employment arrangement that was being used by a couple to provide tax-deductible medical insurance and medical reimbursement plan expenses to the husband's proprietorship. This result occurred largely because of the failure of the taxpayer to present a fact pattern that conformed to the couple's own documents and their inability to establish a bona fide employee relationship between husband and wife (*Poyda v. Comm.*, TC Summary Opinion 2001-91, 6/22/2001).

In the facts of the case, the husband reported as a Schedule F proprietor for his ownership and operation of a Wisconsin Christmas tree farm. During the two years under examination, he issued W-2 forms to his wife in the amounts of $5,200 and $5,400, respectively, for her

services involving the Christmas tree farm. In addition, the husband's proprietorship maintained a medical fringe plan for employees who were age 25 and older, had worked for thirty-six months, and who performed at least thirty-five hours per week of services. Under this plan, his proprietorship deducted family health insurance premiums and out-of-pocket medical reimbursements of approximately $5,000 per year as employee benefits. His wife also worked two days per week at a job in town, earning approximately $6,500 per year through that employment.

The IRS position was that the wife was not a bona fide employee of her husband, and accordingly the medical expenses were not deductible business expenses, but rather nondeductible personal expenditures. As the court noted, whether an individual is an employee is a question of fact. Unfortunately, the IRS was able to point out a number of factual weaknesses in the taxpayer's arrangement, and these were used by the court in siding with the government:

- The employment contract required the wife to work thirty-five hours per week at a monthly salary of $100, which the court pointed out was less than $1 per hour. In fact, the actual salary payments of approximately $450 per month did not conform to the document.
- Facts were not presented that provided evidence that the wife worked thirty-five hours per week. Both the lack of testimony from the wife and the existence of her other outside employment suggested that she did not adhere to the contract by working thirty-five hours per week.
- The court viewed the wife's services as more in the nature of a co-owner than an employee. Husband and wife jointly owned the property, and she assisted her husband with similar duties in other business endeavors (his logging and his ginseng-raising activities) without compensation.
- The court stated, "There is nothing in the record to indicate any connection between the medical benefits Ms. Poyda received and her assistance on the farm." This suggests that the employment contract and the medical fringe benefit arrangement were not properly linked, or if they were linked, good evidence was not provided in the court testimony.

Observation

This case can serve as a useful reminder that clients must have current up-to-date employment agreements and medical fringe benefit plans that reflect the reality of their situation.

There is still ample authority supporting the ability of one spouse, conducting business as a proprietor, to employ the other spouse for

services in that business. See Rev. Rul. 71-588 and TAM 9409006. In fact, two 1999 Coordinated Issue Papers published by the IRS acknowledge that self-employed individuals may hire their spouses as employees and furnish medical fringe benefits as a deductible business expense, but of course also note that the spouse must be a bona fide employee and be providing services to the business in exchange for reasonable compensation (with that reasonable compensation reflecting both the direct salary and the value of the medical fringe benefit package). These two papers are cited as UIL 162.35-02 and UIL 105.06-05, both of 3/29/99.

4.5 Payroll Taxes on Back Wages

The U.S. Supreme Court has ruled that payroll taxes on an award of back wages needed to be computed using the rate, and the reference to the wage base, applicable in the year the back wages were actually paid. The ruling related to the Cleveland Indians baseball team, where payment in 1994 was made to eight former players from the 1986 season and fourteen players from the 1987 season. None of the award recipients was an employee of the baseball team at the time of the payment. The question was whether the payroll taxes were to be computed using the 1994 rate and wage base, or the 1986 and 1987 rates and wage bases. The U.S. Supreme Court unanimously ruled that the wages needed to be taxed according to the year they were actually paid (1994) [*U.S. v. Cleveland Indians Baseball Co.*, 2001-1 USTC ¶50,341, U.S. Sup. Ct., 4/17/2001].

4.6 Employment Taxes on Stock Options

The IRS has announced it will not assess FICA or FUTA tax upon the exercise of incentive stock options (ISOs) or options granted under employee stock purchase plans (ESPPs) before January 1, 2003, and will not treat disposition of stock acquired pursuant to exercise of such options as subject to withholding (IRS Notice 2001-14, IRB No. 2001-6).

4.7 Early Termination Payments

The federal Circuit has affirmed three lower court decisions holding that early termination payments to departing employees represented wages and thus were subject to FICA tax. The termination payments were based on a formula using salary and years of service, so the court determined the payments could be directly connected to the employer-employee relationship and thus were subject to FICA (*Associated Electric*

Cooperative, Inc. v. U.S., CA-FC, 9/28/2000; *Abrahamsen v. U.S.*, CA-FC, 9/28/2000; *Cook v. U.S.*, CA-FC, 10/2/2000).

4.8 Qualified Retirement Plans

The Equal Tax and Relief Act of 2001 (P.L. 107-16) made numerous changes in the retirement plan area, as follows:

- The Section 415(b)(1)(A) limit on annual benefits from a defined benefit plan was increased from $140,000 to $160,000, effective for plan years ending after 2001.
- The Section 415(c)(1) limit on annual additions to a defined contribution plan was raised from $35,000 to $40,000, effective for plan years beginning after 2001.
- The Section 401(a)(17) limit on compensation for retirement plan purposes was raised from the current $170,000 to $200,000, effective for plan years beginning after 2001.
- The current $10,500 limit on elective deferrals was increased to $11,000 in 2002 and then by $1,000 each year until it reaches $15,000 in 2006.
- The current $6,500 SIMPLE retirement account limit was increased to $7,000 in 2002 and then by $1,000 each year until it reaches $10,000 in 2005.
- The special restrictions under current law on plan loans to owner-employees are generally eliminated starting in 2002, allowing plan loans to sole proprietors, more than 10 percent partners, and more than 5 percent S shareholders under the same rules as for other employees.
- The top-heavy rules are changed starting in 2002 as follows:
  - — Three changes have been made to the definition of *key employee:* (1) The determination will be based solely on the participant's status and compensation in the plan year containing the determination date (the preceding four years will no longer be considered), (2) an officer is treated as a key employee based on officer status only if the employee earns more than $130,000, and (3) the top-ten owner category has been eliminated.
  - — Matching contributions will count toward satisfying the top-heavy minimums.
  - — The matching contribution of a safe harbor Section 401(k) plan will be deemed to satisfy the top-heavy rules. This does not mean that the match will automatically satisfy top-heavy rules for an

accompanying profit-sharing plan, although the matching contributions will count toward otherwise satisfying the minimum.
— The five-year lookback rule applicable to distributions will be shortened to one year for distributions other than in-service distributions.
— A frozen top-heavy defined benefit plan will no longer be required to make minimum accruals on behalf of non-key employees.

- Elective deferrals will no longer be considered employer contributions for purposes of the Section 404 deduction limits, starting in 2002.
- The definition of compensation for purposes of the deduction limit rules will include salary reduction amounts treated as compensation under Section 415 (for example, Section 401(k) plan elective deferrals), starting in 2002.
- The annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15 percent to 25 percent of compensation of the employees covered by the plan for the year, effective in 2002. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.
- Effective for taxable years beginning after 2005, participants in certain qualified plans are allowed to make after-tax elective deferrals treated as Roth IRA contributions.
- From 2002 through 2006, eligible individuals will receive a nonrefundable credit of up to 50 percent of contributions made to an IRA, Section 401(k), Section 403(b), SIMPLE, SEP, or Section 457 plan. This credit is available on the first $2,000 of contributions (reduced by certain distributions) and is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The amount of the credit is determined by the adjusted gross income (AGI). For a joint filer with an AGI between $0-$30,000, the credit rate is 50 percent. The rate decreases to 20 percent when the AGI exceeds $30,000, then again to 10 percent when the AGI exceeds $32,500, and finally phases out at AGI of $50,000.
- Effective for plans established after December 31, 2001, in tax years beginning after that date, EGTRRA provides a nonrefundable income tax credit for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan, a SIMPLE plan, or SEP. The credit applies to 50 percent of the first $1,000 of qualified expenses for each of the first three years of the plan.

— The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000.
— For an employer to be eligible for the credit, the plan must cover at least one non-highly compensated employee.
— In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months.
— The 50 percent of qualifying expenses offset by the credit are not deductible.
— The other 50 percent of such expenses (along with other expenses above the $1,000 limit) are deductible to the extent permitted under present law.

- A plan may allow individuals who have attained age 50 by year end to make catch-up contributions. The otherwise applicable dollar limit on elective deferrals under a Section 401(k) or Section 457 plan, Section 403(b) annuity, SARSEP, or SIMPLE is increased. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, they are not subject to applicable nondiscrimination rules. However, they must be available to all participants age 50 or over on an equal basis.
  — An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.
  — The allowable catch-up contribution applicable to Section 401(k), Section 403(b), SARSEP, and Section 457 for 2002 is $1,000. This amount is increased by $1,000 each year until it reaches $5,000 in 2006.
  — For SIMPLE IRA and Section 401(k) plans the amount for 2002 is $500 and is increased $500 each year until it reaches $2,500 in 2006.
- Generally, distributions from a qualified retirement plan, Section 403(b) annuity, IRA, or Section 457 plan can be rolled over to any of such plans or arrangements, effective in 2002.
- Employer matching contributions must vest under a maximum three-year cliff or six-year graded vesting schedule, effective for plan years beginning after 2001.
- The IRS may waive the sixty-day rollover period if the failure to provide a waiver would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual, effective in 2002.

- Qualified retirement planning services provided to an employee and spouse by an employer maintaining a qualified plan are excluded from income and wages, effective in 2002.
  — The benefit must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.
- A qualified employer plan may elect to allow employees to make traditional or Roth IRA type contributions to a plan, effective for taxable years beginning after December 31, 2002.
- User fees will be eliminated for determination letters requested by small employers within five years of the adoption of a new plan or within five years of the end of a remedial amendment period beginning in the first five years the plan is in existence, effective in 2002.
- The multiple use of the alternative limit test has been repealed. Employers may use the alternative limit to pass both the ADP and the ACP tests.

4.9 FICA on Restaurant Tips

The Ninth Circuit has upheld a district court decision, determining that the IRS does not have the authority to assess FICA taxes on a restaurant employer by aggregating unreported tips of unidentified employees. The IRS argued that Section 3121(q) allowed aggregate assessment because it provides that tips are deemed to be paid by the employer. However, the courts determined that an employer's share of FICA was to be based on an individual assessment of each employee's wages and any specified unreported tips. Accordingly, the courts did not allow the aggregate method of determining FICA liability (*Fior d'Italia, Inc. v. U.S.*, 2001-USTC ¶50,261, CA-9, 3/7/2001).

Observation

Previously, the Eleventh Circuit, the Federal Circuit, and the Seventh Circuit, as well as several federal district courts had ruled to the contrary, holding that the IRS has the authority to assess the employer's share of FICA on unreported tips on an aggregate basis (*Quietwater Entertainment, Inc. v. U.S.*, 2000-2 USTC ¶50,540, CA-11, 6/7/2000; *The Bubble Room, Inc. v. U.S.*, 98-2 ¶USTC 50,799, CA-FC, 10/16/98; *33 West Hubbard Restaurant Corporation v. Comm.*, 2000-1 USTC ¶50,225, CA-7, 2/15/2000).

5. MAJOR DEVELOPMENTS

5.1 Corporate Deductions

5.1.1 Deductibility of corporate aircraft

Employees generally have taxable compensation income when their employer provides a free nonbusiness flight on a noncommercial flight [Reg. Sec. 1.61-21(g)]. The employee's compensation amount is determined under the so-called standard industry fare level (SIFL) formula, set forth in Reg. Sections 1.61-21(g)(5) and (7). Using the SIFL formula, the employee's income is an imputed amount and is therefore unrelated to the employer's actual costs of providing the flight. When an employer reports the SIFL formula amount as taxable wages to the employee, the employer is allowed to deduct the actual cost of providing the flight [Sec. 274(e)(2)].

The Eighth Circuit has now upheld a Tax Court ruling, which determined that there is no direct link between the amount of the employee's taxable income and the amount of the employer's deduction when employee income amounts are imputed under the SIFL formula. Accordingly, the corporation was allowed to deduct the full costs associated with corporate aircraft used for vacation trips taken by company executives, where the income value of the trips was correctly reported to the executives using the SIFL formula (*Sutherland Lumber-Southwest, Inc. v. Comm.*, 2001-2 USTC ¶50,503, CA-8, 7/3/2001, aff'g. 114 TC 197, 3/28/2000).

5.1.2 Note and bonus agreement

The IRS determined that an accrual method taxpayer could not deduct payments made to employees under a promissory note and pledge agreement and a bonus agreement. The payments represented compensation for future services rather than loan proceeds. Accordingly, the deduction of the amounts needed to be deferred until the years in which the services were actually performed. As a form of "signing bonus," new employees received amounts up-front, with a form of "earn off" on an annual basis for five years, at which time the "loan" representing the up-front payment was totally forgiven. The IRS indicated that deductibility was only allowed as the earn-off occurred on an annual basis. Although not formalized in the ruling, the IRS indicated the payments represented taxable income to the employees when the up-front payments were made (PLR 200040004).

5.1.3 Cancellation of debt to shareholder

A taxpayer owned 100 percent of two related corporations. The taxpayer took loans from Corporation 1, most of which was then loaned to Corporation 2. Later, the taxpayer transferred the stock in Corporation 2 to Corporation 1 in exchange for his release from the loan amount owed Corporation 1. The Tax Court unraveled the transactions and determined the majority of the dollars taken from Corporation 1 constituted a redemption under Section 304(a). In then assessing the tax treatment of the redemption, the court determined the ownership interest and degree of control maintained by the taxpayer over both corporations precluded sale or exchange treatment under Section 302, and accordingly the canceled loan amount was a dividend to the taxpayer (*Combrink v. Comm.*, 116 TC No. 24, 5/15/2001).

5.1.4 Net operating loss carrybacks

The U.S. Supreme Court ruled that affiliated groups must determine product liability losses on a consolidated basis, rather than by aggregating product liability losses that were separately determined by each member in the group. Previously, the Sixth Circuit had ruled in *Internet Corporation and Subsidiaries v. Comm.* (2000-1 USTC ¶50,382, 4/20/2000) that part of a consolidated group's NOL could qualify for the longer ten-year product liability loss carryback period as a specified liability loss, even though the member with the specified liability expenses had positive separate taxable income. The Fourth Circuit had previously reached the opposite conclusion in the *United Dominion* ruling. The U.S. Supreme Court has now resolved this conflict between the Fourth and Sixth Circuits, holding that the entire group's product liability loss must be figured on a consolidated basis (*United Dominion Industries, Inc. v. U.S.*, 2000-1 USTC ¶50,430, U.S. Sup. Ct., 6/4/2001).

5.1.5 Corporate donations of computer technology

The Community Renewal Tax Relief Act of 2000 (P.L. 106-554) extended through December 31, 2003, the current enhanced deduction for corporate donations of computer software, hardware, and peripheral equipment. Additionally, the bill expands the enhanced deduction to do the following:

- To include donations to public libraries
- To apply to property donated no later than three years (instead of two years) after the date the taxpayer acquired or substantially completed the construction of the donated property
- To apply to property donated after reacquisition by a computer manufacturer

The bill permits the IRS to develop standards to ensure that computer donations meet minimum standards for educational purposes. The provision is effective for contributions made after December 31, 2000.

5.1.6 Environmental remediation costs

The expiration date for the option of expensing (rather than capitalizing) environmental remediation costs was extended by the Community Renewal Tax Relief Act of 2000 (P.L. 106-554) to include expenditures paid or incurred before 2004 (previously, before 2002). The bill also eliminates the targeted area requirement, thereby expanding eligible sites to include any site, other than a site identified on the national priorities list, containing (or potentially containing) a hazardous substance certified by the appropriate state environmental agency. This provision is effective for expenditures paid or incurred after December 21, 2000.

5.2 Corporate Tax Payments and Credits

5.2.1 Corporate estimated tax payments

Under EGTRRA (P.L. 107-16), all of any corporate estimated tax payment that otherwise was due on September 17, 2001 (a Saturday) was due on October 1, 2001.

5.2.2 Suspended research credits

The research credit was previously extended by 1999 legislation (P.L. 106-170) through June 30, 2004. However, as part of the law change, credits attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, are not able to be taken into account as payment amounts before October 1, 2000. Similarly, research credits attributable to the period beginning on October 1, 2000, and ending on September 30, 2001, are not able to be taken into account in determining payment amounts before October 1, 2001. The IRS has now issued guidance for computing the research credits for taxable years that include the suspension periods, and explained how to account for research credits attributable to these periods (IRS Notice 2001-2, IRB No. 2001-2).

5.2.3 Research credits and extension payments

The IRS has also issued a notice advising taxpayers with suspended research credits that those credits may be used to offset balances otherwise due with corporate automatic filing extension requests, even though the credits cannot be claimed on the original returns (IRS Notice 2001-29, IRB No. 2001-14).

5.2.4 Final regulations on research credit

The IRS has also issued final regulations on how to qualify for the Section 41 research credit, introducing a new patent safe harbor, a new recordkeeping requirement, and a rebuttal presumption that the "discovery test" has been met (Regs. §§1.41-0, 1.41-1, 1.41-2, 1.41-3, 1.41-4, and 1.41-8, TD 8930, 1/3/2001).

5.2.5 Denial of research credit

The Tax Court ruled that a corporation that developed information programs for insurance companies was not entitled to the research credit because the software did not involve knowledge that was not readily known within the computer science industry. At trial, the computer programmers testified that they knew at the onset whether a computer program would be feasible, so the court determined no advancement or refinement of any principals of computer science was accomplished (*Eustace v. Comm.*, TC Memo 2001-66, 3/20/2001).

5.2.6 Community Renewal Tax Relief Act of 2000

The Community Renewal Tax Relief Act of 2000 (P.L. 106-554), signed into law on December 21, 2000, designated numerous tax incentives for renewal of communities, including expansion of the work opportunity tax credit for hiring youth residing in renewal communities. The act also extended and expanded empowerment zones, extended the employment credit for empowerment zones and enacted numerous other empowerment zone initiatives. The act also created a new markets tax credit for qualified equity investments made to acquire stock in selected community development entities. The provisions are generally effective starting in 2001.

5.2.7 Accumulated earnings tax

The Tax Court determined that a corporation was not subject to the accumulated earnings tax, where the corporation had accumulated significant amounts that were found by the court to be necessary for the reasonably anticipated needs of the corporation. These needs included the business operating cycle, the possible redemption of stock held by dissenting minority shareholders, the corporation being named as a defendant in a class action suit, and plans for business expansion and required repairs and renovations (*Knight Furniture Company, Inc. v. Comm.*, TC Memo 2001-19, 1/29/2001).

A real estate leasing corporation was found to meet the definition of a "mere holding or investment company," and accordingly could only claim the $250,000 exemption from the accumulated earnings tax

rather than an exemption amount based on its reasonable business needs. Because the accumulated earnings of the corporation exceeded $250,000, the entity was subject to the tax (*Metro Leasing and Development Corp. v. Comm.*, TC Memo 2001-119, 5/18/2001).

5.2.8 Personal holding company

The Tax Court determined that a corporation wholly owned by an individual who provided music editing services was liable for the personal holding company tax, finding that income received from motion picture contracts on which editing was performed represented personal holding company income from personal service contracts (*Calypso Music Incorporated vs. Comm.*, TC Memo 2000-293, 9/20/2000).

5.2.9 Definition of a personal service corporation

A personal service corporation (PSC) is not eligible to use the graduated corporate tax rates, but rather must pay tax on its income at a flat 35 percent [Sec. 11(b)(2)]. A PSC is defined as a corporation substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and substantially all the stock by value is held by employees or retired employees performing services for the corporation in connection with activities in those fields [Sec. 448(d)(2)]. The regulations define "substantially all" of the corporation's activities as 95 percent or more of the employees' time devoted to the performance of services within the particular professional field. The performance of any activity incident to the actual performance of the professional service is considered the performance of services in the field [Reg. Sec. 1.448-1T(e)(4)].

The Tax Court held that a corporation performing engineering services was not a PSC subject to the flat corporate tax rate because more than 5 percent of its services included nonengineering activities, such as soil and concrete testing. The tests of concrete and soil samples were performed by technicians rather than engineers, and the reports were written by clerical staff without engineering analysis. Testing results were accomplished without engineering services, and by employees without engineering education or subject to state licensing (*Alron Engineering & Testing Corp. v. Comm.*, TC Memo 2000-335, 11/1/2000).

Observation

The regulation defining a PSC contains a high standard by requiring that 95 percent or more of the employees' time be devoted to the performance of services within a professional field. In view of the fact that many service businesses no longer confine their activities exclusively

to their professionally licensed area of practice, tax practitioners should annually review the status of each PSC to determine whether it still meets the definitions of a PSC.

5.3 Corporate-Shareholder Transactions

5.3.1 Transfer of funds between related corporations

The Tax Court ruled that the transfer of funds between related corporations was in fact a contribution of capital by the shareholders, with the shareholders realizing constructive dividends on the transfer. Both corporations were wholly owned by two spouses. One corporation had advanced funds to the other corporation. This was treated as a contribution to capital by the court, because the promissory notes were not signed, no schedule of payments or due dates was established, and any repayment depended exclusively on the success of the payor corporation. Additionally, there was no attempt to demand payment or require security. The court then extended constructive dividend treatment to the shareholders, deeming the transaction to be a payment to the shareholders with a subsequent deemed transfer from the shareholders to the related corporation (*Shedd v. Comm.*, TC Memo 2000-292, 9/18/2000).

5.3.2 Redemption payments treated as compensation

A state district court ruled that payments by a corporation to stockholders represented compensation, rather than redemption payments in exchange for their stock, because stock was never transferred to the stockholders under Section 83. The court determined that the acquisition of the stock by the employees did not qualify as a transfer of property under Section 83, so the employees never actually owned the stock. Accordingly, there was no stock present to complete the redemption agreement, resulting in compensation treatment to the shareholders and compensation deductibility to the corporate payor (*Riverton Investment Corp. v. U.S.*, 2001-1 USTC ¶50,318, DC Va., 3/6/2001).

CURRENT-YEAR TAX ISSUES—2001

1. INTRODUCTION

There are always a great number of issues of special importance to tax practitioners. Some of these issues concern current economic and regulatory developments, whereas others are critical because they continue to develop in complexity or breadth of applicability over a period of time.

This section addresses eight general topics of current importance to practitioners. Each is presented in an opening synopsis followed by an analysis of the issues; each is often accompanied by illustrative examples.

The discussions are not intended to be complete treatments of each topic. The issues raised in this section only survey some of the more important matters affecting practitioners. Further analysis and research may be required in certain circumstances.

Readers should briefly review the matters discussed, ascertain which issues may be important to their clients' situations, and then conduct further research as needed. A number of issues are quite technical and may apply to just a handful of practices, whereas other matters are global in nature and affect every tax practitioner.

2. 2001 TAX ACT: ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX CHANGES

2.1 Background

The federal transfer tax system consists of three integrated components:

1. The federal estate tax (Chapter 11 of the Internal Revenue Code).
2. The federal gift tax (Chapter 12 of the Internal Revenue Code).
3. The generation-skipping transfer (GST) tax (Chapter 13 of the Internal Revenue Code).

For transfers by gift or at death before 2002, the unified estate and gift tax rates begin at 18 percent and reach 55 percent on cumulative transfers over $3 million. In addition, a 5 percent surtax (or a 60 percent total rate) is applied to cumulative transfers between $10 million and $17,184,000, in order to phase out the benefit of the lower graduated rates. Accordingly, for estates over $17,184,000, a flat 55 percent rate applies to all taxable transfers.

The GST tax is imposed at a flat rate of 55 percent (the highest estate tax rate).

Every individual is allowed to make a gift of up to $10,000 annually to any donee without incurring the gift tax or GST tax. This exemption amount is expected to rise to $11,000 in 2002 due to inflation indexing. A unified credit is allowed against cumulative estate and gift taxes. For 2001, the maximum credit is $220,550. This credit is equivalent to an exemption of $675,000 of taxable transfers.

Observation

Because the cumulative estate and gift exemption amount is calculated as a credit, it has the effect of offsetting the lower graduated tax rates. Accordingly, when taxable transfers exceed the exemption amount, the tax is imposed at upper tier rates. For example, the first $75,000 of cumulative transfers above the $675,000 exemption is taxed at 37 percent, and the next $250,000 of transfers is taxed at 39 percent.

The GST exemption is $1 million. With inflation indexing, the amount is $1,060,000 for 2001.

2.2 Transfer Tax Rate Changes

Effective for transfers after 2001, the 5 percent surtax that affects cumulative transfers over $10 million is repealed. In addition, the top rate applicable to estate and gift cumulative transfers is lowered from 55 percent to 50 percent, effective for gifts or deaths in 2002. Similarly, the GST flat rate is decreased from 55 percent to 50 percent in 2002.

These top transfer tax rates are further decreased 1 percent per year thereafter until reaching 45 percent in 2007. These rates remain at 45 percent until the estate tax and the GST tax are repealed in 2010. In 2010, the gift tax rate is made equal to the highest individual income tax rate (scheduled to be 35 percent in 2010). The highest estate, gift and GST rates will be as shown in the following table.

Highest Estate and Gift Tax Rates and GST Flat Rate

Calendar Year	*Highest Estate Tax Rate (%)*	*Highest Gift Tax Rate (%)*	*GST Flat Rate (%)*
2001	55	55	55
2002	50	50	50
2003	49	49	49
2004	48	48	48
2005	47	47	47
2006	46	46	46
2007	45	45	45
2008	45	45	45
2009	45	45	45
2010	Repealed	35 (maximum individual income tax rate)	Repealed

Observation

The gift tax was retained to prevent wealthier taxpayers from transferring assets to family members or others in order to reduce the income tax cost associated with asset-based gains or earnings. Without any transfer tax barrier in place, appreciated assets and income-producing assets could be moved freely among family members to reduce income tax costs.

2.3 Exemption Amounts

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increases the cumulative estate and gift exemption amount to $1 million effective in 2002. The $1 million exemption amount is equivalent to a unified credit amount of $345,800. The estate tax exemption amount gradually increases, until repeal is scheduled to occur in 2010. The GST tax exemption also will increase, beginning in 2004, to coincide with the estate tax exemption. However, the gift tax exemption amount remains at $1 million permanently. These exemption amounts are summarized in the following table.

Applicable Exclusion Amounts and GST Exemption

For decedents dying and gifts made in:	*Applicable Exclusion Amount*		
	Estates ($)	*Gifts ($)*	*GST Exemption ($)*
2001	675,000	675,000	1 million*
2002	1 million	1 million	1 million*
2003	1 million	1 million	1 million*
2004	1.5 million	1 million	1.5 million
2005	1.5 million	1 million	1.5 million
2006	2 million	1 million	2 million
2007	2 million	1 million	2 million
2008	2 million	1 million	2 million
2009	3.5 million	1 million	3.5 million
2010	Repealed	1 million	Repealed

*The actual amount will be more than $1 million because the GST exemption is adjusted for inflation before 2004. The inflation-adjusted exemption is $1,060,000 in 2001.

2.4 Impact of Increasing Exemption and Decreasing Rates

In 2002, with the cumulative estate and gift exemption increased to $1 million and the top transfer tax rate lowered to 50 percent, the estate and gift transfer tax will apply at rates ranging from 41 percent (above

$1 million) to 50 percent (above $2.5 million). By 2004, the transfer tax will levy at only two rates: 45 percent above $1.5 million and 48 percent at $2 million and above. When the exemption amount increases to $2 million in 2006, the transfer tax will be imposed at a flat rate of 46 percent in 2006 and 45 percent thereafter, until scheduled repeal in 2010.

2.5 Modified Basis Step-Up Upon Repeal of Estate Tax

In lieu of the unlimited step-up in basis that presently applies under Section 1014, a modified step-up in basis under new Section 1022 would apply effective for deaths after 2009. This provision would coincide with repeal of the estate tax.

A decedent's estate will be permitted to increase the basis of appreciated assets by up to a total of $1.3 million. In addition, an increase is permitted for the decedent's unused capital losses and net operating losses, as well as "built-in" losses (those for which a loss would have been allowable under Section 165 if the property had been sold immediately before death). Further, the basis of assets transferring to a surviving spouse can be increased by up to an additional $3 million.

If the amount of the basis increase available is less than the appreciation in the decedent's assets, the executor makes the allocation as to which assets receive a basis increase. In no case can the basis of an asset be increased beyond its fair market value.

> *Example:* Seth, a single individual, dies in 2010 owning assets with a basis of $2 million and a fair market value of $3.6 million. In addition, Seth has an unused capital loss carryover of $100,000 in his final return. Seth's personal representative will have $1.4 million of basis step-up to allocate among Seth's assets ($1.3 million statutory amount plus $100,000 due to the unused capital loss carryover). This basis increase amount will result in all of Seth's assets receiving a step-up to full market value except for a $200,000 shortfall. Presumably, the personal representative would first allocate the step-up to those assets likely to be sold in the near term and to depreciable assets.

Observation

As under present Section 1014, a basis step-up will not be permitted for items representing income in respect of a decedent (IRD). Common examples of IRD include accrued income receivables, retirement plan accounts, annuities, installment gains, and deferred income on U.S. savings bonds.

Effective for estate transfers after 2009, new reporting requirements apply to transfers in excess of the $1.3 million basis step-up threshold [Sec. 6018]. For transfers at death of non-cash assets in excess of $1.3 million, and for appreciated property received by a decedent within three years before death and required to be reported on a gift tax return, the executor of the estate (or trustee of a revocable trust) must report to the IRS:

1. The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
2. The decedent's holding period for the property,
3. Sufficient information to determine whether the gain on the sale of the property would be treated as ordinary income,
4. The amount of basis increase allocated to the property, and
5. Any other information the IRS may prescribe.

Failure to report to the IRS for transfers at death of non-cash assets in excess of $1.3 million in value may result in a penalty of $10,000 [Sec. 6716(a)]. In addition, a penalty of $50 is imposed for each failure to report such information to a beneficiary.

2.6 Corollary Changes to Estate Tax Repeal

Congress made a number of corollary changes to income tax and gift tax provisions to coincide with repeal of the estate tax in the year 2010, as follows:

1. *Property encumbered by debt.* Under current law, gain is not recognized if encumbered property is transferred to the beneficiary of an estate. However, gain is recognized if encumbered property is transferred via lifetime gift and the debt exceeds the adjusted tax basis of the property.

   Beginning in 2010, gain is not recognized at death when an heir acquires property subject to a liability that is greater than the decedent's basis in that property. This assures that under a carryover basis environment, gain will not occur when encumbered property passes through an estate [Sec. 1022(g)].
2. *Transfers to a trust.* In 2010, without an estate tax barrier, Congress is concerned that transfers to trusts might be used to minimize income taxes via the sprinkling of income to multiple family beneficiaries.

   Effective for gifts after 2009, a transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor provisions of the Code [Sec. 2511(c)].

3. *Transfers of property in satisfaction of a pecuniary trust.* Under present law, if appreciated property is used to satisfy a pecuniary bequest, it is only the excess of the fair market value of the property at the date of distribution over the fair market value at the date of death that creates a gain to the estate. Under a post-death carryover basis environment, large gains could arguably be created if appreciated property is used to satisfy a pecuniary bequest.

   EGTRRA clarifies that the gain on the distribution of appreciated property in satisfaction of a pecuniary bequest will be limited to the excess of the property's fair market value at distribution date over the fair market value at date of death, rather than over the beneficiary's carryover basis [Sec. 1040(a)].
4. *Post-death sale of personal residence.* Effective for deaths after 2009, the $250,000 gain exclusion on the sale of a principal residence under Section 121 will apply to a sale by the decedent's estate, a qualifying revocable trust, or any individual who inherited the property.

   This eliminates some of the risk of a post-death sale of the decedent's principal residence, in the event the modified carryover basis adjustment is insufficient to increase the basis in the decedent's residence to fair market value.

2.7 Repeal of Qualified Family-Owned Business Interest Deduction

Under present law, the qualified family-owned business interest (QFOBI) deduction rules of Section 2057 allow an estate holding a family-owned business to effectively raise the estate tax exemption amount to $1.3 million, regardless of the year of death. To be eligible for this increased estate deduction, the family business interest must be includable in the decedent's gross estate, the business must pass to a qualified heir (that is, generally a person who continues material participation in the business during a 10-year recapture period following death), and the heir must be a member of the decedent's family or an employee of the decedent's business for ten years.

The Section 2057 family-owned business interest deduction is repealed for decedents dying after 2003.

Observation

Congress felt that the ability to increase the estate exemption to $1.3 million when the estate included a family-held business was no longer necessary in 2004 and later years, because every estate receives an exemption of $1.5 million in 2004 and after.

2.8 Modifications to GST Tax

Although the GST tax is repealed effective in 2010, Congress recognized that the present election procedures for allocation of the $1 million GST tax exemption (currently $1,060,000 in 2001) contained a number of technicalities and traps that warranted correction. Accordingly, a number of simplification procedures were enacted, effective retroactively for transfers or deaths after December 31, 2000.

The following modifications were made to the GST tax provisions:

1. A deemed allocation of the GST tax exemption is made to lifetime transfers to trusts that are not direct skips [Sec. 2632(c)].
2. A retroactive reallocation of the GST tax exemption is allowed.
3. A trust holding property having an inclusion ratio greater than zero may be severed into more than one trust.
4. For transfers after 2000, valuation rules are clarified to provide that the GST tax calculations reflect gift values as finally determined after examination or amendment.
5. Relief is granted for certain late GST tax elections [Sec. 2642(g)].

The IRS has released guidance regarding procedures for the additional time to make various GST elections, effective for requests for relief pending on, or filed after, December 31, 2000 [IRS Notice 2001-50, IRB No. 2001-34].

2.9 Repeal of State Death Tax Credit

A credit against the federal estate tax is allowed for any estate, inheritance, legacy, or succession tax actually paid to any state or the District of Columbia [Sec. 2011(a)]. The credit for state death taxes paid is limited to an amount determined using Table B (Computation of Maximum Credit for State Death Taxes) in the Form 706 instructions [Sec. 2011(b)].

Many states impose a "pick-up" estate tax, which assures that the state death tax reaches the maximum amount of tax for which a federal credit is allowed to the estate.

EGTRRA reduces the state death credit amount by 25 percent in 2002, 50 percent in 2003, and 75 percent in 2004. In 2005, the state death tax credit is repealed, and instead a deduction is allowed to the estate for any state tax actually paid.

2.10 Conservation Easement Exclusion

An executor may elect to exclude from the gross estate up to 40 percent of the value of land that is subject to a qualified conservation easement

[Sec. 2031(c)(1)]. The maximum exclusion is $400,000 in 2001 and $500,000 in 2002 and after. To be eligible for this exclusion, the land subject to the conservation easement must be located in very specific geographic boundaries, such as within 25 miles of a major metropolitan area, within 25 miles of a national park or federal wilderness area, or within 10 miles of an urban national forest.

Effective for deaths in 2001 and after, EGTRRA expands the eligibility for the qualified conservation easement exclusion by eliminating the requirement that the land be located within specified distances from a metropolitan area or other eligible area [Sec. 2031(c)(8)]. Accordingly, a conservation easement exclusion may be claimed for any eligible land located within the United States.

2.11 Installment Payment of Estate Tax

If an estate includes an interest in a closely-held business, and the value of that business exceeds 35 percent of the adjusted gross estate, the estate may pay any estate taxes attributable to the business interest under a favorable installment payment provision [Sec. 6166(a)].

The installment payments can be spread over a period of up to 14 years, with interest due only in the first four years, followed by interest and principal over the remaining 10-year period. A beneficial interest rate of 2 percent applies to the deferred taxes attributable to a specified limit of the taxable business value [Sec. 6601(j)].

In addition to other requirements to qualify as a small business, a partnership must have 15 or fewer partners, and a corporation must have 15 or fewer shareholders. The IRS has maintained that an eligible business must be an actively conducted trade or business, and that this definition precludes lending, finance, or real estate leasing activities.

Effective for deaths after 2001, EGTRRA increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely held business for purposes of Section 6166 eligibility [Sec. 6166(b)(1)(B)]. Also effective in 2002, EGTRRA allows a limited use of the installment privilege if the estate holds an interest in a lending and finance business [Sec. 6166(b)(10)].

Lending and finance businesses include loan-making activities, the purchasing or discounting of receivables, the leasing of real and tangible personal property, and services related to these activities. However, there is a "substantial activity" definition that can be met by a safe harbor of having at least one full-time employee in active management of the business, at least 10 full-time nonowners employees substantially involved in the business, and at least $5 million in gross receipts from these activities. For qualifying lending, financing, and leasing businesses,

the installment payments of estate tax are to be made over five years, rather than the 14 years applicable to other businesses qualifying for §6166.

3. MAXIMIZING TAX CAPACITY FOR INDIVIDUAL TAXPAYERS

3.1 Background

Tax capacity is a tax-planning concept, driven by tax compliance, with its value rooted in the precept of "not wasting what is available." It focuses on tax credits and tax brackets to arrive at the amount of total income (or tax capacity) that a taxpayer can handle.

3.2 Opportunities With Negative Taxable Income and IRAs

The general rules for deductible IRAs are described at IRC Section 219 and for Roth IRAs at IRC Section 408A. Under IRC Section 408(o)(2)(B)(ii), a taxpayer is allowed to treat an IRA contribution under IRC Section 219 as being a nondeductible contribution. Effective January 1, 2000, an IRA owner who converts an amount from a traditional IRA to a Roth IRA, and then recharacterizes that amount back to a traditional IRA, may not reconvert that amount from the traditional IRA to Roth IRA status until the following tax return, or, if later, the end of the 30-day period after the recharacterization from Roth back to the traditional IRA status [Reg. 1.408A-5 Q&A 9(a)(1)].

Taxpayers with negative taxable income for a year have two unique opportunities associated with IRA contributions and rollovers. Taxpayers with negative taxable income who have made a deductible IRA contribution under IRC Section 219 should treat the portion of the contribution for which no tax benefit was received as being a nondeductible or Roth IRA contribution.

> *Example:* Ken and his wife, Mona, each make a $2,000 deductible IRA contribution. In completing their tax return, it is noted that their taxable income is negative [for example, ($2,500)], after deducting the IRA amounts.
>
> The tax practitioner should treat $2,500 of the IRA contributions as being nondeductible contributions. In this manner, the taxable income of Ken and Mona is still at a zero tax level, but they retain "basis" in the contributed IRA amount.

Observation

The treatment of a portion of a deductible IRA contribution as a nondeductible contribution can be made as late as the filing due date of the tax return (that is, an "after-the-fact" tax planning opportunity).

Taxpayers with negative taxable income should consider completing a conversion from a regular IRA to a Roth IRA before year end, and then reconverting back to the regular IRA any amount that results in taxable income (or taxable income at a higher tax rate) for the taxpayer.

Example: In completing year-end tax planning for Ken and Mona, negative taxable income is projected of approximately $20,000. Ken and Mona currently have a deductible (i.e., "zero-basis") IRA account with a balance of approximately $25,000.

The tax practitioner should advise Ken and Mona to convert the deductible IRA to a Roth IRA before year end. Then, upon completion of the tax return, any amount in excess of zero taxable income can be reconverted back to the deductible IRA status. Alternatively, Ken and Mona may decide to pay tax on the taxable conversion amount, because it falls within the lowest tax bracket.

4. NURSING HOME COSTS CREATE NEGATIVE TAXABLE INCOME

4.1 Background

Another opportunity for maximizing tax capacity exists with nursing home costs. Numerous opportunities for matching income against nursing home deductions exist, particularly when the taxpayer holds income-in-respect-of-a-decedent (IRD) assets. It is not unusual to see clients enter a nursing home with medical expense deductions that entirely eliminate their taxable income. In such cases, it may be appropriate to bring additional income into the tax return, particularly if it can be achieved using IRD assets.

Example: Jed is a single taxpayer over age 65 who receives $25,000 per year in portfolio and pension income, in addition to $12,000 of gross Social Security benefits. Jed typically does not itemize deductions because he annually incurs $2,000 of medical costs, $1,000 of state and local taxes, and $1,000 of charitable deductions. However, if Jed's health deteriorates and he annually incurs $36,000 of qualified long-term care costs (paid for partly by spending down his assets), his taxable income changes dramatically.

	Before Nursing Home Costs	*After Nursing Home Costs*
Portfolio and pension income	$25,000	$25,000
Taxable Social Security ($12,000 gross)	3,000	3,000
Less: Standard/itemized deductions	(5,650)	(37,900)*
Personal exemption	(2,900)	(2,900)
Taxable income	$19,450	$ 0
Federal income tax	$ 2,918	$ 0
Marginal rate	22.5%	0%

*[$36,000 long-term care costs + $2,000 other medical costs + $1,000 state and local taxes + $1,000 of charitable deductions – 7½% of Jed's $28,000 of adjusted gross income (AGI)]

The resulting taxable income of zero may appear to be a satisfactory answer, but in fact Jed has excess itemized deductions ($25,000 + $3,000 – $37,900 – $2,900). Because this excess does not give rise to a net operating loss carryover, an attempt should be made to increase Jed's AGI so the deductions are not wasted.

Observation

The marginal tax rate of 22.5 percent shown in this example reflects the impact of the phase-in of Social Security taxability. Although Jed is in the 15 percent federal tax bracket before he incurs the nursing home costs, he is also at an income level that adds $1 of taxable Social Security benefits to his tax return for every $2 of additional AGI or tax-exempt income brought into his return. Thus, in attempting to target a breakeven position for such a taxpayer, the phase-in of Social Security benefits will need to be factored into the equation. In many cases, this can be done most efficiently by trial and error using tax planning or tax preparation software because the Social Security benefits are phasing in at the same time itemized deductions are phasing out under the 7½-percent-of-AGI rule.

Example: Assume the same facts as in the previous example, except that Jed's tax practitioner now advises him to recognize additional discretionary income (for example, by cashing in Series EE savings bonds on which the interest has been deferred or taking a larger-than-planned IRA distribution), so that all of his deductible expenses are fully used. In the first column below, this is done by bringing $12,500 more income into his return. The calculations in the second column, however, properly identify $7,004 as the additional discretionary income that brings Jed's taxable income to a breakeven position.

	$12,500 Income Increase	*Income Increase to Breakeven*
Existing portfolio/pension income	$25,000	$25,000
Add: Discretionary income	12,500	7,004
Taxable Social Security ($12,000 gross)	10,200	7,903
Less: Itemized deductions	(36,422)	(37,007)
Personal exemption	(2,900)	(2,900)
Taxable income	$ 8,378	$ 0
Federal income tax	$ 1,257	$ 0
Marginal rate	15%	0%

It is important to recognize that Jed, in the breakeven situation, has moved into the 85 percent phase-in of taxable Social Security benefits. Thus, adding additional discretionary income above the breakeven point will have a high marginal rate cost until Jed reaches the point of full 85 percent reporting of the Social Security benefits.

Example: Continue the same facts as in the previous two examples, except that Jed's tax practitioner does further analysis to determine the point at which Jed reaches the full 85 percent taxability of his Social Security benefits, and also the point at which he reaches the top of the 15 percent marginal rate as a single taxpayer. The illustrations below summarize these points:

	Full Social Security Taxability	*Maximize 15% Rate*
Existing portfolio/pension income	$25,000	$25,000
Add: Discretionary income	9,706	29,870
Taxable Social Security ($12,000 gross)	10,200	10,200
Less: Itemized deductions	(36,632)	(35,120)
Personal exemption	(2,900)	(2,900)
Taxable income	$ 5,374	$27,050
Federal income tax	$ 806	$ 4,058
Marginal rate	15%	15%

In the previous example, Jed reported additional discretionary income of $7,004 to bring taxable income to zero, whereas $9,706 of additional discretionary income is required in this example to reach the point where the maximum portion (85 percent) of Social Security benefits is taxable.

This is only $2,702 more income, yet it moves the federal income tax from $0 to $806, an effective rate of 29.8 percent. This represents the 15 percent nominal rate, nearly doubled because of the 85 percent phase-in of taxable Social Security benefits and the phase-out of the medical expense deduction due to the 7 1/2-percent-of-AGI rule.

4.2 Summary

Practitioners should advise clients to take advantage of opportunities to bring additional income into a return when negative taxable income, such as from nursing home costs, exists. This can be accomplished by drawing in income off IRD assets, or in cases where no IRD assets exist, by triggering capital gain income, even where the assets are immediately repurchased.

For a more sophisticated derivation of this technique, consider bringing in income on a monthly basis to achieve the desired result at month end as nursing home costs occur (this protects against the impact of death during the year).

Observation

This results in an uneven monthly income amount, as the standard deduction and personal exemption amounts are determined on an annual basis, and are not reduced if death occurs during the year.

5. TRIGGERING CAPITAL GAINS IN LOW INCOME YEARS

5.1 Background

Long-term capital gains are taxed at a maximum rate of 20 percent [IRC Sec. 1(h)]. Taxpayers in the 15 percent tax bracket have long-term capital gains taxed at a maximum rate of 10 percent [IRC Sec. 1(h)(1)(B)]. This rate is further reduced to 8 percent starting in 2001 for assets held for more than five years before gain recognition occurs [IRC Sec. 1(h)(2)(A)]. In low income years, taxpayers should consider the sale of capital assets to the extent the capital gain can be reported at the lowest 8 percent/10 percent rate.

5.2 Sale With Immediate Repurchase

A strategy of sale with immediate repurchase may be particularly beneficial starting in the year 2001 because of the new 18 percent capital gain

rate that became effective January 1, 2001, which allows a lower 18 percent rate for assets acquired on or after January 1, 2001, that are held for more than five years before gain recognition occurs [IRC Sec. 1(h)(2)(B)].

Example: In meeting with Don and Cathy at year end, you determine that the net income from Don's business will be close to breakeven because of costs associated with expansion that occurred during the year. Don and Cathy are normally high in the 28 percent federal tax bracket, but for the current year, they have a considerable portion of the lowest 15 percent bracket available to them.

Don and Cathy own appreciated securities, which if sold during the current year, would be taxed at only a 10 percent capital gain rate, as opposed to the normal 20 percent capital gain rate, to the extent the capital gain falls within the lowest 15 percent bracket range.

Observation

If Don and Cathy so desire, they can immediately repurchase the securities after sale (the wash sale rules of IRC Sec. 1091 only apply when securities are sold at a loss). Additionally, by immediately repurchasing the securities, Don and Cathy would qualify the securities for the new 18 percent capital gain rate, assuming the securities are held for more than five years before sale.

6. INVESTMENTS AND KIDDIE TAX

6.1 Background

Special tax rules apply to children under age 14 who have unearned income of more than $1,500 in 2001 ($1,400 in 2000) [IRC Sec. 1(g)(4)(A)(ii)(I)]. Unearned income generally includes all income except wages, salaries, and self-employment earnings.

Effectively, the tax imposes the parents' marginal tax rate on a younger-than-14 child's unearned income in excess of $1,500, unless the child's tax rate is higher than the parents' tax rate. The first $750 of the child's unearned income is tax free. The second $750 of unearned income is taxed at the lowest 15 percent tax bracket (or 10 percent if the unearned income includes long-term capital gains).

6.2 Maximizing Kiddie Tax Opportunities

While the "kiddie tax" rules seem to scare off a lot of taxpayers from investing funds in the name of a child, an opportunity exists to invest sufficient amounts to generate approximately $1,500 of annual portfolio income at a tax cost of just slightly over $100 ($750 tax free and $750 at 15 percent).

The opportunity to realize tax savings of several hundred dollars compared to what the parents would pay on the same amount of investments in their name exists when investing funds in the name of a young child.

Example: Terry and Lisa wish to start a college fund for their daughter, Jenny. Terry and Lisa are in the 31 percent federal tax bracket. If Terry and Lisa invest $25,000 at a 6 percent interest rate, total federal income tax of $465 ($25,000 × 6% × .31) results.

This same investment in Jenny's name results in only $113 ($750 × .15) of federal income tax. Although the "kiddie tax" rules would seem to preclude opportunities for investing funds in the child's name, Terry and Lisa are able to save over $350 of federal tax annually by taking advantage of the tax capacity associated with the "kiddie tax" rules.

Observation

The impact on college financial aid must be assessed when transferring funds to a child to invest in the child's name. Assets in a child's name are assessed for college financial aid purposes at a 35 percent assessment rate, compared to a 5.6 percent assessment rate for assets in the name of the parents.

7. USING THE EDUCATION CREDITS

7.1 Background

While the Code contains the Hope and Lifetime Learning credits, there are also strategies associated with investment alternatives and the interaction of tax/investment techniques that afford additional opportunities. One investment opportunity is to use tax-advantaged mutual funds (for example, index funds or tax-managed funds) to defer investment gains until the education credits are available to offset the tax on such gains.

Index funds, as well as tax-managed funds, are designed to hold securities for the long term, with little or no current buy/sell activity. Accordingly, rather than the fund passing out capital gains to the investors on an annual basis, investment gains are retained within the fund in the form of appreciated securities. With these investments, investors normally trigger the capital gain on these funds only when the investment is redeemed. Investing in these funds in early years and later triggering the taxable capital gain on redemption when the taxpayer qualifies for the education credits can create a form of tax-free income.

7.2 IRS Proposed Regulations

IRS proposed regulations provide an elective opportunity to claim the Hope or Lifetime Learning credits in the tax return of a dependent child where the parents are eligible to, but do not, claim the child as a dependent [Prop. Reg. 1.25A-1(g)(1)].

Example: Joel, age 12, took $10,000 that he has accumulated over the years from odd jobs, paper routes, and parental and grandparent gifts and invested in a growth index mutual fund. The fund liquidates no securities over the years, so Joel has no annual income reporting shown on a Form 1099-DIV, despite the fact the fund appreciates substantially in value.

Assume that as Joel enters his first year of college, his parents electively do not claim him as a dependent and he pays sufficient tuition to qualify for the maximum $1,500 Hope credit. Joel's only other source of income is $4,550 of wages from a part-time job. The index mutual fund has grown to a value of $25,000. Upon sale of the fund, Joel's Form 1040 would be completed as follows:

Wages	$ 4,550
Capital gain on mutual fund sale	15,000
Total	$19,550
Less: Standard deduction	(4,550)
Taxable income	$15,000
Tax at 10% capital gain rate/ 15% ordinary	$ 1,500
Hope credit	(1,500)
Total tax due	$ 0

Joel has avoided all tax on the appreciation of the index mutual fund and has maximized use of his education credit.

A derivation of the above strategy is to use a deductible IRA to shelter investment income in precollege years, later withdrawing the IRA to

pay college tuition, and using education credits to offset the tax on the IRA withdrawal. Under IRC Section 72(t)(2)(E), an exception exists to the 10 percent early withdrawal penalty for IRA withdrawals when the distribution is used to pay for qualified higher education expenses.

Example: Larry is a dependent on his parents' return during his high school years. Upon entering college, Larry claims himself as a dependent (see discussion, following, for eligibility requirements) because he provides over one-half of his own support by paying tuition and room and board from his own funds. Assume that Larry's $7,000 of IRA contributions have appreciated to $9,000 (including $2,000 of earnings) by the time he enters college. The following summarizes the tax treatment over his last four high school years and his first college year:

	High School: Dependent				*College: Not Dependent*
Age:	*15*	*16*	*17*	*18*	*19*
Wages	$ 1,500	$ 3,000	$ 4,000	$ 4,000	$ 5,450
Interest/ dividends	1,500	2,000	2,250	2,250	3,000
IRA	(1,250)	(1,750)	(2,000)	(2,000)	9,000
Personal exemption					(2,900)
Standard deduction	(1,750)	(3,250)	(4,250)	(4,250)	(4,550)
Taxable income	$ 0	$ 0	$ 0	$ 0	$10,000
Tax					$ 1,500
Hope credit					(1,500)
Total					$ 0

Example: Assume the same facts as the previous example, except Larry's parents want to build up additional funds for Larry to use for a number of purposes, including self-payment of education costs, purchase of a vehicle during college, and down payment on a residence after graduation. Accordingly, his parents give Larry substantially appreciated assets over a number of years, resulting in capital gain taxation at the 10 percent rate within the lowest bracket when the assets are sold.

The following summarizes the tax treatment over his last four high school years and his first college year by maximizing use of the lowest 15 percent ordinary/10 percent capital gain tax bracket (the example assumes 2001 deduction amounts in all years).

	High School: Dependent				*College: Not Dependent*
Age:	*15*	*16*	*17*	*18*	*19*
Wages	$ 1,500	$ 3,000	$ 4,000	$ 4,000	$ 4,550
Interest/ dividends	1,500	2,000	2,250	2,250	2,900
Capital gains	27,050	27,050	27,050	27,050	27,050
IRA	(1,250)	(1,750)	(2,000)	(2,000)	
Personal exemption					(2,900)
Standard deduction	(1,750)	(3,250)	(4,250)	(4,250)	(4,550)
Taxable income	$27,050	$27,050	$27,050	$27,050	$27,050
Tax	$ 2,705	$ 2,705	$ 2,705	$ 2,705	$ 2,705
Hope credit					(1,500)
					$ 1,205

Example: Larry, the individual in the previous example, can fully use the $1,500 Hope credit in his second year of college, and the $1,000 Lifetime Learning credit during his last two years of college (the Lifetime Learning credit is scheduled to rise to a maximum amount of $2,000 in 2003).

These $3,500 of additional credits ($1,500 Hope credit and two $1,000 Lifetime Learning credits) support the offset of tax on an additional $35,000 of capital gain income (at a 10 percent capital gain rate) over the last three years of college, while $4,550 of earned income can be offset by the standard deduction and $2,900 of other income can be offset by the personal exemption during these same three years.

The following summaries maximization of the credits during the last three years of college:

	Sophomore Year	*Junior Year*	*Senior Year*
Wages	$ 4,550	$ 4,550	$ 4,550
Interest/dividends	2,900	2,900	2,900
Cap gains	15,000	10,000	10,000
Personal exemption	(2,900)	(2,900)	(2,900)
Standard deduction	(4,550)	(4,550)	(4,550)
Taxable income	$15,000	$10,000	$10,000
Tax	$ 1,500	$ 1,000	$ 1,000
Hope/Lifetime Learning credit	(1,500)	(1,000)	(1,000)
Total	$ 0	$ 0	$ 0

However, for wealthier taxpayers, if Larry wanted to fully use the availability of the lowest bracket 10 percent capital gain rate, the following income could be reported during the last three years of college.

	Sophomore Year	*Junior Year*	*Senior Year*
Wages	$ 4,550	$ 4,550	$ 4,550
Interest/dividends	2,900	2,900	2,900
Cap gains	27,050	27,050	27,050
Personal exemption	(2,900)	(2,900)	(2,900)
Standard deduction	(4,550)	(4,550)	(4,550)
Taxable income	$27,050	$27,050	$27,050
Tax	$ 2,705	$ 2,705	$ 2,705
Hope/Lifetime Learning credit	(1,500)	(1,000)	(1,000)
Total	$ 1,205	$ 1,705	$ 1,705

Example: By following the results of the previous examples, the following level of cash build-up is generated after four years of high school and four years of college by maximizing use of the lowest 10 percent/15 percent bracket.

Total wages reported	$ 30,700
Interest/dividends	19,600
Capital gains	216,400
Net cash available	$266,700

Larry might then expend these funds as follows:

Cash available	$266,700
Tax costs	(16,640)
College costs	(100,000)
Car purchase	(20,000)
	$130,060

The $130,060 would be available to Larry for the down payment on a residence or for investment purposes upon college graduation. His parents will have effectively moved over $200,000 of capital gains income to Larry, which, when combined with his other income, produces a marginal tax rate of only about 6.2 percent ($16,640 of tax on $266,700 [$30,700 + $19,600 + $216,400] of income).

7.3 Claiming One's Self as a Dependent

An individual is not allowed to claim himself or herself as a dependent if he or she is eligible to be claimed on the tax return of another [IRC Sec. 151(d)(2)]. For many wealthy parents, the child's dependency exemption provides little or no benefit, due to the phase-out that occurs at higher income levels [IRC Sec. 151(d)(3)]. The phase-out range for joint filers for 2001 is $199,450 of AGI to $321,950, and for single filers from $132,950 to $255,450.

Observation

Declining to claim a dependent above these AGI phase-out ranges is of no detriment to the parental return.

Higher income parents who find their child's dependency deduction phased out at higher income levels might consider making gifts to a child, so that the child has assets to fund his or her own support and tuition payments, and thus remove the child as their dependent.

Old authority suggests that gifts are counted as support of the donee in the year made when determining dependency status, unless there is proof the gift was invested rather than expended on living costs [Rev. Rul. 58-404, Rev. Rul. 77-282, and Reg. 1.152-1(a)].

Example: Lee and Lisa, reporting AGI of approximately $350,000, receive no tax benefit by claiming a dependency deduction for their daughter, Linda. Lee and Lisa each give $10,000 cash to Linda during December 2001, which Linda expends during 2002 for college tuition and related costs.

Because Linda used funds she owned at the beginning of the year for support purposes (that is, payment of higher educational expenses), Linda should be able to prove that she provided over 50 percent of her own support and thus claim herself as a dependent on her 2002 individual tax return.

Variation: Had Lee and Lisa made the gifts to Linda during the early part of 2002, which Linda then expended on higher educational costs during the same year, Linda would not be able to claim herself as a dependent because the support would still be deemed to come from her parents (unless Linda could specifically prove the cash gifts were invested and she paid the higher education costs out of other funds in her name).

Observation

The strategy of moving the dependency deduction to a child adds tax capacity opportunities for the child, particularly when the dependency deduction would otherwise be phased out on the parental return.

8. SOCIAL SECURITY BENEFITS

The Social Security Administration uses a formula for calculating Social Security benefits based on the amount of Social Security tax paid by a taxpayer.

The year 2001 impact on benefits of Social Security tax payments for workers born in 1939 (age 62 in 2001) is as follows:

Social Security Earnings Amount	
$0–$6,732	90%
$6,733–$40,572	32%
more than $40,572	15%

Example: Linda pays into Social Security on an annual Schedule C net income of approximately $60,000. Ron pays into Social Security on an annual Schedule C net income of $6,000.

Although Linda will pay in 10 times as much in terms of Social Security tax payments as Ron, her potential benefits will be significantly less than (perhaps only two to two-and-a-half times) Ron's potential benefits. This is because the weighting of future benefits is heavily affected by about the first $6,000 of annual Social Security earnings, with significantly reduced benefits at higher amounts.

Practitioners should understand and recognize the impact that Social Security tax payments have on future benefits, particularly as it relates to family employment situations.

9. PER DIEM AMOUNTS

The IRS provides alternative options for determining lodging plus meals and incidental expenses (M&IE) per diems (Reg. 1.274-5). In lieu of actual documentation, the amount is considered substantiated by using either of two methods.

One technique for determining per diems is the federal maximum per diem rate, which uses the continental United States (CONUS) table or outside continental United States (OCONUS) tables (tables of separate lodging and M&IE rates appear under Federal Travel Regulations, 41 C.F.R. Part 301-7).

Another method uses the maximum per diem rate using IRS Revenue Procedure 2000-39 *high-low* method. The high-low method may not be used for meals and incidentals only; the reason for breaking the M&IE amount out in Rev. Proc. 2000-39 is to allow computation of the 50 percent meals disallowance amount. Accordingly, the separate

M&IE rates under the Federal Travel Regulations need to be referenced to determine the M&IE amounts only. Per diem rates for high-cost and low-cost areas, effective January 1, 2001, are:

	Lodging Rate	*M&IE Rate*	*Combined Per Diem*
High-cost areas	$159	$42	$201
All other areas	90	34	124

Rev. Proc. 2000-39 (IRB No. 2000-41) updates and supersedes Rev. Proc. 98-64 (IRB No. 1998-52) and applies to amounts paid or incurred on or after January 1, 2001.

If travel occurs outside the continental United States (OCONUS) or is reimbursed at an amount less than the federal per diem rate, the M&IE portion is 40 percent of the total OCONUS per diem rate for that locality, or 40 percent of the lesser reimbursement amount. OCONUS per diems are reflected as one amount to include lodging and M&IE.

The combined per diem can be used only for employees or other payees under a reimbursement plan. It cannot be used by self-employeds or employees deducting their own expenses. Also, neither the combined per diem nor the M&IE rate is allowed for reimbursement of an employee by a related party (as defined in Sec. 267(b), with a 10-percent ownership standard applied instead of the 50-percent stated in Sec. 267(b)(2)). The payor of the M&IE rate must remove 50 percent from deductibility under the meal and entertainment rules. For example, an employer using the combined per diem rate of $201 would be subject to the 50 percent disallowance on $42, thereby allowing a $180 deduction.

9.1 Meal and Incidental Expenses Per Diems

In addition to employer-employee reimbursement and advances, the M&IE per diem may be used by a self-employed individual. This may also be used by nonreimbursed employees on Form 2106, or between certain payor-payee relationships such as independent contractors and customers.

High-cost areas, for use of the high-low method, are established by the IRS. A taxpayer is considered to be in a high-cost area when the taxpayer stops for sleep and rest in certain locations. The most recent high-cost localities can be found in Rev. Proc. 2000-39, IRB No. 2000-41.

It should be noted that the CONUS tables do not have the same high-cost areas as set out in the high-low table. The standard CONUS M&IE rate is $30 per day with certain localities ranging from $30 to $46. The CONUS tables contain lodging per diem rates that vary from $50 to $281 depending on the location. If a payor uses the high-low method for an employee, the CONUS per diem is not available for the same calendar year (except the employer may use the OCONUS rates for travel outside the United States, the CONUS meal-only rate, or actual expense reimbursement).

The regulations allow special meal rates for the travel industry (Rev. Proc. 2000-39). They include $38 per day for travel within the United States and $42 per day for travel outside the United States. In addition, the Taxpayer Relief Act of 1997 gradually increases the deductible percentage for meals from 55 percent in 1998 to 80 percent in 2008 for individuals subject to the hours of service limitations of the Department of Transportation (that is, airline pilots, over-the-road truck drivers, railroad employees, and so on). The taxpayer working in the travel industry must meet two eligibility requirements. The criteria include moving people or goods by airplane, bus, ship, train or truck and regularly required travel away from home that, during any single trip, involves localities with differing federal M&IE rates. THE payor is not required to reduce the per diem rate for a meal provided in kind. For example, an airline employee per diem need not be reduced for meals received from an airline.

When an individual travels partial days, per diem amounts must be prorated based on either of the following methods:

1. The method prescribed by the Federal Travel Regulations, which allows three-fourths of the applicable federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual.
2. Any method that is consistently applied and in accordance with reasonable business practice. For example, an employer who consistently reimburses an employee traveling away from home from 9 a.m. one day until 5 p.m. the next an amount equal to two times the federal M&IE rate will be considered to be in accordance with reasonable business practice, even though under the first method above, the same employee would have only received one-and-one-half times the federal M&IE rate.

9.2 Table of Per Diem Rules for Taxpayers

Availability of Per Diems to Various Taxpayers

Per diems and Allowances	*Employee Reimbursed*	*Employee Not Reimbursed*	*Self-Employed*	*Independent Contractor/ Payee**	*Related Party***
M&IE	Yes	Yes	Yes	Yes	No—must use actual
M&IE plus Lodging	Yes	No—must use actual	No—must use actual	Yes	No—must use actual

*Certain payor-payee relationships under a reimbursement (accountable) plan.

**As defined in Sec. 267(b), 10-percent common ownership instead of standard 50-percent stated in Sec. 267(b)(2).

CASH MANAGEMENT

1. INTRODUCTION

Adequate cash flow is the single most important element in the ongoing success of an enterprise. The management and projection of cash balances eclipse all other guides to fiscal well-being, because without sufficient cash to fund operations and expansion plans, an enterprise cannot survive. Correspondingly, cash is very expensive to keep. Excess cash indicates that a firm's resources are not being used to the best advantage.

This chapter will discuss the three major concerns about cash resources:

— Cash management

— Projection of cash flow

— Profit erosion due to interest rate movements resulting from a firm's capital structure

1.1 Cash Management

The objective of an effective cash management technique is to have the exact amount of money in the checking account the moment funds are to be withdrawn—not before and definitely not after. In today's environment of electronic funds transfers, the timing of receipts and disbursements is even more critical.

As interest rates fluctuate, so does the emphasis on cash management. Rising interest rates will place demands on businesses and require more effective use of cash.

Cash management is also important to firms encountering liquidity problems along with profit compression. With new computer technology, managers are better able to make informed cash decisions to get maximum use from this expensive asset.

1.2 Cash Flow Projections

Mismatched timing of cash inflows and outflows, or the failure to predict cash requirements, can be fatal to any size business. One of the most effective cash management tools developed by modern business is the cash flow projection. Such projections touch on all aspects of the company and include not only current issues, such as the aging of accounts receivable and payable, but also prospective events, such as new product introductions, anticipated market penetration, and movements in interest rates.

New or expanding businesses will find cash flow projections to be of the utmost importance. This is especially true for capital-intensive enterprises that are required to pay for ever-increasing goods and services well before collections may be made. It is management's responsibility to implement procedures to accelerate the collection of funds while making the best use of trade payables.

Cash is projected in many ways using various key management indicators (such as financial ratios) and techniques (including automated simulation analysis). Emphasis on different aspects of a firm's cash projection will change as the company evolves through its life cycle.

The objective of a cash flow projection is to provide

— An accurate prediction of cash sources and uses.

— Useful feedback on how cash management decisions are working to achieve management's objectives.

— Timely information that helps management anticipate and head off cash problems as well as assist in making decisions affecting profit margins, production levels, and sales activity.

2. DEFINITION AND OBJECTIVES

Cash management is the art of maximizing a business's cash resources by

— Hastening cash inflow.

— Delaying cash outflow.

Cash inflow can be accelerated so that the time lag between revenue generation and the arrival of usable funds in the firm's checking account is reduced to an absolute minimum. Likewise, the time between the purchase of goods and services required for operations and the time that the firm's payment check clears the bank can be maximized.

Accelerating cash inflows should not damage customer relationships or render the firm noncompetitive in the marketplace. Slowing the cash outflow should not impugn the firm's credit reputation or give rise to negative rumors about the firm's financial viability.

Effective cash management is an art rather than an exact science. Its success often depends on management's ability to negotiate effectively with creditors, bankers, and the firm's customers.

2.1 Benefits of Cash Management

Modern cash management techniques will benefit businesses in many ways. Generally, such benefits are more efficient use of corporate resources, lower interest costs, and tighter management control. Specifically, effective cash management will allow for the following:

— *Management foresight.* Because an effective cash control program identifies the timing of cash inflows and outflows, management is afforded a look into the business's future cash position. Having reliable cash flow information available, managers can expect few surprises resulting from emergency cash requirements or underemployed cash receipts. Managers can also measure business development against projected goals and receive signals about necessary policy and procedure changes.

— *Financing alternatives.* Because the cash control system identifies future cash requirements on a routine basis, financing needs are known well in advance, and management has time to effectively negotiate the most advantageous credit facilities available. Also, since both the amount and the timing of cash needs are known, funding draws can be negotiated to occur when needed, not before.

— *Untapped resources.* Aggressive managers are constantly looking for ways to reduce working capital requirements. When cash is made available, it can be used to reduce borrowings, to reinvest in the business, or to fund an outside investment.

— *Reduced interest expense.* Like any other asset, cash has a holding cost. Usually this cost is the business's aggregate borrowing rate. Firms that maximize cash utility rigorously control unnecessary borrowing. Working capital reductions are often achieved by such measures as accelerating collection of accounts receivable.

2.2 Overview of Cash Management Techniques

Cash management techniques generally emphasize efficient use of the firm's cash resources. Cash is allocated to areas that require it and removed from areas that can get along without it. The inflow of cash is accelerated using a variety of techniques both inside and outside the firm—generally with its customers and banking relations.

Working capital reduction and cash inflow acceleration techniques implemented inside the firm focus on areas that tend to accumulate working capital:

— *Billing.* Slow billing increases working capital requirements.
— *Collections.* Slow collections increase receivables and working capital requirements.
— *Receivables.* Rising receivables increase working capital requirements.

2.3 Overview of Analytical Techniques

The analytical techniques used to control cash range from very simple accounts receivable aging analyses to more complex automated financing simulation models.

Simple financial ratios can quickly tell management where too much cash is needlessly accumulating or where the firm is bleeding cash. Such ratios are generally in the areas of liquidity, activity, and profitability.

Computers play a key role in more sophisticated cash management techniques. Automated systems are used to obtain available cash balances from the company's bank accounts. Such treasury systems provide the ability to quickly transfer funds from numerous ancillary accounts to a single cash-concentration account and then invest the funds not required that day.

With microcomputer systems and user-friendly modeling software, prospective cash positions can be simulated to quickly identify cash excesses and shortfalls for even the smallest of businesses.

2.4 Overview of Cash Management Decisions

Decisions regarding the company's cash management can be among the most important determinations made. For this reason, senior management is almost always closely involved. Areas of cash management decisions include

— Customer credit policies.
— Billing and collection policies.
— Banking relationships.
— Financing and capital structure.
— Long-term corporate strategies.

3. ACCELERATING CASH INFLOWS

Modern cash acceleration techniques employ an overall concept termed *cash concentration.* A *cash concentration system* encompasses all the various

areas of the business that obtain cash and funnel it into a single usable account, called the *cash concentration account.*

Throughout the company, various opportunities exist to increase the velocity at which sales are converted to useful cash in the bank account. The first such opportunity exists in the billing and invoicing departments.

3.1 Billing and Invoicing

The first step in identifying the extent of opportunity in the billing area is to assess the length of time it takes from sale to issuance of a bill to the customer or client. For example, if a business waits until the beginning of the new month to render invoices for goods sold or services performed in the prior month, there is a time lag of between one and thirty days between sales and invoice dates. This increases working capital requirements and gives customers additional time to pay.

A useful method of computing the time lag between sale and invoice is to take a representative sample of sales occuring for each day in a given month. This is compared with the day an invoice for each sale was mailed. A simple analysis of just such a time lag appears as follows:

ABC CORPORATION
Analysis of Sales and Billing Time Lag
Month of July 199X

Customer	*Sale Amount*	*Sale Date*	*Billing Date*	*# of Days*	*Weighted Av. # of Days*
1	$ 10,000	7-1-9X	8-5-9X	35	.63
2	100,000	7-2-9X	8-5-9X	34	6.07
3	50,000	7-4-9X	8-5-9X	32	2.86
4	75,000	7-7-9X	8-5-9X	29	3.88
5	90,000	7-15-9X	8-5-9X	21	3.38
6	30,000	7-17-9X	8-5-9X	19	1.02
7	10,000	7-20-9X	8-5-9X	16	0.29
8	110,000	7-25-9X	8-5-9X	11	2.16
9	25,000	7-26-9X	8-5-9X	10	0.45
10	60,000	7-31-9X	8-5-9X	5	0.54
	$560,000				21.28

The weighted average billing time lag for the ABC Corporation is about 21 days. This means that its receivables have aged 21 days before the customers are even billed. This translates into an interest cost of approximately $3,300 {[($560,000 × 10% interest rate)/360 days]} × 21 days = $3,267.

The obvious solution would be to decrease the time lag as much as possible. Invoices should be rendered, if not on the day a sale is made, then on a semi-monthly or even a weekly cycle. Although the interest saving, $3,300 in this example, is not a fortune, attention to such details becomes worthwhile if enough such holes in the cash management system can be filled. For particularly large sales, it often makes economic sense to send an invoice via overnight messenger or wire.

Cash management quickly gets executive attention when the numbers a firm is dealing with are large. Interest savings in the above example would be $33,000 if the sales were $5.6 million instead of $560,000.

3.2 Credit and Collections

The collections area can be an accumulator of working capital if it is allowed to get out of control. In the receivables and collections area, speed is management's major goal. There is a much higher probability of successfully collecting a receivable 30 days old amounting to only $10,000 than there is for one 180 days old that has been allowed to grow to $60,000.

Terms are frequently a part of the sales agreement on large transactions. Often businesses unwittingly give away part of their profit margin by not negotiating the form of payment (check, wire transfer of funds, bank check, or cashier's check), the time of payment, or the interest assessment on late payments. Such details are significant negotiating points with a firm's customers.

An effective collections system actually begins with management's credit policy decisions regarding the type of customers on which the firm is willing to bear credit risk. Overly stringent credit policies may discourage customers who might then turn to competitors. Liberal policies, on the other hand, may cause a rise in bad-debt expense, an increase in collection costs, and a greater concentration of working capital in accounts receivable.

Proper balancing of credit policies should consider collection costs and whether increased interest expense will be reflected in product-pricing decisions. Many firms, large and small, employ automated simulation models to assist in projecting profit margins resulting from these and other factors that are influenced by various credit policies.

Collection techniques used by many small businesses include the following:

— *Dunning letters and phone calls.* These serve to remind the delinquent customer that the firm is serious in its collection efforts and will pursue all remedies available to successfully collect its receivables.

— *Credit manager.* Many firms employ a credit manager whose responsibility includes establishing credit policies, approving credit terms to customers, and overseeing collection efforts.

— *Law firms.* A letter from the creditor's law firm explaining the consequences of not paying a bill is often enough to collect a receivable. This, however, is expensive and tends to offend valued customers. Legal remedies should be used as a last resort.

— *Credit insurance.* There are insurance firms that will insure a specified percentage of accounts receivable.

— *Factoring.* Businesses that cannot afford the working capital required to carry receivables can factor (or sell) their receivables at a discount to a factoring firm. This technique is expensive, however, since it amounts to a discount on sales.

3.2.1 Electronic funds transfer

To achieve virtually immediate collection on accounts, more businesses are implementing electronic funds transfers (EFTs). Funds are required to be electronically transferred on receipt of the product. This virtually eliminates the time from sale to collection.

3.2.2 Analytical techniques

Because many businesses may find it impractical to implement EFT and other such techniques, it will be extremely important to monitor their accounts receivable balances. The area of receivables and collections has a variety of analytical tools for management to survey performance, including the following:

— *Aging analyses.* Aging reports usually include a complete listing of accounts receivable by customer, showing balances that are current or thirty, sixty, or ninety days and older. The aging report totals should tie to the total accounts receivable balance (see section 6.2 herein).

The aging report is used to identify those customers that are delinquent in their payment habits. Such information can be used to allocate collections resources more effectively. Most automated accounting systems allow for a variety of sort routines in the receivables aging module. One such sort routine that is particularly effective is the sort by geographic region and by salesperson. Using such information, management can quickly see trends developing in geographic areas or the payment habits of customers sought by particular salespeople. Using such data, the firm may wish to reallocate its sales and marketing resources to other regions or adjust its

commission payment policy to one that pays only on the *collected* sale. Some companies adopt a policy of requiring a customer to advance funds that are held on deposit and drawn against as sales are made. Future sales may be suspended until the customer replenishes the account.

— *Roll rate analysis.* Roll rates are simply another aging technique. The rate at which receivables are "rolling" from one aging bucket to another is analyzed. Information resulting from roll rate analyses indicates what percentage of receivables roll from the current to the thirty-day, sixty-day, and ninety-day aging buckets. Such information is useful to determine the effectiveness of a business's collection effort. For example, say that a firm has an average of 10 percent of all sales rolling to the ninety-day bucket before collection. The most current roll rate analysis indicates, however, two things:

Over the past two months, the percentage of sales rolling to the ninety-day bucket before collection has steadily escalated from a 10 percent rate to 15 percent.

The roll rate from the thirty-day bucket to the sixty-day bucket has jumped from its normal 5 percent to 15 percent.

From this information, management knows that a collection problem exists; it can project the increased interest cost and bad debt expense due to the problem, and it can identify which aging bucket is responsible. Armed with such information, corrective steps can be taken in time to control the damage.

— *Average collection period.* Average collection periods represent the amount of time sales are tied up in receivables. It is determined by dividing sales by 360 (days). This result is then divided into accounts receivable. The higher the period, the more attention should be provided to collections.

— *Receivables to sales ratios.* This ratio is determined by dividing total sales by accounts receivable. A high turnover indicates a quick collection period and liquid receivables.

— *Order-entry controls.* Most modern automated order-entry systems connect with the accounts receivable system. Such connection is useful to the order taker in providing on-line real-time information regarding

Current receivable balance information.

Credit limits placed on particular customers.

Payment history of particular customers.

With these data, the order taker may implement management's credit policies immediately at the point of order for particular customers.

3.3 Inventory Control

Inventory is another accumulator of working capital. Most nonservice businesses have a substantial amount of working capital tied up in inventory. Since inventory levels must be kept at a minimum and are influenced to a large extent by market demand and availability, inventory is one of the most difficult components of the working capital equation to balance. Management's objective related to inventory and cash management is to have an appropriate amount of the *right inventory* on hand. Roughly translated, the right inventory means those products that can be quickly sold and converted to usable cash.

3.3.1 Inventory control techniques

The subject of inventory control is a topic separate from cash management. However, as related to cash, there are several simple techniques that management can employ to ensure that

— Inventory levels are not inappropriately high, thus causing an unacceptable amount of cash to accumulate.

— Inventory turnover is sufficient, demonstrating that management is purchasing salable products that can be converted to cash.

Techniques that cash managers employ to quickly determine whether the working capital required by the inventory operation is an efficient use of cash include the following:

— *Inventory turnover.* The frequency with which inventory turns over indicates to the manager whether cash is tied up in inventory that cannot be readily sold. A low turnover rate indicates that cash is trapped in low-demand inventory. Inventory turnover is computed as follows:

$$\text{Inventory turnover} = \frac{\text{cost of goods sold}}{\text{average inventory}}$$

As with any ratio analysis, careful attention must be given to the particular type of business being analyzed. If a firm's inventory turnover is highly seasonal, the ratio could be misinterpreted unless some adjustment is made for peak demands.

— *Days of inventory on hand.* If a firm has an inappropriately high number of days of an inventory item on hand, yet is still ordering more, management may want to know the reason. An easy way to determine the number of days of inventory on hand is the following:

$$\text{Days of inventory on hand} = \frac{\text{total inventory}}{\text{daily demand}}$$

— *Inventory concentration reports.* The amount of cash invested in inventory segregated by frequency of sale illustrates to the cash manager how effectively working capital invested in inventory is employed. Inventory concentration reports include the following information:

Inventory item by number and description.

Number of items on hand.

Unit cost and extended cost.

Report segregated by the top ten best sellers and the bottom ten worst sellers.

— *Overstock reports.* Cash is not effectively employed when the firm is carrying overstocked inventory. Many modern automated inventory-control systems allow for a maximum stock level to be entered for each inventory item. The overstock report indicates those items for which the quantity on hand exceeds the maximum stock level determined by management.

— *Economic order quantity (EOQ).* The optimum size of an inventory order defines the EOQ. The EOQ is useful in determining management's control over its inventory purchasing procedures. EOQ is computed as follows:

EOQ = square root of $[(2ap) \div s]$

where:

a is the annual quantity of the item used in units.

p is the purchase order cost.

s is the annual cost of carrying a unit in stock for one year. The carrying cost of inventory includes such costs as allocated warehouse expenses and interest costs.

— *Safety stock.* The cash manager is concerned that inventory levels do not exceed requirements plus a *safety stock.* Computation of safety stock considers such variables as the probability and cost of being short an inventory item, the orders placed per year (from the EOQ), and the cost-to-carry inventory. The lowest carrying cost of inventory at varying safety stock levels is computed as follows:

Probability of stock-out at a given level of safety stock × Stock-out cost × Number of orders per year (Demand/EOQ) = Expected stock-out cost

Expected stock-out + Carrying cost of safety stock = Total inventory cost

An example of safety stock computation is as follows:

Units of Safety Stock	*Probability of Stock-Out*	*Cost of Stock-Out*	*No. of Orders Per Year*	*Expected Stock-Out Cost (A)*	*Safety Stock Carrying Cost (B)*	*Total Cost (C)*
20	60%	$200	10	$1,200	$200	$1,400
30	40%	$200	10	$ 800	$300	$1,100
40	30%	$200	10	$ 600	$400	$1,000
50	28%	$200	10	$ 560	$500	$1,060

(A) Stock-out cost is computed as the probability of stock-out × stock-out cost × number of orders per year (EOQ).

(B) Carrying cost is computed as the carrying cost of one unit per year (assumed to be $10) × safety stock.

(C) Total cost is computed as expected stock-out cost + carrying cost of safety stock.

The objective is to compute the level of safety stock that has the lowest inventory carrying cost. In this example, the optimum safety stock is forty units. To the cash manager, such control of inventory helps to ensure that purchases are well managed and that excessive inventory is not accumulated in the name of safety stock (masking poor inventory control procedures). These two objectives help ensure that working capital is not being unnecessarily stockpiled.

3.4 Wire Transfers

A wire transfer is the electronic conveyance of funds from one bank account to another. Wire transfers are moved through the Federal Reserve system using its Fedwire mechanism. Funds received via wire transfer are termed to be *good funds* (that is, the funds may be used immediately and require no further clearing procedures). Because of the speed with which wire transfers move throughout the banking system and the fact that they convey usable funds, receipt of a payment via wire is desirable from a cash management standpoint.

Wire transfer payments received by a business reduce the following time lags that affect cash management.

— *Mail float.* This is the float that the payor enjoys from the time a payment check is written and mailed to the time it arrives at the

payee's business. Mail float may be anywhere from a single day to a week or more. The mail is also a convenient scapegoat to account for late payments.

— *Internal float.* Once the payment check arrives at the payee's office, it must go through the mail room, be distributed to the proper individual, recorded, listed for deposit, and finally taken to the bank for deposit. Depending on how fast this process is, the internal time lag may be anywhere from a matter of hours to several days. One method to reduce this internal float is to use a special colored return address envelope sent with the invoice and addressed to the particular individual who deposits cash. Internal float may be eliminated entirely by having the checks sent to a bank lockbox. The bank is made responsible for opening the mail and depositing the checks into the company's bank account.

— *Bank float.* This is the float that the payor enjoys from the time the payment check is deposited in the payee's bank to the time it clears and the funds become usable. Depending on whether the payor's bank is a member of the Federal Reserve system, bank float can be anywhere from a single day to more than a week for remotely located institutions.

Since the wire transfer goes directly into the payee's bank account in the form of usable funds, all of the above floats are circumvented. However, as advantageous as the wire transfer is for the payee, it is an equal disadvantage to the payor. For this reason, the form of payment must be negotiated as part of the terms of purchase. Often such negotiations may be worked so that both parties win. In return for the accelerated cash flow, a certain type of payment provides the payee a price discount or some other concession that may be extended to the payor.

3.5 Lockboxes

Another common method of accelerating cash inflow is the lockbox. The lockbox is simply a central collection location that receives payment checks. Generally, the most efficient collection location is the bank in which a business's central checking account is situated. For businesses with a widely distributed customer base, a network of lockboxes is often implemented to cut down on mail float. Funds from each lockbox in the network then flow daily to the firm's central bank.

Based on the level of checks coming into the firm's lockbox, and the average float on payments clearing the bank, a negotiated percentage of usable (termed *available*) funds from each day's deposits will be determined. This percentage, when multiplied by the deposits received,

provides the cash manager with the amount of funds available for use. With this information, the cash manager can more precisely evaluate the firm's daily borrowing requirements or funds available for investment.

3.6 Depository Transfer Checks

Depository transfer checks (DTCs) are generally used in conjunction with a network of lockboxes. The DTC is a particular type of check that the network lockbox bank draws to transfer funds collected from its lockbox to the client's central bank.

Banks charge for both lockbox and DTC services. This cost can be at least partially offset by the float credit a bank customer receives by allowing the network bank to draft a DTC (and thereby itself enjoy the bank system float) rather than wire the funds, thus eliminating any float.

3.7 PACs, PADs, and ACHs

These three tools allow the cash manager to further refine the speed at which cash flows into the firm.

— *Preauthorized Checks (PACs).* The PAC is simply a preauthorized check. The preauthorized check allows a vendor that regularly provides goods or services to write itself a payment check on the customer's checking account. The time lag between the time of invoice receipt and payment is eliminated. PACs are limited to a maximum amount and require specific backup documentation to be forwarded to the customer.

Another form of preauthorized check is a preauthorized debit. This is frequently used by such businesses as insurance companies to withdraw the premium automatically from a customer's checking account.

— *Preauthorized Electronic Deposit (PADs).* The PAD is similar to a PAC except that instead of a check, it employs a wire transfer, further reducing bank float. For this reason, the PAD is used mostly for larger payments whose purchase terms provide for such a device.

— *Automated Clearing House (ACH).* The ACH clears PADs. The national automated clearing house is actually a collection of thirty-two regional ACHs located throughout the United States. Each ACH member bank submits its PADs daily for electronic debit or credit to its account. The ACH then routes these debits and credits

throughout its system to the proper member bank. It is even becoming possible to access the ACH system directly from your business in connection with your local bank.

An additional service provided by the ACH is called *electronic trade payments.* This was developed for use along with PADs and the ACH to provide nonbanking-payment-related information, such as invoice and purchase order numbers necessary for proper identification of electronic payments.

4. DECELERATING CASH OUTFLOWS

The cash manager is responsible for preserving cash once it has been captured by the firm. To do this, cash outflow is slowed as much as possible by leveraging accounts payable. Trade accounts often do not carry an interest charge if paid within a certain time period. This does not imply that a firm should stop paying its bills or pass up early payment discounts. However, there is a difference between paying bills when customarily due and not taking advantage of the working capital costs the vendor has likely included in the product price anyway. The firm does not want to slow cash outflow to the point where its ability to obtain credit is reduced, unfounded rumors regarding financial stability begin to circulate, or suppliers refuse to deal with it.

There are two major areas where most businesses have an opportunity to improve cash utility by decreasing the rate at which funds flow out of the firm. These two areas revolve around the firm's payment function and include controlling payments and managing accounts payable.

4.1 Payment Control Techniques

Controlling the speed with which a business pays its liabilities can have a dramatic impact on cash requirements and allow the cash manager to preserve this expensive asset. The faster bills are paid, the greater is the requirement for working capital and the greater will be the demand on the line of credit. One easy analytical method to determine the speed with which a business pays its bills is the *average age of payables analysis.*

4.1.1 Average age of payables

Computing the average age of payables tells the cash manager how long an invoice is retained before it is paid, thus indicating whether

an opportunity exists to stretch the average payment times to more appropriately conform to customary industry standards without negatively reflecting on the firm's reputation or vendor relationships. For example, if a firm's average payable is aged only fifteen days before payment, whereas the industry standard is forty-five days, an opportunity exists to retain cash equivalent to thirty days of the payables requirements. If a business is paying $1 million per month, stretching the payables by thirty days will reduce the borrowing requirement by $1 million (at a borrowing rate of 10 percent, this translates to an annual interest savings of $100,000).

ABC CORPORATION
Analysis of Payables Aging
Month of July 199X

Vendor	*Invoice Amt.*	*Inv. Date*	*Pymt. Date*	*Weighted Av. # of Days*
1	$ 50,000	7-1-9X	7-15-9X	.40
2	75,000	7-2-9X	7-15-9X	.56
3	25,000	7-5-9X	7-15-9X	.14
4	10,000	7-7-9X	7-15-9X	.05
5	150,000	7-8-9X	7-22-9X	1.21
6	5,000	7-8-9X	7-22-9X	.04
7	90,000	7-12-9X	7-22-9X	.52
8	1,000,000	7-15-9X	7-29-9X	8.07
9	250,000	7-21-9X	7-29-9X	1.15
10	80,000	7-29-9X	7-29-9X	0.00
	$1,735,000			12.14

The weighted average number of days is found by multiplying the percentage of total July invoices that each invoice represents by the number of days between an invoice and its payment date, then adding the weighted days. Thus, the weighted average number of days is a little over twelve days. For most businesses, such a payment policy, while promoting a certain amount of goodwill among its vendors, exceeds what is customary. Were ABC to stretch its payable policy to thirty-five days before payment, the annual interest savings would be approximately $129,000, computed as follows:

Average monthly payables:	$1,735,000
Number of days payables are stretched:	23
Daily payables cash requirement: $1,735,000 ÷ 31 =	$ 55,968
Cash retained by stretching payables 23 days:	
$55,968 × 23 days =	$1,287,264
Interest savings:	
Cash retained of $1,287,264 × 10% interest =	128,726

Many businesses set up payment dates that are on a regular basis, such as every week, regardless of when the invoice hits the accounts payable system. Such rote management of payables is not unusual, but it can be costly. Most modern accounts payable systems allow management to request a listing of invoices that are a designated number of days old for payment. Using this technique, obtaining control of accounts payable payment terms is relatively easy.

Also see section 6.4 herein for a sample accounts payable aging report.

4.2 Management of Accounts Payable

In addition to managing the timing of accounts payable payments, overall management of a firm's payables is a good way to slow the speed with which cash flows out of the firm. This should begin with negotiating the terms of large purchases. Points eligible for negotiation to better manage accounts payable include

— Type of payment, such as wire transfer, check, DTC, and so forth.

— Date of payment.

— Progress or partial payments.

— Discounts if paid prior to due date.

Each of the above payment terms, if ignored during negotiations, will increase the overall cost of purchase. If aggressively pursued by the negotiating team, the overall purchase cost will decline.

4.2.1 Purchase discounts

Purchase discounts are a reward to the payee for promptly paying invoices. In essence, the vendor is compensating customers for the interest costs they incur by paying bills early.

Generally, if cash is available, it is good policy to take advantage of discounts whenever they are offered.

When formulating discount payment policy, one criterion that should be considered is the discount offered cut-off point. This means the point where the cost to pay early (in terms of interest expense) equals the benefit derived by early payment.

Computation of the business's point of indifference with respect to purchase discounts is as follows:

[Discount percent ÷ (due date – discount date)] × 360 days = Annualized interest income from taking advantage of the discount.

For payment terms of 1%/10 days, net/30, the interest rate is computed as follows:

$$[.01 \div (30 - 10)] \times 360 = 18\%$$

This is compared against the firm's aggregate borrowing costs. If the interest rate as computed above is greater than the borrowing rate (and the cash is available), taking advantage of the purchase discount is advised. In terms of dollars and cents, this is computed as follows:

Invoice amount:	$10,000
Terms:	1%/10, Net/30
Aggregate borrowing rate:	10%
Interest earned by taking discount: $10,000 × .01 =	$ 100
Interest cost by taking discount: [($10,000 × 10%) ÷ 360] × (30 days − 10 days) =	$ 57
Net interest profit by taking discount:	$ 43

5. USE OF BANKS

The banking system itself can assist the cash manager in achieving both goals of accelerating cash inflow and slowing cash outflow without undue cost or management effort. This section will discuss some of the common uses of bank float, remote disbursement techniques, sweep accounts, and banking relationships.

5.1 Float

Float is the time it takes funds to move through the banking system. When a business is collecting funds, the objective is to minimize bank float. When disbursing funds, management wants to stretch the time between check disbursement and check clearing.

A cash manager's objective is to take advantage of the benefits inherent in the banking system without abusing it.

To minimize the time required to clear receipts through the banking system, a cash manager employs some or all of the following float techniques:

— Lockbox system, which minimizes the time it takes to move funds from the point of receipt to the firm's central bank depository

— Depository transfer checks

— Wire transfer of large receipts to the cash concentration account

To maximize the time required to clear payment checks through the banking system, the following float techniques are employed:

— Remote disbursement banks (see section 5.2, below)

— Use of disbursement banks that are not members of the Federal Reserve system (see section 5.2, below)

— Payment via check whenever possible rather than wire transfer funds

5.2 Choice of Banks

The choice of banking institutions can make a difference in how long it takes to have a firm's payment checks clear through the banking system. For example, if a firm pays vendors primarily concentrated on both the west coast and east coast, the west coast vendors should receive a check drawn on an east coast bank and vice versa. Using remote disbursement banks increases the mail float in the payables system.

An extension of the remote disbursement concept is to choose a bank that is not only geographically separated from the payee, but is also as far off the beaten path as possible. Certain small towns in Texas and South Carolina have served many treasurers as remote disbursement centers. If the chosen bank is not a member of the Federal Reserve system, so much the better since this will further increase the time required for check clearing.

5.3 Sweep Accounts

Sweep accounts are very popular with those businesses that cannot earn interest on checking accounts. A sweep account allows the cash manager to keep only the amount of money required for check clearing that day in the non-interest-bearing demand deposit account (DDA). All other balances are "swept" into an interest-bearing account. Such accounts relieve the manager of the need for precise calculation of how much money will be required to fund daily check clearings plus a small cushion. This technique may also be used in connection with firms that have branch locations. Funds may be swept from the branch bank account to the home office bank account (see section 5.4, below).

A close cousin of a sweep account is the zero-balance checking account. Such an account maintains a zero balance, drawing just the amount of funds required for checks clearing into it from an interest-bearing account.

Sweep account drawbacks are high cost per transaction and a lower yield on the interest-bearing account than could be obtained on excess

funds placed independently. Still, the sweep account provides an alternative to leaving idle funds in a non-interest-bearing checking account over the amount required for compensating balance purposes.

5.4 Cash Concentration Systems

A cash concentration system automatically channels funds from every source of the business into a single usable account. Such a system allows the cash manager to quickly identify available funds each day, move them to accounts that will have funding requirements that day, and invest the remainder in overnight repurchase agreements, short-term commercial paper, or other interest-bearing instruments until needed.

The mechanism of the cash concentration system was discussed under depository transfer checks (DTCs), the preauthorized electronic deposits, and the sweep account. The objective of the concentration system is to automatically transfer daily all funds from outlying checking accounts into the single concentration account.

A reliable cash concentration system reduces the cash balances left in accounts or other vehicles that underemploy, or worse, do not employ, funds that would otherwise be available for the cash manager's use. An additional spinoff of the concentration system is that often the utility of ancillary accounts begins to be questioned, and the number of bank accounts can be dramatically reduced. The fewer the accounts, (1) the less likely available funds will remain idle, (2) the less effort is exerted in monthly account reconciliation, (3) the more remote the possibility of unauthorized check writing on a seldom used account, and (4) the lower overall bank charges.

A final note on the concentration system is that it should work every day the bank or the post office is open. Many post offices provide mail service on Saturdays. Even if the bank is not open for check processing on Saturdays, the firm's staff should collect and process checks received and prepare them for deposit on the next business day. If Saturday check receipts are high enough, the interest savings will justify the additional staff cost.

5.5 Funds Availability

Availability of funds refers to the amount of funds in an account that have cleared through the banking system. Funds are said to be available when they are collected by the cash manager's bank (in which the checks were deposited) from the payor's bank. Funds availability can be negotiated.

Most businesses receive monthly checks from the same or similar customers. Using a historical period, the cash manager and banker can compute how long it takes the average check to clear through the banking system. From this analysis, the banking agreement can provide for availability of a specified percentage of daily deposits the same day, the next day, in two days, and so forth.

A business might improve availability of funds from three days on 100 percent of deposited funds to the following tiered system:

— Same day availability: 20% of deposited funds
— Next day availability: 75% of deposited funds
— Two-day availability: 5% of deposited funds

The following cash is thus freed from the banking system:

Daily cash deposits:	$1,000,000
Under the old system of availability, interest cost on idle funds was	
[($1,000,000 × 10%) ÷ 360] × 3 days =	$ 833
Under the new system, interest cost on idle funds was	
[($1,000,000 × 75% × 10%) ÷ 360] × 1 day =	$ 208
Plus [($1,000,000 × 5% × 10%) ÷ 360] × 2 days =	28
Total interest cost on idle funds per deposit =	$ 236

By negotiating funds availability with the bank, the above example saved $597 ($833 – $236) in foregone interest income on idle funds for each deposit. Assuming that deposits are made five days per week, fifty-two weeks per year, this amounts to $155,220 per year.

Funds availability is a point many bankers are willing to negotiate, particularly if it means the difference in obtaining a new blue chip customer or keeping a valued customer. It is the cash manager's responsibility to specify the funds availability that meets his or her cash management requirements.

5.6 Account Analysis

Banks often send out account analysis statements to their corporate customers. Such statements indicate a variety of things related to average collected balances, year-to-date balances, loan covenants as related to compensating balance, and bank service credit for outstanding balances.

Cash managers should monitor closely the account analysis statement to determine just how much the firm is paying for banking services. The objective is to honor the terms of the banking agreement, but not to overcompensate the bank.

Many businesses have an opportunity to free cash from compensating balances that are overfunded. The account analysis statement shows the average and year-to-date balance in the compensating balance account(s). The cash manager should first compare these numbers with his or her own year-to-date balances in these accounts to be sure the bank did not make a computational error. Secondly, the agreement that produced the compensating balance (usually a loan agreement) should be reviewed to determine if the bank is appropriately compensated. If the bank has been overcompensated, steps should be taken to correct this problem.

5.7 Banking Relationships

The banking relationship can be among the most valuable associations maintained by a business. The banker should be treated as a valued investor. The cash manager/treasurer is responsible for maintaining the banking relationship. To help to maintain that relationship:

— Send the banker quarterly and annual financial statements without being asked. Usually, such statements are part of any loan covenant.

— Keep the bank informed of all major developments in the business.

— The board of directors or owners should meet with the banker several times each year to maintain a close personal relationship.

Finally, even though the relationship with a firm's present banking institution may be excellent, management should continue to cultivate associations with other banking executives. Some firms go so far as to draft stand-by lending agreements with other banking institutions. These agreements are specifically designed to provide credit facilities in the event the business turns downward and normal credit facilities are withdrawn by the present bank.

5.8 Investment of Excess Cash

Investment of excess cash involves the three watchwords of cash management: safety, liquidity, and yield. Above all, whatever the instrument of excess cash investment, it must provide a risk factor acceptable to the business. Second, the investment must be available for conversion back into cash at the required time. Last, the investment must yield an acceptable return. These three concepts tie in with the saying that "There is a rate for every risk." In other words, the higher the interest rate given, the higher will be the risk factor.

The most commonly used short-term investment instruments for excess cash include:

— *Repurchase agreement (repo).* A repo is a contract with a bank or brokerage firm whereby the investor loans excess cash, taking acceptable collateral as security (usually a government security). The bank or brokerage firm is contractually obligated to repurchase the loan at a specified time. The terms of repos range anywhere from overnight (the most common) to thirty days or more.

— *Commercial paper.* Most firms offering short-term commercial paper are rated by Moody's and/or Standard & Poor's, thus providing an index of risk.

— *Money market funds.* Some firms use their money market funds as a short-term method of employing excess cash.

See also the chapter on Investment Vehicles for a discussion of other investment instruments.

5.9 Lines of Credit

Lines of credit (LOCs) are now almost a necessity for doing business. LOCs range anywhere from tens of thousands to hundreds of millions of dollars. Terms of LOCs are negotiable with the banker. Most terms include:

— A maximum draw of the LOC, in effect, the credit limit.

— An interest rate charged, usually a fixed amount above an interest rate index, such as the prime interest rate.

— A commitment fee, which is a charge for the unused portion of the LOC, usually a percentage (one-quarter or one-eighth of a point) of the undrawn line.

— A clean-up clause. Many banks require the entire line to be repaid for a specified period of time during a twelve-month period.

— Loan convenants. Some LOCs specify that certain financial milestones be met (often stated as sales or financial ratios). Failure to meet such covenants places the firm in default.

6. CASH MANAGEMENT REPORTS

Four cash management reports are indispensable to most managers. These reports are

— Available cash report.

— Aged accounts receivable.

— Cash requirements report.
— Accounts payable aging.

Examples of each of these reports are shown on the following pages.

6.1 Available Cash Reports

From the available cash report, managers have knowledge of cash that may be available in the next few days. This report could be projected for a longer period or periods such as weekly or monthly.

ABC CORPORATION
Analysis of Available Cash
As of July 25, 199X

	Day 1	*Day 2*	*Day 3*	*Day 4*	*Day 5*
Beginning cash balance	$500,000	$677,500	$930,000	$1,066,250	$1,306,250
Anticipated cash receipts	250,000	300,000	200,000	400,000	100,000
% Available from day 1 (75%)	187,500	225,000	150,000	300,000	75,000
% Available from day 2 (20%)	0	50,000	60,000	40,000	80,000
% Available from day 3 (5%)	0	0	12,500	15,000	10,000
Total available receipts	$187,500	$275,000	$222,500	$355,000	$165,000
Scheduled disbursements	(100,000)	(75,000)	(250,000)	(200,000)	(50,000)
% Clearing day 1 (10%)	(10,000)	(7,500)	(25,000)	(20,000)	(5,000)
% Clearing day 2 (15%)	0	(15,000)	(11,250)	(37,500)	(30,000)
% Clearing day 3 (50%)	0	0	(50,000)	(37,500)	(125,000)
% Clearing day 4 (20%)	0	0	0	(20,000)	(15,000)
% Clearing day 5 (5%)	0	0	0	0	(5,000)
Total cleared disbursements	($10,000)	($22,500)	($86,250)	($115,000)	($180,000)
Ending available cash balance	$677,500	$930,000	$1,066,250	$1,306,250	$1,291,250

Note the following:

— All deposits are available for use within three days. The percentages used tie in with the guaranteed funds availability specified in the banking agreement.

— All disbursements are scheduled to clear within five days. The percentages are derived from experience.

— The ending balance of one day becomes the beginning balance for the next day.

6.2 Aged Accounts Receivable

The following is a sample of an aged accounts receivable report as discussed in section 3.2.2 herein.

ABC CORPORATION
Accounts Receivable Aging
July 199X

Cust. No.	*Customer Name*	*Current*	*30–60 Days*	*60–90 Days*	*Over 90 Days*	*Total*
1	333 Bush Street	$ 0.00	$ 0.00	$0.00	$ 315.00	$ 315.00
2	Asian American Theatre Co.	236.36	236.25	0.00	708.75	1,181.36
3	AT&T	0.00	3,207.05	0.00	60.00	3,267.05
4	BAR/BRI	0.00	0.00	0.00	250.00	250.00
5	Carnevale	0.00	0.00	0.00	525.00	525.00
6	Chinese Hospital	0.00	0.00	0.00	0.00	0.00
7	City Cycle	0.00	0.00	0.00	150.00	150.00
8	Columbia Pictures	0.00	0.00	0.00	0.00	0.00
9	Disney's World on Ice	0.01–	0.00	0.00	0.00	0.01–
10	Egghead Software	0.00	0.00	0.00	8,896.00	8,896.00
11	El Dorado	1,181.70	1,181.70	0.00	0.00	2,363.40
12	Elite Modeling	340.00	0.00	0.00	149.62	489.62
13	The Equitable	190.00	190.00	0.00	341.50	721.50
14	Fong & Associates	0.00	346.50	0.00	1,323.00	1,669.50
15	Foot Locker	0.00	0.00	0.00	315.00	315.00
16	French Hospital	548.62	548.62	0.00	0.00	1,097.24
17	Futon Shop	0.00	0.00	0.00	0.00	0.00
18	Gaylord India Restaurant	0.00	0.00	0.00	75.00	75.00
19	Harbor View Holiday Inn	0.00	0.00	0.00	1,050.00	1,050.00
20	Harbor View/Tsui Hang Village	0.00	0.00	0.00	1,050.00	1,050.00
Accounts Receivable		$2,496.67	$5,710.12	$0.00	$15,208.87	$23,415.66
		10.66%	24.39%	0.00%	64.95%	

6.3 Cash Requirements Report

The cash requirements report illustrates payables that must be paid within the time frames shown in each column to keep from becoming delinquent. This report is used to determine how much cash is required to honor the firm's payables commitment (see page 28).

6.4 Accounts Payable Aging

The accounts payable aging report illustrates how old the firm's payables are for each vendor owed. Note, in the example on page 29, approximately 46 percent of the payables are aged over sixty days. See also section 4.1.1 herein for a discussion of the average age of payables.

7. CASH PLANNING TECHNIQUES

Modern cash managers use projections in much the same way a pilot uses the airplane's compass and map: to determine in which direction they are going and to make mid-course corrections.

Planning and the resultant projections fall into two major categories: strategic plans, which are long range and encompass the whole firm, and tactical plans, which are of shorter range and deal with specific segments of the business. Of the two categories, cash flow is usually included in the tactical plan. Cash flow projections provide a blueprint of how the cash and financing part of the business plan will be executed.

Most cash plans identify certain specific items critical to the treasury function. These include

— Cash inflows and scheduled cash outflows, such as loan repayments and cash dividends to stockholders, bond interest payments, and so forth.

— Financing requirements and excess cash balances that may be used to repay existing financing.

— Projected ending cash balance.

— Compliance with loan covenants and restrictions. Such covenants are often in the form of balance sheet ratios. Therefore, the treasurer must produce not only a cash plan, but balance sheet and income statement projections as well.

ABC CORPORATION
Cash Requirements Report

Vendor Number	*Vendor Name*	*Invoice Number*	*Discount/ Due Date*	*Current*	*10 to 20 Days*	*20 to 30 Days*	*Over 30 Days*	*Total*
1	Alhambra National Water Co.			$ 12.80	0.00	0.00	0.00	$ 12.80
4	Alphabetics			2,926.00	0.00	0.00	0.00	2,926.00
8	Cine Kerska Productions			8.52	0.00	0.00	0.00	8.52
9	Colorsplendor			4,742.00	0.00	0.00	0.00	4,742.00
10	CSC			758.83	0.00	0.00	0.00	758.83
12	Federal Express, Inc.			67.25	39.00	0.00	0.00	106.25
14	Graphic Sportswear			134.19	0.00	0.00	0.00	134.19
15	JLA Credit Corp.			0.00	176.18	0.00	0.00	176.18
18	City of Los Angeles			1,347.96	0.00	0.00	0.00	1,347.96
20	L'Image Photographic Lab, Inc.			464.86	0.00	0.00	0.00	464.86
				$10,462.41	215.18	0.00	0.00	$10,677.59
				97.98%	2.02%	0.00%	0.00%	

ABC CORPORATION
Accounts Payable Aging

Vendor Number	*Vendor Name/ Invoice Number*	*Due Date*	*Current*	*0 to 30 Days*	*30 to 60 Days*	*Over 60 Days*	*Total Overdue*	*Total Payables*
1	Alhambra National Water Co.		$ 0.00	$ 12.80	$ 0.00	$ 0.00	$ 12.80	$ 12.80
4	Alphabetics		0.00	1,426.00	0.00	1,500.00	2,926.00	2,926.00
8	Cine Kerska Productions		0.00	0.00	0.00	8.52	8.52	8.52
9	Colorsplendor		0.00	0.00	3,339.00	1,403.00	4,742.00	4,742.00
10	CSC		0.00	758.83	0.00	0.00	758.83	758.83
12	Federal Express, Inc.		70.25	22.00	0.00	14.00	36.00	106.25
14	Graphic Sportswear		0.00	0.00	0.00	134.19	134.19	134.19
15	JLA Credit Corp.		176.18	0.00	0.00	0.00	0.00	176.18
18	City of Los Angeles		0.00	0.00	0.00	0.00	0.00	0.00
	On hold:		0.00	0.00	0.00	1,347.96	1,347.96	1,347.96
20	L'Image Photographic Lab, Inc.		0.00	0.00	0.00	464.86	464.86	464.86
	Subtotal:		246.43	2,219.63	3,339.00	3,524.57	9,083.20	9,329.63
	Total on hold:		0.00	0.00	0.00	1,347.96	1,347.96	1,347.96
	Report total:		$246.43	$2,219.63	$3,339.00	$4,872.53	$10,431.16	$10,677.59
			2.31%	20.79%	31.27%	45.63%	97.69%	

7.1 Approach to Cash Projections

The approach used to produce an accurate cash projection varies from business to business and according to the audience and uses of the end product.

Cash planning involves most areas of the business. Management's approach to formulating a cash plan should be one that considers all relevant input about the firm. A good example of this would be the start-up costs of implementing a new manufacturing technique. The manager would need to know how much capital investment is required for plant and equipment and when payment must be made. Other costs and benefits such as labor, insurance, repairs, utilities, and sales are also considered. Additionally, the timing of each cost and benefit should be included in the cash plan.

In summary, cash forecasts involve the following steps:

— Project cash receipts (often as a percentage of sales)

— Project cash disbursements

— Compute net cash inflows and outflows

— Compute projected cash balance or shortfall

Formulating a cash plan should include these four goals:

— *Predictive accuracy.* The plan must reliably project ending cash balances, financing requirements, and compliance with loan restrictions. Accuracy is achieved only through the underlying assumptions and mathematical relationships, so the plan's credibility depends largely on the information obtained from within the business.

— *Feedback value.* The cash plan should provide a source of feedback on execution of the original plan, so that adjustments can be made if actual performance goes astray. Thus, elements of actual performance and planned performance should be comparable, and deviations should be readily apparent.

— *Relevance.* The cash plan must be kept current and should reflect developments occurring throughout the enterprise. Not only relevance but credibility is impugned if an underlying assumption that affects cash is changed without recognition in the most current plan.

— *Timeliness.* To provide predictive value and relevance, the cash flow projection must provide timely information for decision making.

7.2 Presentation Format

Formatting the presentation of a cash flow plan is the first step in its creation. The manager should have a detailed idea of what schedules are to be included in the plan and how best to present the key performance and decision indicators. The format should also consider ease of entry for actual performance data to be compared with the plan. Finally, the plan should be formatted in such a way as to allow for quick updating of the plan and assumption changes for asking "what if" questions.

7.2.1 Planning without a computer

Most of the planning exercise is the same regardless of whether an automated planning system is used. Data are obtained in the same manner; assumptions are used in the same ways. The only difference is in the computational labor involved. Planning without the aid of a computer requires the computation of many resulting impacts to the business that are caused by assumption changes. For example, sales are usually a key assumption. However, as sales change, so will accounts receivable, accounts payable, advertising expenses, sales commissions, and inventory costs, to list only a few. Each of these changes would be manually computed.

The turnaround time involved in making assumption changes or creating several scenarios in the plan will be longer when planning without a computer.

7.2.2 Planning with a computer

Generally, cash projections use automated models that can be readily changed as circumstances dictate. This is true for even the smallest of businesses using only a microcomputer and spreadsheet software. Use of automated cash models allows the simulation and assessment of new ideas without the time and effort required to manually calculate the results.

Today, many spreadsheet programs are available at a reasonable cost and can be very easy for anyone to operate or adapt to. In addition, more sophisticated modeling software is available for large applications.

If the decision is made to use "user friendly" software, which can be programmed by the financial management staff and run on a microcomputer, there are a variety of programs available, many of which accept data "downloaded" (electronically transmitted) from the firm's host computer to the microcomputer.

7.3 Detail Required and Model Accuracy

The level of detail included in the cash plan should be the minimum required to fulfill all design requirements of the system. By making the cash planning system as simple as possible, less can go wrong with it, it is easier to understand, the cost of development and operation is lower, and it generally has a higher degree of reliability. Most experienced planners, given a choice, would rather have too little detail than too much. More detail can always be obtained. However, if too much detail is presented without enhancing the final work product, the cost of developing that detail was wasted effort because the same conclusions could be reached without incurring additional development costs.

Model precision can be related to the reliability of the least accurate material assumption. For many systems, this is the interest rate forecast used to project interest expense. The model, by definition, can be no more accurate than the least reliable assumption contained therein. Understand, however, that some assumptions have a larger allowable error tolerance because a minor misstatement would not change the conclusions reached.

7.4 Uses of the Cash Plan

The most obvious use, and the one for which the plan was originally developed, is to project cash requirements. However, since the plan crosses over most departmental lines of the business, and since it has the ability to identify actual performance that deviates from the plan, there are a variety of other uses. Some uses that may not be readily apparent at first include:

— *Inventory.* Accounts payable levels and movement is a component of most cash plans. If payables begin to deviate from the plan, one area that may be causing the change could be inventory. There may be a variety of reasons, such as increased wastage, adverse material price variance, or changes in payment terms to vendors.

— *Receivables.* If receivables begin to increase, the cash plan will indicate an adverse deviation. This may point, for example, to a need for adjustment of geographic marketing concentration away from depressed areas. Additionally, if management has recently adjusted the firm's sales commission policy to include collection of receivables rather than solely sales, careful monitoring of the cash position impact of receivables will indicate the effectiveness of this decision.

— *Capital expenditures.* The cash plan can be used to help determine when capital expenditures can be made, when the most likely favorable financing can be obtained, and when the business will be able to repay the expenditure.

7.5 Decision Making Using Multiple Scenarios

Computing the plan under a variety of different assumptions will simulate a range of contingencies under which the business can successfully operate. It is recommended that the cash plan be executed at least three times, showing a best case, worst case, and most likely case. The required financing and ability to repay debt is then projected as a range rather than as absolute figures. Such a presentation will indicate that, as long as the assumptions specified in each of the three scenarios fall within the range, cash flow will be sufficient to maintain operations.

Additional decisions for which the cash planning system can be used under varying simulations include the following:

— *Sales price.* As discussed before, payment terms help to determine the overall price received for a sale. Terms can be analyzed using the cash plan to determine the impact on cash position under various options. It may be discovered that a smaller price increase than the competition's can be made in exchange for less lenient payment terms without damaging the overall profit to the business.

— *Financing vehicles.* In terms of the business's cash flow, the optimum financing vehicle can be derived by simulating the various options available.

— *Performance of receivables and payables.* An assumption included in most cash plans is the time to collect an average receivable and the time an average payable is held. When formulating the firm's policies toward these two critical components of cash flow, multiple simulations may be run to determine the acceptable range for the policy. Again, it is possible that the firm can gain a competitive advantage in either its buying of goods and services, or selling its product by adjusting these policies, without endangering cash flow beyond the benefit created by the policy change.

7.6 Nine Steps to Cash Planning

There are nine key steps to producing a useful cash plan. These are summarized as follows:

— Describe exactly how the plan will be used.

— Identify the users of the plan, including who will create the plan, update it, and make decisions from its output.

— Identify the time period over which the plan will be used.

— Define the content of the finished product including schematics of all reports, graphics, and sensitivity analyses.

— Define the degree of precision required of the plan, and work toward achieving that level.

— Identify the key causal relationships in the plan (termed *driver assumptions*) and the secondary assumptions that depend on the driver assumptions.

— Create the plan, preferably using an automated planning program.

— Validate the plan by entering historical data with a known result, compute the plan, and verify that the computed cash balances equal the already known results.

— Monitor actual performance against that which was planned and make adjustments in the plan to conform to changes that have taken place since the plan was developed.

7.7 Cash Management Warning Signs

There are nine warning signs in identifying potential cash flow problems or opportunities to improve a firm's cash position.

— Poor cash-related ratios, such as the current ratio, quick ratio, inventory turnover, receivables turnover, asset turnover, and profit margin.

— Excessive balances in non-interest-bearing accounts.

— A large number of bank accounts.

— Emergency borrowings resulting from surprise cash shortfalls.

— Lower-than-normal short-term investment returns resulting from surprise cash inflows.

— Unreconciled bank accounts.

— Slow collections and fast payments.

— Poor banking relationships.

— Poor availability of deposited funds resulting from a lack of float information.

No single sign indicates a problem; however, when taken as a whole and combined with a reliable cash plan, the analyst will get a good indication of the state of a firm's cash management effort.

8. INTEREST RATE RISK

The cash position and profits of many firms are unnecessarily eroded by movements in interest rates. Sensitivity to interest rate movements varies by industry. However, it is most pronounced in financial institutions and insurance companies, which rely on achieving a spread between interest income and interest expense. Cash managers need to be aware of their firm's exposure to interest rate risk and understand how to insulate their cash position and profits from unfavorable swings in interest rates.

This section will define interest rate risk and illustrate some commonly used financial tools for its management, concluding with a sample case study of a firm facing exposure to movements in interest rates.

8.1 Definitions and Symptoms

Interest rate risk occurs when a business has assets and liabilities for which the market value, earning power, and cost vary in relation to movements in interest rates. For example, consider the following selected balance sheet and income statement items of a hypothetical manufacturing company:

Total assets	$18.0 million
Adjustable rate loans	10.0 million
Interest expense on adjustable loans	1.1 million
Gross revenue	5.0 million
Expenses	4.5 million
Net income	$ .5 million

From the above items, it can be seen that if rates rise by just one hundred basis points (or one percent), net income will fall by $100,000 (total adjustable rate loans of $10 million × 1% = $100,000), a movement of 20 percent ($100,000/$500,000 = 20%). As profits fluctuate, so do the firm's cash position, its requirement for outside financing, its earnings capacity, and its ability to attract additional investors and credit facilities. The range over which profits and cash balances move as rates change defines the boundaries of a firm's interest rate risk.

The objective of interest rate risk management is to minimize downside risk if rates go against the firm, while leaving the upside potential intact if rates stay the same or move in a positive manner. These seemingly are mutually exclusive goals. However, through a computerized process called *simulation analysis,* management is able to develop rate risk-control strategies.

8.2 Simulation Analysis

Automated simulation analysis is the most effective technique to identify interest rate risk and formulate possible strategies for its control. Simulation uses a mathematical computer model of the rate-sensitive portion of the business to simulate the effect on earnings and the resulting changes in cash position caused by different risk-control strategies. The objective of simulation analysis is to find the best solution or combination of solutions to solve a firm's interest-rate-risk problem.

A typical simulation would perform the following two analyses:

— *Embedded risk.* This is the interest rate risk present in the balance sheet prior to attempting any control strategies. It is computed by assuming that the balance sheet remains constant while an earnings simulation is run through varying interest rate scenarios. Embedded interest rate risk defines the starting point for implementing the control strategies. The boundaries defined by embedded risk are illustrated by the graph in exhibit 1 on page 38. The lines labeled *embedded potential* and *embedded downside* form the limits of embedded risk shown as the shaded region in the graph. The goal of risk-control strategies is to reduce the size of this risk-embedded risk wedge.

— *Identifying possible strategies.* Once embedded risk is identified, the effect of specific corrective strategies—such as swaps, floors, and restructuring of the balance sheet—is simulated (see exhibit 2 on page 39 for a glossary of terms). During this phase, the utility of a computer model becomes apparent, allowing for the quick and efficient evaluation of various strategies. Once the embedded risk and possible alternative strategies are identified, management can begin to formulate a specific solution to its interest-rate-risk problem.

8.3 Formulation of Solutions

Controlling interest rate risk centers on creating an "insurance policy" against the effects of rate movement. Like a life insurance policy, one

hopes it is never used. Most businesses coordinate their strategies to relieve rate risk immediately while restructuring their asset/liability portfolios and policies to achieve long-term control.

The following case study illustrates how one company with an interest-rate-risk problem was able to identify a series of possible solutions using a simple automated simulation model.

8.4 Case Study: Drug Manufacturing, Inc.

Profile: Drug Manufacturing, Inc. (DMI) manufactures and distributes worldwide a complete line of ethical pharmaceutical products. Selected items on DMI's balance sheet before any risk-control measures were introduced are shown in exhibit 3, below.

The $200 million variable rate loan is indexed to the London Interbank Offered Rate (LIBOR), a commonly used index for many variable rate instruments. The interest rate charged on the line of credit floats with the prime.

The embedded interest rate risk in DMI's balance sheet was computed using a simulation model. Interest rate forecasts were provided by an economic forecasting firm. Risk to earnings caused by interest rate fluctuations was found to be $7.8 million by the sixth quarter and is illustrated in exhibit 4, below.

DMI is said to be "liability sensitive" because more liabilities than assets are affected by interest rate movements. This is seen in the selected balance sheet items shown in exhibit 3, where rate-sensitive liabilities are $260 million versus $175 million for rate-sensitive assets. Because DMI is liability sensitive, net rate-sensitive expenses rise under the unfavorable rising rate scenario and fall under the more advantageous falling rate scenario.

In management's judgment, an interest rate risk of $7.8 million to their earnings by the sixth quarter was unacceptable. Therefore, management set out to bring that risk under control by testing the benefits of various strategies under consideration.

8.5 Rate Risk Simulation Results

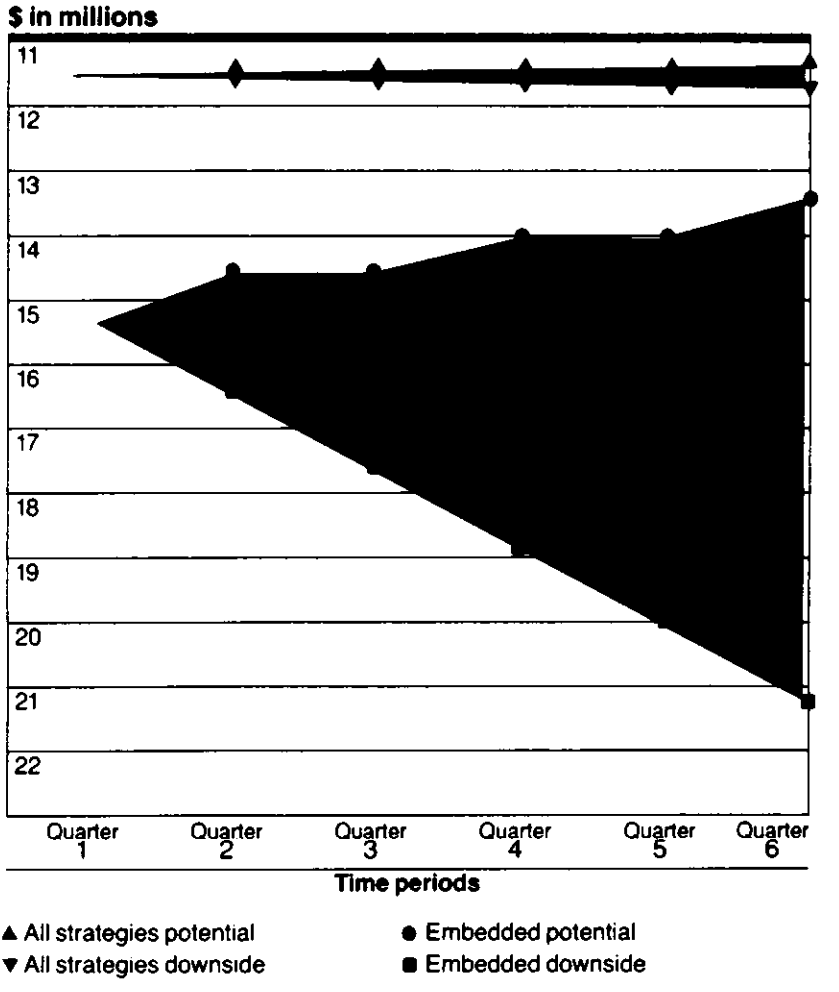
A simple computer model was developed to project the net rate-sensitive interest expense under the same rate scenarios used in computing the embedded risk described earlier. This model was again plotted over a period of six quarters. In all, fifteen computer runs were done to test each alternative and combination of alternatives using each rate sce-

(Text continues on page 40)

EXHIBIT 1

Drug Manufacturing, Inc.

Interest rate risk: embedded vs. all



Note

Exhibits 1 through 6 are reprinted from Christopher R. Malburg, "Identification and Management of Interest Rate Risk," Focus on Industry Dept., *Journal of Accountancy*, May 1988: 130–138.

Exhibit 2

INSTRUMENTS USED IN RATE-RISK REDUCTION STRATEGIES

SWAPS
An interest rate swap is an off-balance-sheet contractual exchange of cash flows (rather than actual assets) linked to adjustable interest rates that are traded for fixed rate cash flows or vice versa. Additionally, swaps are often executed to control basis risk—the risk of spread between an asset and funding liability—both of which adjust using different indexes.

FLOORS
A floor is a guaranteed rate below which interest income on the face amount will not fall. Unlike swaps, floors require a capital outlay to execute. A put option is purchased on an interest rate index, such as prime or LIBOR. If rates decline past the floor, the owner receives the difference between the current interest rate and the contractual floor.

CEILINGS
A ceiling is the reverse of a floor. The ceiling will ensure that the increased interest expense caused by rising rates is in part made up by profit from the position. A company would purchase a ceiling if it had an adjustable-rate loan and wished to insure against a rise in interest rates. Like floors, ceilings require a capital outlay.

The risk, or insurance cost, of a floor or ceiling if rates go against the position and in the company's favor is limited to the cost of the position.

COLLARS
A collar is a floor and ceiling entered into simultaneously. The intent is much the same as that of either strategy done individually, depending on where a company's risk lies in relation to rate movements. Assuming the cash outlay for the ceiling call would equal the cash received for the floor put, the net cash paid out to initiate the position would be close to zero.

Exhibit 3

Drug Manufacturing, Inc.

Selected balance sheet items before implementation of risk-control measures

Bonded debt:
$20,000,000

Variable-rate loan:
$200,000,000

Revolving line of credit:
$40,000,000

Fixed-income securities:
$175,000,000

nario. For illustrative purposes, a sample of one of the fifteen runs—showing all strategies combined under a rising rate scenario—is presented in exhibit 5 on page 42. Additionally, exhibit 6 on page 43 compares the simulation results of each alternative.

The following are the alternative strategies, purposes, and simulation results investigated by management.

Alternative 1. Execute an interest rate swap in the amount of $100 million on the $200 million variable rate loan.

Purpose. Reduce exposure to a rise in interest rates by converting half of the $200 million variable rate cash outflow to a fixed rate cash outflow.

Result. After executing this swap, interest rate risk was reduced from $7.8 million to $4.5 million by quarter 6.

Alternative 2. Sell $85 million of the fixed income securities, bringing the remaining balance to $90 million, then

1. Use $60 million of the revenues from sale of the fixed income securities to purchase weekly floating rate municipal notes (weekly floaters).
2. Use the remaining $25 million from sale of the fixed income securities to reduce the balance owed on the prime indexed revolving line of credit.

(Text continues on page 44)

Exhibit 4

DRUG MANUFACTURING, INC.
Computation of interest rate risk by quarter
under varying interest rate scenarios and strategies
($ in millions)

	Quarter 1	*Quarter 2*	*Quarter 3*	*Quarter 4*	*Quarter 5*	*Quarter 6*
Net interest expense						
Rising scenario	$15.2	$16.4	$17.6	$18.8	$20.0	$21.2
Falling scenario	15.2	14.6	14.6	14.0	14.0	13.4
Rate risk	$ 0	$ 1.8	$ 3.0	$ 4.8	$ 6.0	$ 7.8

(The results of this table are shown in the graph in exhibit 1 as the shaded region.)

Exhibit 5

Scenario: All strategies, rising rates

DRUG MANUFACTURING, INC.
Interest rate risk
($ in thousands)

	Year 1 1st half	*Year 1 2nd half*	*Year 2 1st half*	*Year 2 2nd half*	*Year 3 1st half*	*Year 3 2nd half*
Interest income on bonds	$ 7,425	$ 7,425	$ 7,425	$ 7,425	$ 7,425	$ 7,425
Swap receipts on $200mm variable-rate loan	11,750	12,250	12,750	13,250	13,750	14,250
Swap receipts on fixed-income securities	4,950	5,175	5,400	5,625	5,850	6,075
Weekly floater receipts	5,400	5,700	6,000	6,300	6,600	6,900
Total rate-sensistive income	$29,525	$30,550	$31,575	$32,600	$33,625	$34,650
Interest expense on bonds	$ 1,700	$ 1,700	$ 1,700	$ 1,700	$ 1,700	$ 1,700
Interest expense on variable-rate loan	23,500	24,500	25,500	26,500	27,500	28,500
Interest expense on revolving line of credit	1,650	1,725	1,800	1,875	1,950	2,025
Swap outflow on $200mm variable loan	10,500	10,500	10,500	10,500	10,500	10,500
Swap outflow on fixed-income securities	3,713	3,713	3,713	3,713	3,713	3,713
Total rate-sensitive expenses	$41,063	$42,138	$43,213	$44,288	$45,363	$46,438
Total rate-sensitive income (expense)	($11,538)	($11,588)	($11,638)	($11,688)	($11,738)	($11,788)

Exhibit 6

DRUG MANUFACTURING, INC.
Table of interest rate risk by quarter under varying risk reduction strategies
($ in millions)

	Quarter 1	*Quarter 2*	*Quarter 3*	*Quarter 4*	*Quarter 5*	*Quarter 6*
Embedded risk	$0	$1.8	$3.0	$4.8	$6.0	$7.8
Alternative 1: $100mm swap	$0	$1.0	$1.7	$2.8	$3.5	$4.5
Alternative 2: Sell $85mm fixed-income securities	$0	$1.2	$2.0	$3.1	$3.8	$5.0
Alternative 3: Swap $45mm fixed-income securities	$0	$1.5	$2.5	$3.9	$4.8	$6.3
Alternative 4: Implement all strategies	$0	$0.1	$0.1	$0.2	$0.2	$0.3

Purpose. This strategy was suggested to help provide an offset to increased interest expense in the event of a rise in rates. This was accomplished by reallocating cash from the fixed income securities (providing no offset under rising rates) to an asset that did provide such relief (weekly floaters). Additionally, the expense exposure to rising rates was reduced by paying down some of the revolving line of credit.

Result. After selling $85 million in securities, then buying $60 million in weekly floaters and paying down $25 million on the line of credit, interest rate risk was reduced from $7.8 million to $5.0 million by quarter 6.

Alternative 3. Execute an interest rate swap on $45 million of the remaining $90 million of fixed income securities to convert to a variable rate cash inflow.

Purpose. Further reduction of exposure in the event of a rise in interest rates could be accomplished by owning a greater number of variable rate assets. This is achieved without selling the bonds—that is, by doing a swap of the fixed rate cash inflow for variable rate cash inflow.

Result. After executing this swap, interest rate risk was reduced from $7.8 million to $6.3 million by quarter 6.

Alternative 4. Employ all strategies under consideration.

Purpose. By employing all risk reduction strategies under consideration, exposure to rising rates is minimized and offset by rising interest income.

Result. After executing this swap, interest rate risk was reduced from $7.8 million to $300,000 by quarter 6. This is shown in exhibit 1 as the shaded area.

Following are two peripheral benefits of a successful interest-rate-risk reduction program:

— Management is less tempted to gamble on where interest rates will go.

— Pricing of the firm's products will no longer include an "interest-rate-risk factor," thus providing a price advantage if competitors have not similarly insulated themselves and still include such a premium in their prices.

8.6 Protecting Profits and Cash

The objective of interest-rate-risk management is not to accurately predict where rates will go to take advantage of them. Rather, rate risk

management seeks to insulate profitability and cash balances from changes in interest rates by combining short-term financial transactions, which take effect immediately, with longer-term strategies, which seek to implement overall risk-control policy over time.

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BUSINESS PLANS

1. INTRODUCTION

Business planning should be a continuing and central activity in every business. The greatest misconception about business plans is that they are nothing but sales documents used by start-up businesses. A business plan that is nothing more than a showpiece for raising money — for a start-up venture or for an existing business — probably will not succeed even at that.

For a business plan to be of real use, it must serve as a working document that owners and managers use to plan, control, evaluate, and manage their business. Any business, regardless of size, is more likely to be successful and profitable if it plans for the future, anticipates change, and carefully weighs its responses to an ever-changing environment. A business plan helps entrepreneurs, owners, and managers do the following:

— Define the objectives of a business and reach a consensus on how to reach those objectives.

— Allocate scarce resources — cash in particular.

— Obtain financing by gaining the confidence of creditors and investors.

Surveys show that many small (and many not-so-small) businesses consider accountants their most trusted business advisers. As such, accountants need to know how business plans are used to obtain debt financing or equity capital. They must also be able to show clients how to use business plans to help manage and control their businesses.

Accountants in industry have no less a need to understand how to do business planning. Their companies also frequently require outside financing, so they must be able to prepare formal presentations on the company's business, its financial goals and objectives, and how it intends to achieve those goals and objectives.

Even if an existing business does not seek debt or equity financing, a business plan is a way to ensure that owners and managers formally agree about the company's goals and objectives (which means extended discussion and reconciliation of conflicting views) and that all work cooperatively to make them happen. This type of long-range planning forces a business to prioritize opportunities and provides the framework on which a true management team can be built. In effect, therefore, a business plan is a budget written in general terms. It is an organized and systematic attempt to project all of a company's resources and influences, including finances, work force, and market factors. The financial statements (or "back end") of the business plan may be the heart and soul of the plan, but they do not exist in isolation. Like a

budget, an updated business plan is needed each year to tie the company's finances and short-term projections explicitly to its goals, objectives, strategy, and tactics in every important area, including marketing, production, operations, sales, and human resources. This will enable a company to remain both focused and flexible.

2. WHAT IS A BUSINESS PLAN?

A business plan is simply an attempt to be prepared for what is expected to happen in the future, to take control of those things that can be influenced and therefore to achieve the goals and objectives that have been set for the enterprise.

A business plan should be two things: a sales document to be used to obtain financing and also an overall operating plan for starting and running a business. It is important to remember that *it should be both.* The cash flow projections submitted to a bank by a long-time patron may be all that is required to demonstrate the need for an equipment loan that will help the company increase sales and profits. These projections, however, do not meet the criteria of being an overall operating plan.

In substance, business plans all share the same goal: to maximize the chances of success. In form, however, business plans vary considerably. The business plan for a start-up business and the plan for an existing business ordinarily would look substantially different, though they usually follow much the same outline. For example, while a well-established business may concentrate the presentation of its plan in the financial (cash flow) area, a start-up business will need to expend more effort in the marketing, production, and operations areas.

No two business plans look alike simply because no two businesses are alike. What ultimately determines how a business plan looks and what it includes is *who the plan is intended for and what its purpose is.* A plan for obtaining financing covers in detail what the business is (including its marketing and operating strategy and tactics) and how much capital the business needs to raise (including for what purpose), as well as projected financial statements and related analyses. But a business plan intended mainly to help owners and managers plan, control, and manage a business may look very different.

2.1 Start-Up Business Plans

Economic viability is what start-up business plans are about. New businesses fail at an appalling rate. The usual statistic cited in the press, by

academics, and in popular books about entrepreneurship is that four out of five start-up companies fail within the first five years (though recent studies suggest that the failure rate is lower).[1]

The elements usually cited in most business failures are

— Management (lack of experience, education, sales ability, or just sheer incompetence).

— Inadequate capital (whether start-up or subsequent cash flow because of, for example, poor credit-granting practices).

— No planning beyond how to survive from one day to the next.

— Poor choice of business.

— Unfavorable location.

— Unplanned growth.

— Inadequate record keeping.

— Excessive inventory or fixed assets.

This list of reasons for business failures should make it clear that business planning for a start-up business is an attempt to recognize and deal in advance with the myriad obstacles and issues that a new business faces.

Start-up business plans are usually the most comprehensive and detailed. Business plans for existing businesses (particularly if the plans will not be used to raise capital from outsiders) are usually adaptations of the form and content of start-up plans, but may eliminate some of the detail in an effort to focus on overall objectives and more exact financial data.

2.2 Existing Businesses

Like start-ups, existing businesses need business plans for two basic reasons:

— To plan, manage, and control the business

— To raise capital

In many ways, plans for existing businesses should be much easier than business plans for start-ups. For example, projecting pro forma financial statements can begin with actual data, so the process has a stronger starting point. A company with several years' experience can (by considering historical data) better examine its operating policies

[1]Buck Brown, "Business Failure Rates Aren't So Bad After All," *Wall Street Journal* (Friday, 20 May 1988, p. 27).

and assumptions about the future, which is one of the most important aspects of planning.

2.3 Summary Benefits of Planning and Goal Setting

The value of carefully conceived and continually revisited business plans cannot be overemphasized. In summary, they provide the following benefits:

Improved resource utilization—Goal setting and planning require management to evaluate the business's resources and thereby better determine capabilities and limitations.

Increased employee motivation—The unified company direction established by goal setting and planning underscores a "corporate culture," emphasizes mutuality and cooperation, and reduces employee anomie and frustration.

Improved understanding of opportunities, problems, and weaknesses—Planning involves programs and activities that are geared to assessing the business's environment—internal and external—and reacting positively to challenges and problems and taking advantage of opportunities.

Greater organizational control—Planning encourages and in some cases enforces adherence to project completion dates and performance standards essential to maintaining control.

Information for third parties—Written plans and objectives are useful in seeking financing, in planning mergers and acquisitions, and in a host of situations involving third parties.

3. CONTENTS OF A BUSINESS PLAN

Plans vary according to the type and complexity of the business, the stage of the business in its economic life cycle, and the intended purpose of the plan and its audience.

There are certain generally accepted formats for business plans. Usually, the narrative sections (descriptions of the business and the product) go up front, while the prospective financial statements — which are by far the most important component for most readers — usually go in the back.

Appendix 1, "Sample Business Plan Outline," provides a comprehensive overview of what a business plan might include.

Not all the information discussed in this section belongs in every business plan. The sample outline in appendix 1 tries to cover all

possible considerations, which makes it more useful as a checklist, than as a model to follow for each and every business plan.

A business plan should not be cluttered with unnecessary detail. It should include objectives, major assumptions, concerns, and projected results of the business, but should omit information and data that might obscure the main outlines of what must be communicated.

The following sections provide additional information about each major heading of the outline shown in appendix 1.

3.1 Cover Sheet and Table of Contents

Cover sheets of business plans provide:

— The name and address of the business.

— The names, addresses, and phone numbers of the contacts (the lead entrepreneurs, ordinarily).

A cover sheet might also include a disclaimer about the projections, such as the following example, which has been adapted from the AICPA's Statements on Standards for Attestation Engagements, *Financial Forecasts and Projections,* and the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information:*

> The projections in this business plan reflect our best judgment of the company's future operating results at the time this plan was prepared. The numbers used are based on expected conditions and our expected course of action. Since there will usually be differences between projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material, the planned results may not be achieved.

This paragraph, of course, contains the essential written representations that accountants must obtain from the client for a compilation.

If a plan contains important proprietary information, it might be advisable to include a paragraph, such as the one shown below, to restrict further distribution of the plan or disclosures of its contents:

> This business plan is being submitted confidentially. It contains proprietary information. You should not disclose the contents of the plan or distribute this or other copies of the plan to others without our authorization. By accepting this copy of the plan, you agree to these conditions and agree to return this copy upon our request.

When such a paragraph is to be included, it is generally advisable to obtain receipt signatures acknowledging the terms specified.

Although many business plans do not contain a table of contents, it makes sense to include one as a means by which readers can identify important elements in the plan and readily locate data.

3.2 Executive Summary

A typical venture capital firm probably receives numerous business plans every day, which means that the time and attention devoted to any one plan is scant. Unless the executive summary can command the interest of potential creditors or investors, the remainder of the plan may never be read.

Whether a business plan is intended for outsiders or as an internal working document, the executive summary should be short and succinct—probably no longer than one page. A longer summary suggests the plan preparer is unable to see the "big picture" or focus on particular challenges. The summary should be prepared after the rest of the business plan is complete.

An executive summary must cause its reader to want more information. It should explain in broad terms what the company intends to do and how it intends to do it. These goals and objectives should be followed by a brief explanation of the resources that will be used in obtaining them.

The executive summary should briefly

— Explain what the company's products or services are.

— Give an overview of the present market conditions and expected fluctuations.

— Review the industry.

— Explain the company's projected financial performance, discussing profitability and projected return on investment.

The executive summary briefly explains the company's critical success factors by setting forth its objectives, strategies, and tactics, and the internal and external influences affecting them.

3.3 Organization, Management, and Human Resources

This section should help provide answers to five questions:

— What business is the enterprise in?

— What management, key personnel, and employees are in place or available to make the venture succeed?

— What are the company's strengths and weaknesses, and what problems does it face?

— How much capital (and is it in the form of debt or equity) does the business need?

— How will the funds be used?

3.3.1 Organization

This section presents the basic facts about the business, such as

— A brief history of the business, including when the business began and (if applicable) the date and state of incorporation.

— The legal form of business (for example, partnership, limited partnership, corporation) and its tax status (S corporation, C corporation, partnership).

— The location of headquarters and principal offices.

— Major successes or achievements to date.

— Major problems or obstacles facing the company.

— Risks and potential liabilities (insurability and coverage, potentially dangerous products, unasserted claims).

— Funding required, specifying percentage of debt versus equity.

— How funds will be used.

— Current and proposed capital structure (common and preferred stock issued and outstanding, with descriptions of rights; major shareholders; long-term debt or bonds, with descriptions of each type; relationships with major banks; discussions of leverage and the pricing of additional equity interests).

3.3.2 Management and human resources

When asked what venture capitalists look for in a business plan, the response of one major venture capitalist was: "Three things—people, people, and then people."[2] Because events never turn out exactly as projected, a skilled and experienced management team is the best insurance a creditor or lender can have that a business can adapt to change. Such a team should be able to direct and focus a company toward the achievement of its objectives.

A business plan intended for outside use should explain relevant education and skill, business experience (including knowledge of the

[2]Lawrence M. Alleva and Steven W. Barnes, "Marrying for Money: The Venture into Venture Capital," *Price Waterhouse Review*, 1988, no. 2:47.

industry), and applicable technical knowledge. Depth of management is also important. Brief biographies are frequently presented, and detailed resumes are sometimes included in the exhibits section (see section 3.8 following).

Management alone cannot make a business successful. Other human resource issues should be covered, including

— Special technicians that are needed and their availability.
— Current and proposed number of employees, with a breakdown of functional areas (for example, fifty-five manufacturing personnel, twelve supervisors, three managers, four administrative personnel).
— Availability of personnel in this geographic region or nationwide (and any special ability to attract personnel).
— Compensation and benefits policies (especially incentive performance programs).
— Union affiliations (current or foreseen).

3.4 Objectives and Action Plan

The section that explains the company's objectives and action plan draws all areas of an enterprise together—finance, marketing, and operations. It explains what the company wants to accomplish and by what means. Both short- and long-term objectives should be covered, which means also covering specific actions needed to meet both types of objectives.

3.4.1 Strategies and Objectives

Business planning is projecting

— **What** the entity will do with its resources.
— **When** it will do it.
— **How** it proposes to do it.

Objectives must be stated in terms that are measurable and based on specified intervals of time (for example, "by July 199X, sales will reach . . . "). A goal like "obtain financing" or "reach our market" is of no value because achievement cannot be measured or gauged. Examples of objectives that are specific enough to include in a business plan are these:

— "Attain a return on equity of 40 percent by the fourth year of operation."
— "Increase sales by 50 percent per year for the first two years, then by 25 percent for the next three years."

— "Install 100 systems by the end of 199Y."

— "Capture a 15 percent share of the market by 199X."

3.4.2 Action plan

The action plan must explain how the objectives will be accomplished, relating them in terms of dates and priorities. It should tie together management's or the owner's objectives (for example, to go public in five years after expanding sales by a factor of five), overall financial objectives (for example, specific return on equity and growth in sales amounts), marketing objectives (such as attaining a 10 percent share of the market by 199X), and the operating and production objectives (such as opening two new retail outlets on the West Coast, three in the Southeast, and four in the Northeast by 199Y).

This section also itemizes the specific and detailed steps that explain how these objectives will be accomplished: *who,* in other words, is responsible for doing precisely *what,* and by *when.*

3.5 Marketing

The marketing section of business plans should include

— A discussion of the product or service.

— A market and industry analysis.

— Marketing objectives and strategies.

3.5.1 Product or service

The section that explains the company's product or service is especially important for start-ups as well as for going concerns that wish to add or expand a line of business. A company must be able to predict customers' needs and wants, because these define the business. The emphasis, therefore, should be not on what the company has to sell, but on what it offers that *people want or need to buy.*

The section on the product or service must make clear

— What customers will be buying when they choose what the company sells.

— Why customers will buy the product or service from the company.

— Who in the market will make the buying decision.

If the company hopes to garner venture capital, it must usually have a proprietary product or a service that no one else can offer or that no

one else can offer in the same way. The company's product or service must be explained in detail; often it is even appropriate to include illustrations, drawings, or photographs (either in this section or as one of the exhibits; see section 3.8 herein).

Brand names, if applicable, and prices should also be discussed and the product or service must be compared to the competition, which means discussing competitive strengths and weaknesses (such as price, serviceability, distribution networks, warranties, timeliness, convenience, and prestige).

Results of relevant market research (whether primary research, like focus groups and surveys, or secondary research) can also be presented. Patents, trademarks, copyrights, franchises, and licensing agreements (owned, obtainable, and competing) should be covered.

The section on products or services must also take a broader view of what the company has to offer. Specifically, what are the implications of the company's product or services to customers or consumers?

The owners and managers of the business should identify such underlying assumptions so that they can be evaluated objectively both within the company and by potential outside creditors or investors.

3.5.2 Market analysis

Offering a product or service that a company *thinks* customers need and want does not necessarily mean that a viable market already exists.

The market analysis covers

— Who will buy the product or service.

— The size of the market.

— Projected sales.

— The projected growth of the industry and market.

A company whose "top line" (sales) isn't big enough has no chance of having a satisfactory bottom line. Particularly with start-ups, the business plan must generally demonstrate the prospect of dramatic and sustainable growths in sales; otherwise, there's no use in starting up. To attract venture capital, in particular, growth must be emphasized.

These matters are addressed first by analyzing the current status of the product or service. More specifically, the market analysis discusses

— Customer preferences and needs (for example, whether preferences have changed or trends or events will influence preferences).

— Customers versus end users (that is, for example, mothers who buy children's cereal).

— Demographics and segments of the market (age, gender, location, income, ethnic background, "lifestyle," values, and so forth) and how the company can reach them.
— Size, history, and trends in the market.
— The target market segments, including apparent market opportunities (geographical expansion, niches to exploit, new uses of the product).
— Market threats (new products, new technology, changing customer preferences).

3.5.3 Industry analysis

The industry analysis further considers the product or service in terms of the competition:

— Critical success factors in the market
— Important risks (for example, cheaper, knock-off imports or technological obsolescence)
— Barriers to or ease of entry into the market
— Stage and maturity of the market (take-off, growing, stable, or declining)
— Seasonality
— Sensitivity to business cycles
— Government regulation
— Normal credit policies
— Advertising and promotion
— Trends, fads, and the importance of innovations and technological changes (including possible obsolescence)
— Price sensitivity and possible product or service substitutions
— Major competitors, including their strengths and weaknesses, market shares, and prospects
— Location of competitors
— Varying methods and levels of distribution
— Important trade associations
— Varying sales methodologies (for example, salaried sales staff versus commission-only sales, direct marketing trade shows, and so forth)

3.5.4 Marketing strategy

The marketing strategy explains the company's marketing goals and objectives and tells how the desired results will be achieved. The strategy

must follow logically and persuasively from the product or service analysis, the market analysis, and the industry analysis described in the three preceding sections.

The section on marketing strategy should answer questions about

— Product or market attributes.
— Pricing policies.
— Development or evolutionary plans (spin-offs, organizational changes, mergers, acquisitions).
— Research and development efforts.
— Competitive responses.
— Distribution channels.
— Service or warranty policies.
— Credit policies.
— Advertising and promotion.
— Service and customer support.
— Sales personnel or direct marketing staffing and the compensation policies.

3.6 Production and Operations

The production and operations section covers how products will be manufactured or brought to market or, in the case of a service, how the service will be delivered.

The elements this section addresses include

— Processes or equipment used.
— Facilities requirements.
— Sources of supplies, equipment, raw materials, purchased components, and direct labor (including plans for purchasing operations and hiring).
— Major components of operating expenses (labor versus direct materials) and the resulting cash flow implications.
— Inspections and quality control.
— Logistics (notably, how products or services will actually be delivered to customers, dealers, and brokers).

More specifically, the production and operations sections should include items such as these:

— A brief description of the manufacturing operations, purchasing operations (especially, for example, in the case of retail operations), or method of delivering services

— Location and description of plants, warehouses, headquarters, and any other significant offices

— Capacity and utilization

— Expansion plans

— Major fixed assets (current and planned)

— Make-versus-buy considerations

— Quality control

— Changes in production technology and threats from imports

— Shelf life and potential obsolescence of inventory

— Current and expected inventory turnover

— Major suppliers (including their financial services, benefits, credit policies, locations, and risks of inadequate or subnormal supplies or availability)

— Major cost components (such as direct labor versus specific direct material costs)

3.7 Financial Presentations and Data

The heart of a business plan is the projected financial statements. They provide answers to the most fundamental questions about any business:

— What is the business worth now?

— What will the business be worth in the future?

Since value is a function of cash flows, including the initial investment and residual values, the cash flow statement is the first place to which a banker, venture capitalist, or any other sophisticated reader of a business plan usually turns.

The information that should be provided in this section about the company's future includes

— The company's cash position.

— The company's projected financial performance.

— The company's financial position.

— The significant assumptions that underlie the projections.

Specific items included in this section include

— Audited financial statements, including notes and audit opinions (existing companies).

— Detailed description of accounting principles and practices (new companies).

— Projected balance sheets, income statements, and cash flow statements for five years (usually monthly for the first year or two, then quarterly for the second or third year, and yearly thereafter).

— A statement of significant assumptions used in preparing the projected financial statements (such as interest rates, profit margins, inflation, turnover ratios, and expansion rates).

— Key financial ratios (past, if available, and projected).

— Cost/volume analysis (break-even).

— Sensitivity analyses.

3.7.1 Feasibility studies

Especially for start-ups, financial feasibility studies, which may consist of little more than projected cash flow statements, should be a first step. An entrepreneur who does not do a cash flow projection (or hire an accountant to do one) cannot truly understand the financial considerations with which the person is dealing.

A minimum of detail is needed in the initial figures to determine whether a proposed venture is worth pursuing at all. If the preliminary numbers look promising, a full-blown business plan with complete financial statements should be prepared, and detailed projections (particularly for all material sources and uses of cash) should be accumulated.

3.7.2 Different scenarios and time periods

Ordinarily, three different financial scenarios are covered in the prospective financial statements: the best case, the most likely case, and the worst case. Whether prospective financial information is considered a forecast or projection depends on the company's objectives. A *forecast* is defined by the AICPA Statement on Standards *Financial Forecasts and Projections* as prospective financial statements that present information that reflects conditions as they are expected to exist. A *projection* answers the question "What would happen if . . . ." Generally, in a business plan, the most likely scenario would be considered a forecast while the best and worst case scenarios would be projections (see section 5.2.4 in this chapter).

Sales is usually the only variable changed in this type of sensitivity analysis, though other variables or assumptions could also be tested.

See section 3.7.5 in this chapter for a discussion of "what if . . . " analyses using computer spreadsheets and specialized software for projections.

The time horizon for presenting projected financial statements depends on the intended audience and their use of the business plan, as well as on how meaningful the projections will be. For example, trying to project more than five years into the future is probably a vain undertaking. But, whatever the time horizon in years, the periods for the first year, at least, should be months. Thereafter, quarters may be used. Statements should, for the final year or two, show only yearly projections.

3.7.3 Assumptions

Unless the assumptions are documented and can be changed (for example, "40 percent growth in sales over seven years"), the projected financial statements and data are suspect, however well presented and mathematically correct they may be.

Among the assumptions that need to be discussed, analyzed, and documented are the following:

— Beginning and ending dates of the plan
— Appropriate time periods (months, quarters, years)
— Interest rates used on debt
— Interest rates used on short-term investments of excess cash
— Effective income tax rates (federal, state, and local)
— Growth in sales (for example, by a constant percentage, by product, in specific units sold, or in dollar increments)
— Capital expenditures
— Inventory levels maintained (turnover rates)
— Inflation
— Seasonality
— Business cycles
— Wage and salary growth
— Incentive compensation to be paid
— Service, replacement, and warranty costs
— Sales returns
— Accounts receivables collection periods
— Accounts receivables discounts taken
— Accounts receivables write-off rates
— Accounts payable payment periods

— Accounts payable discounts taken

— Aggregate gross margin for all products and gross margin by product line

— Dividend (or withdrawal) policy

— Accounting policies (for example, useful lives of assets, depreciation, and amortization methods)

— Tax policies (such as use of an accelerated depreciation method or the availability of the research credit)

— Beginning financial statement amounts (including assumptions about capital structure) for start-ups

— Debt or equity financing anticipated

See section 5.2 for a discussion of the reporting requirements imposed by professional standards regarding assumptions used in a business plan.

3.7.4 Detail and financial statement presentation

If historical financial statements (preferably audited) exist, they should be provided for the past three years. (See section 5.2 on professional standards when historical financial statements are included in a business plan.) Especially for start-up businesses, however, cash is most important, so this section focuses on cash flow statements from which the projected balance sheets and income statements can be derived.

The projected cash flow statements identify and provide for all possible cash inflows and outflows. A detailed buildup of budgets and schedules for all significant line items on the balance sheet and income statement is equally important.

Although all appropriate subsidiary budgets and schedules should be prepared, they should *not* all be included in the business plan. Many banks prefer specific formats, with many using Robert Morris Associates forms (www.rmahq.com). See appendix 2, "Sample Format for Financial Statement Projections," also available on the *Accountant's Business Manual Toolkit CD-ROM* for a sample projection form. Since many bankers receive their credit training using this form, and many former bankers are venture capitalists, using a familiar presentation is helpful.

Even if an original form is not used, its format (as reproduced on a spreadsheet) can be used to demonstrate the interrelationships between the financial statements and to show the effect that various decisions have on all three statements. The same data would be available from financial statements on separate pages, but seeing the offsetting effects all at once on all three statements often helps in understanding the important variables.

3.7.5 Use of spreadsheets and other business planning software

Most accountants are adept enough with spreadsheets to prepare templates for integrated financial statement projections. The template should be as general as possible so that changing assumptions and facts won't invalidate prior programming. A general model can be used for many business plans. For ease in updating, make a separate assumptions screen for every parameter that could conceivably change (for example, interest rates, returned sales, and day's sales outstanding). See section 3.7.3 for a list of assumptions used in a business plan and section 5.2 for a discussion of professional standards regarding assumptions.

Several commercial business planning packages are available. Appendix 3 lists many of them, provides a brief explanation of what they do, and includes Web addresses for further details.

3.7.6 Sales forecasts

The first step in preparing a cash flow statement is to project sales, after which other significant line items to be shown must be determined. Sales should be based on the market analysis (see section 3.5.2) done for the product or service. The sales forecast largely determines what must be accomplished by the various functions (such as manufacturing, marketing, personnel) of the business.

Existing businesses can usually predict sales figures with relative confidence; their main interest may instead be in controlling or reducing costs. For start-ups, however, estimating sales is the most important step, because if actual sales prove to be higher or lower than expected, the company's cash needs can increase or decrease significantly.

Forecasting sales can be especially difficult for high-growth start-ups, because their whole operating strategy depends on enormous and rapid increases in sales.

3.7.7 Cash flow statements

In its most basic terms, a cash flow statement is just three things: cash in, cash out, and timing—the familiar sources and uses of cash.

Unlike cash flow statements prepared in accordance with generally accepted accounting principles (GAAP), cash flow projections in business plans often begin with sales in units. Showing units and unit prices adds another dimension to a cash flow analysis: The figures for units sold tie in to the projected production schedule (see section 3.6), while the figures for price per unit and volume in units tie in to the break-even analysis (see section 3.7.8). Often only net cash sales are shown, though sometimes the presentation of gross sales and returns (or deductions) and of the resulting net sales may be justified. A sample projected

cash flow presentation is shown in appendix 4. (Also, see the *Accountant's Business Manual Toolkit CD-ROM.*) Note that the periods can be months, quarters, or years.

Preparing cash flow projections usually requires many iterations. Among the important variables or assumptions to test are varying levels of inventory (a notorious cash drain), short-term debt (which increases the company's risk and vulnerability to recession), and accounts receivable (because bad debt or slow-paying customers can ruin the company). Iterated cash flow projections help to determine the ultimate appearance of the other financial statements, the appropriate debt/equity decision for the business, and the percentage of ownership that outsiders should get for their investments.

3.7.8 Other financial analyses

Many business plans include a break-even (or cost/volume) analysis, usually in graph form. Even if break-even figures or graphs are not included in plans intended for outside use, they can be very useful for internal management purposes because they underscore the fact that there are only three possible ways to increase profitability: increase prices, increase volume, and decrease costs (whether fixed or variable). Either break-even sales revenue or break-even unit sales could be provided. Both analyses require assumptions regarding sales volume and prices.

Key financial ratios are sometimes also presented, especially for bank loans. The ratios usually included are

— Current ratio.

— Debt-to-net-worth ratio.

— Return on equity.

— Gross margin percentage.

These ratios are discussed in the chapter on Obtaining Financing.

3.8 Supporting Documents and Exhibits

The supporting documents section of most business plans is somewhat general. It includes any information relevant to the business plan that is not segregated elsewhere. Occasionally, historical financial statements are also put in this section. Organizational charts are sometimes provided, and some business plans place biographies of the lead entrepreneurs or of important owners and managers here. Articles from trade magazines about the industry, product, or service may be relevant to substantiate or corroborate positions presented in the plan. Finally,

copies of significant contracts or agreements might also be shown (for example, leases, union agreements, line-of-credit agreements, patents, and licensing agreements).

(Text continued on page 21)

4. FINANCING

This section discusses financing considerations, especially venture capital. The chapter on Obtaining Financing provides an overview of the various sources of debt and equity financing available.

4.1 Debt Versus Equity

The reward an entrepreneur reaps from a business varies tremendously depending on whether debt or equity financing is used. Using all debt is seldom feasible. It is also very risky, because as leverage increases, risk escalates from the ever-increasing drain of cash caused by servicing the debt. If the business fails (the probability of which increases as leverage increases), the entrepreneur often faces personal as well as professional disaster because, typically, the entrepreneur is forced to guarantee the business debt personally.

Alternatively, using all equity is usually equally repugnant to entrepreneurs, because doing so means having to relinquish a significant share of the business—sometimes even majority control.

Leverage affects risk, as does the type and stage of a business venture; both, therefore, affect whether debt or equity financing should be used. In the early stages of a venture, equity financing is often the only choice. As the business grows, establishes a record, and thus appears less risky, debt financing becomes more available and more attractive. The newer and the more untested the company, the greater the risk presented by debt financing.

4.2 Venture Capital

Large growth potential and large capital needs, together with potentially large payoffs (and big risks), are the signs that point to seeking venture capital as a source of funds.[3] Venture capitalists have to see significant potential before they will be interested in a company.

4.2.1 Characteristics of venture capital

Depending on the risk, venture capitalists may require an annual return on investment of from 30 percent to 80 percent. In return for their investment, they usually obtain a significant share of the business—often majority control and always significant influence over decision

[3]This section draws on the excellent discussion of venture capital found in Alleva and Barnes, *Price Waterhouse Review*, 1988, no. 2:42–51.

making. If the business begins to collapse, they may take over daily control or replace management. Finally, although venture capitalists provide long-term capital and are willing to wait from three to ten years for a return on their investment, they want to be able to bail out. Venture capitalists want to be able to liquidate their investments by a sale or merger of the company or else by taking it public through an initial public offering.

Although venture capitalists expect a high return, the degree of risk of the businesses funded by venture capital should always be kept in mind. Even if an entrepreneur must relinquish a major share of the business, it is better to own part of a well-capitalized company that stands a good chance of success than to own 100 percent of a company that will fail or never even get off the ground for lack of capital.

Many venture capital firms specialize in certain industries—for example, computer hardware or software, genetic engineering, or publishing. Some fund only companies in the conceptual stage by providing "seed money," whereas others will not even consider funding a business until it has a track record of a few years.

4.2.2 Pricing of venture capital deals

There are many ways to value a business (see the chapter on Business Valuations herein). A typical venture capital pricing, however, involves the use of price/earnings (P/E) ratios (earnings multiples) and discounted cash flow techniques.

To illustrate, assume that a venture capitalist agrees to invest $1 million in a privately held manufacturing company that expects $3 million net earnings five years from now. The company has one million shares of stock outstanding. Similar public companies have P/E ratios of 10, and the same earnings multiples are expected to hold true for the next five years. The venture capitalist requires a 50-percent return on its investment and plans to cash out at the end of the fifth year by taking the company public.

The calculation of the share of the business that goes to the venture capitalist is as follows:

Projected Earnings Per Share (EPS):

$$\frac{\text{\$3 million projected net earnings in fifth year}}{\text{1 million shares outstanding}} = \text{\$3 EPS}$$

Projected Stock Price When Company Goes Public:

$3 EPS × 10 P/E ratio = $30 per share

Projected Value of Company When Company Goes Public:

$30 per share × 1 million shares = $30 million

Present Value of Business:

$$\frac{\$30 \text{ million future value of company}}{(1 + 0.50\%) \quad \text{Discount factor (50\% return for 5 years)}}$$

$= \$3{,}950{,}617$ Present value of business

Percentage Ownership Venture Capitalist Gets for $1 Million Invested:

$$= \frac{\$1 \text{ million invested}}{\$3{,}950{,}617 \text{ present value of business}}$$

25% ownership interest

5. THE ACCOUNTANT'S ROLE

An accountant's training and experience provide an overall business sense that few other professionals can match. Financial projections and the related financial analyses make up the inner workings of a business plan. Accountants (whether practicing CPAs or part of financial management in industry) should, therefore, be closely involved in all aspects of business planning.

Especially with start-ups, the immediate concern is raising capital and, based on projected financial statements, showing some evidence that the business will ultimately be able to generate enough operating income to repay creditors and provide a return on investment commensurate with the risk of the venture.

Although most accountants should be able to help project financial statements, many businesses—especially start-ups—need extensive help in targeting how much debt or equity to seek, which creditors or investors to approach, and how to minimize the usually lengthy delay from business-plan completion to obtainment of suitable financing. In part, this means maintaining close relationships with banks, other commercial lenders, large private investors, and a range of venture capital firms.

5.1 Business Planning Engagements and Clients

Business planning clients must usually be sought out. Perhaps the best way to build a business planning practice is to build on existing client relationships: Many of an accountant's existing write-up, audit, and tax clients need business plans, even if they don't know it.

The following situations all suggest the need for formal business planning help that accountants can provide:

— Additional capital for needed growth

— Cash flow difficulties (for example, trouble in paying suppliers, meeting payrolls, or servicing debt)

— Impending bankruptcy

— New competition or changed technology in the industry

— Changes in management

— Calls for help with specific problems that may be symptomatic of bigger problems (for example, chaotic record keeping suggests underlying management problems)

— Mergers and acquisitions

Of course, many companies do some sort of budgeting, but few take the added step of formally tying a budget to the company's overall strategic plan for marketing, production and operations, and logistics. For those clients who do budget already, accountants should help them make the leap to incorporating the yearly budget into an annual business plan. For those clients who do not even have a formal budgeting system, the accountant can urge beginning with a formal business plan (which is simply a far more comprehensive budget document) or can suggest that the client start with a one- or two-year budget, then later integrate the budgeting system into a continually updated business plan. A company's tactics—and often even its goals and objectives—need to change. The important thing is to regularly compare actual results with projections and to update and adapt plans accordingly. Sometimes clients can do this themselves, but often accountants can gain valuable ongoing planning engagements by simply being alert to opportunities.

5.1.1 Undertaking a planning engagement

A client may request a consulting engagement for assistance in establishing business goals and developing plans, or the practitioner may recommend it, based on knowledge of the client's operations and need for planning. When a client requests assistance, the practitioner may want to determine whether there are any underlying reasons or special purposes for the request. The practitioner needs to know the pertinent facts to help the client develop goals and plans that are appropriate and well matched to the needs of the organization.

In deciding whether to accept the engagement, the practitioner considers the nature of the client's business and the specific request for service in light of the practitioner's own standards, policies, and capabilities. If the request for services is from a prospective client, the practitioner might ask the following pertinent questions:

— Who referred the prospective client?

— Has the prospective client previously engaged another accountant, and if so, why is a new one being sought?

— Is the prospective client seeking to establish a continuing relationship with the practitioner or asking for one-time-only assistance?

— How long has the client been in business?

— Who are the owners/partners?

— What is the nature of the client's current business?

— What is the financial history of the client's current business?

— Were there any earlier business ventures, and what resulted from them?

— With whom does the client bank?

— What law firm does the client use?

The practitioner may conduct a brief preliminary fact-finding survey to develop an understanding of the client. The most critical factors are the benefits the client anticipates and what the practitioner needs to do to accomplish the engagement objectives. The time devoted to a preliminary survey may be less for an existing client because of the practitioner's familiarity with the client's operations, personnel, and other key factors.

From the information obtained during discussions with the client and from the preliminary fact-finding survey, the practitioner might prepare notes for reaching an oral understanding with the client or might develop a written engagement proposal. If the client accepts the proposal, the practitioner develops an engagement schedule, which establishes target dates or time allocations and the responsibilities of persons involved in the engagement work phases and activities.

5.2 Professional Standards for Business Plans

The close relationship of business planning to other types of professional engagements provided by CPAs makes determining the scope of service important. Understanding the requirements is especially so, because the procedures and reports required by the various professional standards and the resulting fees that must be charged have to be explained to the client in advance. The client must understand and agree to both the ultimate scope and the cost of the engagement.

Briefly, business planning engagements that involve the use of historical financial information should be conducted in accordance with

the AICPA's Statements on Auditing Standards (SASs) or Statements on Standards for Accounting and Review Services (SSARSs). In addition, since prospective financial information is the main core of business plans, *Guide for Prospective Financial Information* (April 1997) applies to all business plan engagements that involve a financial forecast or projection for third-party use.

The *Guide* incorporates SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements* (SPFI), and SOP 92-2, *Questions and Answers on the Term "Reasonably Objective Basis" and Other Issues Affecting Prospective Financial Statements.* Also included in the Guide is SOP 90-1, *Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations.* This SOP applies to prospective information that is not intended for general use.

Note that in 1987 the Auditing Standards Board implicitly recognized the difficulty of sorting out all the existing professional guidance by establishing a Financial Forecasts and Projections Task Force whose goals were to identify problems in implementing the SPFI and the *Guide for Prospective Financial Information.* Questions or problems regarding forecasts or projections may be directed to the Task Force as follows: AICPA, Auditing Standards Division, File 2660, 1211 Avenue of the Americas, New York, NY 10036-8775. In addition, the Management Advisory Services (MAS) Practice Standards and Administration Subcommittee issued a Management Advisory Services Special Report in 1988 entitled *Comparing Attest and Management Advisory Services: A Guide for the Practitioner.* See the next section for a discussion of professional standards for management consulting services engagements. In 1991, the Management Advisory Services Executive Committee changed the MAS designation to Management Consulting Services (MCS) to more closely reflect industry usage.

Note that attestation standards—which one might logically think would be applicable to the projected financial information in business plans—in fact do *not* apply. As the Introduction to Statement on Standards for Attestation Engagements *Attestation Standards* states, CPAs should instead follow the guidance provided in SPFI:

> The attestation standards do not supersede any of the existing standards in Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARSs), and Statement on Standards for Accountants' Services on Prospective Financial Information. Therefore, the practitioner who is engaged to perform an engagement subject to these existing standards should follow such standards.

The applicable professional guidance and standards for business planning engagements are discussed in the sections that follow.

5.2.1 Business plans as management consulting services

Developing business plans is a form of management consulting service. The authoritative professional literature on management consulting services is contained in the Statement on Standards for Consulting Services (SSCS) issued by the Management Consulting Services Executive Committee of the AICPA.

Statement on Standards for Consulting Services No. 1, *Definitions and Standards,* requires that MCS consultants be professionally competent and that they exercise due professional care. MCS engagements must be adequately planned and supervised, and sufficient relevant data must be obtained to afford a reasonable basis for conclusions or recommendations.

Among other requirements, SSCS No. 1 requires a CPA who performs a business plan engagement to *reach an understanding with the client.* Although either oral or written understandings are permitted, reducing the understanding to a clear, unequivocal written agreement signed by both parties is the preferable approach.

SSCS No. 1 states that agreements with clients should address:

— Nature of the services

— Scope of engagement, including limitations or constraints

— Roles, responsibilities, and relationships of all parties involved

The following issues may also be made explicit in the agreement for this type of engagement (although not specified in the SSCS):

— Overall approach to the engagement, including major tasks, activities, and methods

— Form and timing of both status reports and the final report

— Work schedule

— Fee arrangement

— Whether historical financial statements will be included in the business plan

— How the client intends to use the business plan (that is, strictly for internal use or for the use of certain contemplated third parties, such as prospective lenders or creditors)

— Whether the accountant's name will be associated with any of the financial information presented (whether historical or prospective)

— Whether specialists will be used (for example, marketing experts)

In discussing fee arrangements, the CPA must take into account all the professional standards that must be met for the engagement and make

sure that the client understands the required work, time commitments, and resulting fees.

After completing the engagement, the CPA should provide a report (oral or written, though, again, a written document should virtually always be prepared) on all significant results, assumptions made (see section 3.7.3 herein for a discussion of financial assumptions used in business plans), and any qualifications or reservations the CPA may have.

5.2.2 Historical financial statements and SSARS No. 1

If a business plan includes unaudited historical financial statements of a nonpublic company, SSARS No. 1, *Compilation and Review of Financial Statements*, issued in December 1988, sets forth the accountant's responsibility as such:

> An accountant should not consent to the use of his name in a document or written communication containing unaudited financial statements of a nonpublic entity unless (*a*) he has compiled or reviewed the financial statements and his report accompanies them, or (*b*) the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that he assumes no responsibility for them.

SSARS No. 1 makes no exception according to the intended use of the statements—that is, business plans that will be used only internally versus those that will be distributed to certain contemplated third parties. The conclusion to be reached, therefore, is that accountants must always indicate their responsibility for historical financial statements included in a business plan.

One exception that SSARS No. 1 does make applies if only *selected* financial information is included in a business plan. Examples include specified elements of financial statements (such as sales figures) or certain accounts. However, a CPA may attest to such specified elements under the Statement on Standards for Attestation Engagements *Attestation Standards.*

5.2.3 Financial Forecasts and Projections

SSAE No. 1, AT sec. 200, "Financial Forecasts and Projections," applies only to complete presentations; essentially, this means full basic financial statements of prospective financial information that is intended for use by third parties.

SSAE No. 1 defines *financial forecasts* as the expected, or best, estimate of future financial results. *Financial projections* is a broader term that includes financial forecasts. Projections are "what if . . ." results

that assume certain specified hypothetical circumstances or courses of action.

CPAs are required to examine or at least compile financial statements submitted to clients (or others) that are intended for third parties (or reasonably expected to be used by third parties). SSAE No. 1 has been amended by SSAE No. 4, *Agreed-Upon Procedures Engagements,* to cover situations where the accountant performs agreed-upon procedures on the prospective financial information. The procedures and reports required depend, of course, on the type of engagement: an examination, compilation, or agreed-upon procedures.

5.2.4 Guide for Prospective Financial Statements

Although the AICPA audit and accounting guide *Guide for Prospective Financial Information* does not have the authority of pronouncements enforceable under rule 202 of the AICPA Code of Professional Conduct, it provides suggestions and recommendations on the preparation and presentation of prospective financial information. A CPA who fails to follow what the guide recommends should be prepared to justify departures from the recommended practice.

Among the many topics covered in the guide are

— Definitions, types, and uses of prospective financial statements.

— Responsibility for prospective financial statements.

— Preparation and presentation guidelines.

— Types of accountants' services.

— Appropriate procedures, representation letters, engagement letters, and reports for compilations, examinations, and agreed-upon procedures.

— Partial presentations.

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APPENDIX 1: Sample Business Plan Outline

I. COVER SHEET
II. TABLE OF CONTENTS
III. EXECUTIVE SUMMARY
  A. Product or service
  B. Market
  C. Objectives, strategies, and critical success factors
  D. Funding needed and purpose
  E. Projected financial performance
IV. ORGANIZATION, MANAGEMENT, AND HUMAN RESOURCES
  A. Organization
    1. Description and history
    2. Legal form and tax status
    3. Locations of headquarters, plants, offices
    4. Achievements and problems (both past and foreseen)
    5. Capital (debt or equity) sought and uses planned
    6. Current and planned capital structure
  B. Management and human resources
    1. Short biographies or resumes of key managers and other personnel
    2. Current and proposed number of employees
    3. Compensation and benefits policies
    4. Union affiliations (present or foreseen)
    5. Management and human resources budget
V. OBJECTIVES
  A. Projected returns, plans to go public
  B. Expected use of resources
  C. Timing of expected use
  D. Methods planned
VI. ACTION PLAN
  A. Detailed, specific, and coordinated steps to be taken to meet objectives specified
VII. MARKETING
  A. Product or service
    1. Description (plus broader implications of product or service sold)
    2. Brand names, if applicable, and prices
    3. Patents, trademarks, copyrights, franchises, or licensing agreements
    4. Budget

B. Market analysis
   1. Target market
   2. Customer preferences and needs
   3. Customers versus end users
   4. Size, history, and trends market
   5. Demographics
   6. Market research

C. Industry analysis
   1. Critical success factors
   2. Projected growth of industry, market, and company
   3. Important risks
   4. Ease of entry into market
   5. Industry patents, trademarks, copyrights, franchises, and licensing agreements
   6. Stage and maturity of the market
   7. Seasonality
   8. Sensitivity to business cycles
   9. Government regulation
   10. Normal credit policies
   11. Advertising and promotion
   12. Trends, fads, and importance of innovations and technological changes
   13. Price sensitivity analyses and possible substitutions
   14. Major competitors
   15. Distribution
   16. Prevailing sales methods

D. Marketing strategy
   1. Attributes of the product or service to be emphasized
   2. Pricing policies
   3. Distribution channels
   4. Service and warranties
   5. Credit policies
   6. Advertising and promotion
   7. Sales personnel or direct-marketing staffing and compensation

VIII. PRODUCTION AND OPERATIONS

A. Description of manufacturing, purchasing (retail), or delivery of services
B. Location, description of plants or offices
C. Capacity and utilization
D. Major cost components (e.g., direct labor versus specific direct material costs)
E. Expansion plans
F. Major fixed assets (current and planned)

G. Make-versus-buy considerations
H. Quality control
I. Changes in production technology and threats from imports
J. Shelf-life, potential obsolescence of inventory
K. Current and expected inventory turnover
L. Discussion of major suppliers
M. Budget

IX. FINANCIAL PRESENTATION AND DATA
A. Feasibility studies
B. Scenarios and time horizons
C. Assumptions
D. Historical financial statements
E. Prospective sales forecasts, cash flow statements, balance sheets, and income statements
F. Other financial analyses (e.g., break-even analyses, financial ratios)

X. SUPPORTING DOCUMENTS AND EXHIBITS
A. Management biographies or resumes (optional)
B. Organizational charts
C. Pictures of product
D. Historical financial statements (optional)
E. Significant contracts or agreements
F. Articles from trade magazines

APPENDIX 2: Sample Format for Financial Statement Projections

BUSINESS PLANS

APPENDIX 2: Sample Format for Financial Statement Projections

Projection of Financial Statements

Submitted By:

				Actual	Projections		
		Spreadsheet in Hundreds ☐	Date	6/30/99	6/30/00	6/30/01	6/30/02
		Spreadsheet in Thousands ☐	Period	1	2	3	4
1		NET SALES					
2	P	COST OF GOODS SOLD					
3	R	GROSS PROFIT		0	0	0	0
4	O	Less: Sales Expense					
5	F	General & Administrative Expense					
6	I	Depreciation					
7	T	OPERATING PROFIT		0	0	0	0
8	and	Less: Other Expense					
9	L	Add: Other Income					
10	O	Gain/(Loss) on Sale of Fixed Assets					
11	S	PRE TAX PROFIT		0	0	0	0
12	S	Less: Income Tax Provision					
13		NET PROFIT		0	0	0	0
14	MEMO	Inventory Purchases					
15		CASH BALANCE (Opening)			0	0	0
16	C	Add: Cash Sales Plus Receivable Collections					
17	A	Other Income		0	0	0	0
18	S	Bank Loan Proceeds					
19	H	Other Loan Proceeds					
20		Proceeds from Fixed Asset Sales					
21	P	TOTAL CASH AND RECEIPTS		0	0	0	0
22	R	Less Disbursements: Trade Payables					
23	O	Other Expense		0	0	0	0
24	J	Operating Expenses		0	0	0	0
25	E	Capital Expenditures					
26	C	Income Taxes					
27	T	Dividends or Withdrawls					
28	I	Bank Loan Repayments					
29	O	Other Loan Repayments					
30	N	Payment on LTD					
31	S	TOTAL CASH DISBURSEMENTS		0	0	0	0
32		CASH BALANCE (Closing)		0	0	0	0
33		ASSETS Cash & Cash Equivalents		0	0	0	0
34		Receivables			0	0	0
35	B	Inventory (Net)			0	0	0
36	A	CURRENT ASSETS		0	0	0	0
37	L	Fixed Assets (Net)			0	0	0
38	A	TOTAL ASSETS		0	0	0	0
39	N	LIABILITIES Notes Payable Banks			0	0	0
40	C	Notes Payable Others			0	0	0
41	E	Trade Payables			0	0	0
42		Income Tax Payable			0	0	0
43	S	Current Portion L T D			0	0	0
44	H	CURRENT LIABILITIES		0	0	0	0
45	E	Long Term Liabilities			0	0	0
46	E	TOTAL LIABILITIES		0	0	0	0
47	T	NET WORTH Capital Stock			0	0	0
48		Retained Earnings			0	0	0
49		TOTAL LIABILITIES AND NET WORTH		0	0	0	0

BUSINESS PLANS App. 2

HOW TO USE THE FINANCIAL STATEMENT PROJECTION TEMPLATE

The Financial Statements projection is presented as an interactive template and may be completed by the banker, the customer, or both working together. It is designed to be flexible and may be used as a

1) Projection tool to provide a picture of the customer's present and future financial condition. Actual and estimated financial data form the basis of the calculations.
2) Tool for Analysis of the customer's borrowing needs and debt repayment ability.
3) Budget to aid in planning for the customer's financial requirements and repaying the banker's credit accommodation.

INSTRUCTIONS In the first column, enter the actual PROFIT AND LOSS STATEMENT and BALANCE SHEET of the date immediately prior to projection period. Then, in each subsequent column, covering a projection period (e.g. month, quarter, annual).

- Enter on the "date" line, the ending date of each projection period (e.g. 1/31, 3/31, 19____).
- Then follow the line-by-line instructions below.

Line No	Title	Instructions
PROFIT AND LOSS STATEMENT		
1	NET SALES	Enter the actual or beginning net sales figure in the first vertical column. We suggest you project future net sales based upon a % sales increase or decrease. Estimate acceptable % figure and record here _____%. (This % is generally calculated based on historical changes in net sales. However, consideration must also be given to factors, such as general business conditions, net products and services, and competition.)
2	COST OF GOODS SOLD	Enter all relevant components of customer's cost of goods sold calculation. Project future cost of goods sold based upon % increase or decrease. Estimate acceptable percentage figure and insert here _____%. (This figure is generally based on an increase or decrease. Estimate acceptable percentage.
3	GROSS PROFIT	Line 1 minus line 2. This field is automatically calculated and protected from overwrite.
4 through 6	Sales Expense, Other Expense, General and Administrative Expense.	Enter all items. Project future expenses based on an increase or decrease. Estimate acceptable percentage figure and insert here _____%. (This figure is generally estimated as a percentage of sales based on prior years. Anticipated increases in major expenses, such as lease, officers' salaries, etc. should also be considered).
7	OPERATING PROFIT	Line 2 minus the sum of lines 4 through 6 (calculated).
8 through 10	Various adjustments to Operating Profit	Enter all items and estimate future adjustments (e.g. rents received, interest earned, gain (loss) on asset disposals, and miscellaneous income).
11	PRE-TAX PROFIT	Line 3 minus the sum of lines 8 through 10 (calculated).
12	Income Tax Provision	Common methods used for calculating Income Tax Provision include the must current year's tax as a % of the Pre-Tax Profit.
13	NET PROFIT	Line 7 minus the sum of lines 8 through 15 (calculated).

MEMORANDUM ENTRY

14 Inventory Purchases — This input is necessary for calculation of inventory and trade payables (line 35 and line 41) in the balance sheet section. If inventory purchase figure is not available, calculate balances based on historic turnover ratios.

CASH PROJECTION CALCULATION

15 CASH BALANCE — Enter opening cash balance. For subsequent periods, the closing cash balance (Line 32) from previous period is automatically carried forward in the template. Or, enter an adjusted amount to reflect a desired cash balance.

16 Receipts — Enter total cash sales plus receivables collection. Receivable collections must be calculated separately. This requires an analysis of the customer's sale and collection patterns.

(1) Estimate the portion of each month's sales collected in that month and subsequent months.
(2) From the sale's figure last month and the previous month(s), calculate how much of the existing receivable figure will be collected in the current month.
(3) Deduct the collected receivables balance calculated in (2) above from the month-end balance of accounts receivables.
(4) Add this month's sales figure to the remainder of receivable calculated in (3) above. This figure is the new accounts receivable figure for the end of the current month.

EXAMPLE

Assumptions: Projection calculation - monthly

Monthly net sales	9/30 - $250M
	10/30 - $300M
	11/30 - $150M
Accounts Receivable Balance	9/30 - $250M
	10/30 - $367M

The average collection period is 45 days. This means that 66.7% (30 days:45 days) of each month's sales will be collected the following month and the remaining 33.3% in the second month.

To determine receivable collections for November

Accounts Receivable Balance	10/30		$367M
Deduct 66% of 10/31 sales		200M	
33% of 9/30 sales		83M	283M
			84M
Add 11/30 sales			150M
Accounts Receivable Balance, 11/30			$234M

17 Other Income — Automatically transfers from entry on line 9.

18 Bank Loan Proceeds — Enter actual or projected bank loan proceeds on line 18.

19 Other Loan Proceeds — Enter any other loan proceeds on line 19.

20 Fixed Asset Proceeds — Enter cash amount received for sale of assets during the period on line 20.

21	TOTAL CASH AND RECEIPTS	Sum of line 15 through 20 (calculated)
22 through 30	Disbursements	Enter actual or estimated cash disbursements on these lines. Except, note line 23 and 24, other and operating expenses automatically transfer from the Profit and Loss section - lines 4, 5, and 8.
31	TOTAL DISBURSEMENTS	Sum of lines 22 through 30 (calculated).
32	CASH BALANCE (Closing)	Line 21 minus line 31 (calculated). Note: The closing cash balance on line 32 is automatically entered on line 15 in the next column. However, if the closing cash balance is negative or below the desired opening cash balance, then bank loans (line 18 and 19) may be needed to raise the closing cash balance to zero, or to the desired opening cash balance. The bank loan necessitates planning for repayment (line 28 and 29) in subsequent columns.
BALANCE SHEET		
(33 through 37)	ASSETS	
33	Cash and Equivalents	The closing cash balance (line 32) automatically transfers for all periods.
34	Receivables	Enter actual receivables in the first column, only Spreadsheet automatically projects subsequent amounts using previous receivables figure plus projected net sales (line 1), minus projected cash sales and receivables collections (line 19).
35	Inventory	Enter actual inventory in the first column, only. Spreadsheet projects subsequent periods by adding purchases (line14) to beginning inventory. Then subtracting materials used (line 2) to calculate the ending inventory amount.
36	Current Assets	Sum of line 33 through 35 (calculated).
37	Fixed Assets (Net)	Enter fixed assets in first column. Spreadsheet projects subsequent periods by, adding previous year's fixed asset balance to fixed asset additions (line 25) and loss on sale of fixed assets (line 10). Then, deduct amount received from sale of asset (line 20), any gain on fixed asset sale (line 10) and depreciation expense (line6).
38	TOTAL ASSETS	Sum of lines 33 through 37 (calculated).
(39 through 46)	LIABILITIES	
39	Notes Payable-Banks	Enter first column, only. Spreadsheet projects subsequent periods using prior period balance plus loan proceeds (line 18), less repayments (line 28).
40	Notes Payable-Others	Enter first column, only. Spreadsheet projects subsequent periods using prior period balance plus note proceeds (line 19), less repayments (line 29).
41	Trade Payables	Enter first column, only. Spreadsheet projects subsequent periods using prior period balance plus purchases (line 14) less payments (line 22).
42	Income Tax Payable	Enter first column, only. Spreadsheet projects subsequent periods by adding prior period balance to income tax provision (line 12) and deducting income taxes paid (line 26).

43	Current Portion Long-Term Debt	Enter first column, only. Spreadsheet projects subsequent periods current maturities equal to the first column payments. Changes will need to be made to subsequent periods current portion of long term debt, if this assumption is not true.
44	CURRENT LIABILITIES	Sum of lines 46 through 51 (calculated).
45	Long-Term Liabilities	Enter long-term liabilities in first column, only. Spreadsheet projects subsequent periods by addition of the previous period long-term debt (line 45) to current portion (line 43) less loan payments (line 30). Note: Additions to long-term debt have been assumed to be zero, if additions occur adjustments to the template will be necessary.
46	TOTAL LIABILITIES	Sum of lines 39 through 45 (calculated).
(47 through 48)	NET WORTH	
47	Capital Stock	Enter current capital stock figure in first column, only. An increase will occur if capital stock is sold, a decrease will occur if existing stock is repurchased or retired. Spreadsheet assumes no changes to capital stock for subsequent periods.
48	Retained Earnings	Enter first column, only. Spreadsheet will calculate subsequent periods by adding prior period retained earnings to projected net profit (line 13), and deducting dividends or withdrawals (line 27)
49	TOTAL LIABILITIES AND NET WORTH	Sum of lines 46 through 48 (calculated).

NOTE: Additional rows may need to be inserted in the appropriate section of the template to allow for items not included in the example due to space limitations (e.g. other current or non-current assets, stockholder receivables, intangibles, current or long term liabilities, equities, etc.). If rows are inserted in the template, formulas may be affected, therefore, adjustments to formulas within the template will also be necessary.

APPENDIX 3: Business Planning Software

This exhibit lists software that can be used to help assemble business plans.

Adarus® Business Plan, Adarus Software, LLC. Develop a professional business plan quickly and easily with the help of four easy-to-use step-by-step wizards (sales, expense, asset/loan, business plan). The Microsoft Excel add-in and template create financial reports needed for a business plan, such as the cash flow, income, balance sheet, break-even, and financial ratios. A formatted business plan outline (title page, table of contents) is created in Microsoft Word. $59.95. www.adarus.com/.

Automate Your Business Plan, Linda Pinson. Designed for novices, this is a standalone software program, rather than a set of templates that depends on third-party software for compatibility and support. This software presents a step-by-step planning process that enables the user to organize industry expertise into a working business plan that will attract capital and ensure success. Automate Your Business Plan is now being used in every SBA Business Information Center, Women's Business Development Center, and 1-Stop Capital Shop in the United States. $80. www.business-plan.com/.

BizPlanBuilder®7.0, JIAN. This package includes spreadsheet and word-processing documents covering the entire spectrum of business plans. The software uses spreadsheet-based tools, including standalone financial model templates (for start-ups or established companies), investor tracking, proceeds from sale of business, space requirements worksheet, and stock option tracking. Word documents include Application for Business Credit, Articles of Incorporation, Commercial Lease Agreement, Core Practices, Core Values, Due Diligence Checklist, General Partnership Agreement, Independent Contractor Agreement, Invitations to Join Board of Directors/Advisors, Loan Proposal Summary Letter, Trademark Application, Press Release to Announce Your New Company, and Private Offering Cover Disclaimer. $99.95. www.jian.com/.

Business Plan Manual/Your Plan, My Business Analyst.com. This software package includes professionally written templates already formatted in Word and Excel documents. The narrative description is organized into more than 90 pages of consciously scripted text: compelling headlines, sentences, whole paragraphs, tables, and lists. Sections include Executive Summary, Vision and Mission, Present Situation,

Goals, Objectives, Company Overview, Legal Business Description, Management Team, Board of Directors, Strategic Alliances, Product Strategy, Current Product, Research and Development, Production and Delivery, Market Analysis, Market Definition, Customer Profile, Competition, Risk, Marketing Plan, Sales Strategy, Distribution Channels, Advertising and Promotion, Public Relations, Financial Plan, Assumptions, Financial Statements, Capital Requirements, Exit/Payback Strategy, Conclusion, Supporting Documents, Integrated Financial Spreadsheets and Basic Financials. $189. www.mybusinessanalyst.com/.

Business Plan Master, Versatile Software Solutions, Inc. Available in both a standard and professional version, the software includes template files for Lotus, Excel, Word, WordPerfect, and Works for Windows with online documentation. Also included are some very useful "bonus" files, such as amortization schedules, graphs for charting business growth, personal financial statement, and a nondisclosure form, among others. $44. www.vssi.net/.

Business Plan Pro, Palo Alto Software, Inc. This business plan software package integrates with Marketing Plan Pro and Web Strategy Pro software, without overlap, to create a business plan and a corresponding Internet strategy. Demo available. $89.95. www.paloalto.com/.

Business Plan Toolkit Version 7.0, Palo Alto Software, Inc. Macintosh users may create a comprehensive business plan that is simple enough for novices, yet detailed enough for pros. $79.95. www.paloalto.com/.

Business Plan Writer®, Graphite Software, Inc. This package enables entrepreneurs to create high-quality business plans for the purposes of obtaining financing or charting a course for their enterprises. There is no new software to learn with this product because preformatted model text and spreadsheet documents work directly with users' existing word processor and spreadsheet programs. Users replace the existing text in the model text templates with their own words and replace the existing sample data in the prebuilt spreadsheets with their business numbers by following the guidelines embedded in the model business plan and appendices. A comprehensive User's Guide provides further mentoring. $44. www.graphitesoftware.com/.

Exl-Plan (pronounced X-L-PLAN), Invest-Tech Limited. Included are a range of powerful, easy-to-use shareware packages for preparing, for example, comprehensive financial projections, budgets, and business plans for six months and one, three, five or seven years ahead. They can also be used as a tool for strategic and corporate planning, business

restructuring, financial appraisals, and performance monitoring within almost any size business. Packages incorporate comprehensive facilities and features and are suitable for managers and business people with minimal previous experience of financial or business planning, as well as for experienced planners, accountants, consultants and model builders. Exl-Plan is distributed as shareware and freeware ($0–$249 to register). www.planware.org/.

PlanMagic Business, PlanMagic Corporation. This package features an easy-to-use browser interface, which guides the user through the planning process, product line analysis, detailed marketing, and sales and cash-flow forecasts. All the financial sheets are in an easy-to-use Finance Pro module, which offers automatic calculations, automatic ratios, automated charts, and much more. $84.95. planmagic.com/.

PLANMaker, POWERSolutions for Business. This standalone business planning software features a unique tutorial system to go step-by-step through the entire business planning process. Users can cut and paste from any of the three professionally written sample business plans that are included. These sample business plans can assist in the start-up business planning stages by fine-tuning business concepts and business strategy. Formatting, pagination, and projected fiscal layout are automatic business planning tools incorporated into PLANMaker's business plan software. $129. www.planmaker.com/.

Plan Write® for Business, Business Resource Software, Inc. Software contains the knowledge and the tools to help users document a plan including Internet, traditional, product, or service business plans. Not only can users print a polished and complete business plan, the software also allows users to create easily a document ready to be published to the Internet. Plan Write for Business creates the HTML and graphic files as well as a Table of Contents hyper-linked to the business plan. Once the files have been created, the business plan may be placed on a secure Web site. $129.95. www.businessplansoftware.org/.

Quick Plan™2000, Demand Creation, Inc. The only complete industry-specific business plan, this software is available for these industries: Restaurant (full service, limited service, fast food, bakeries, caterers, night clubs, themed, expansions, and franchised), Pizzeria, Specialty Coffee, Salon and Day Spa, Bed and Breakfast, Hotel, and Internet Start Up. Saves hours of research by providing detailed assumptions about the latest industry trends. $195–$295. www.quickplan.com/.

APPENDIX 4: Sample Cash Flow Statement Format

(All figures except units are in dollars.)

	Period 1	*Period 2*	*Period 3*	*Period 4*	*Period 5*	*Period 6*	*Period 7*	*Period 8*	*Total*
Sources of cash									
Units sold									
Price/unit									
Net sales									
Cash collections on sales									
Stock issued									
Short-term borrowings									
Long-term borrowings									
Other									
Net sources of cash									
Uses of cash									
Units purchased									
Cost/unit									
Cash paid for purchases									
Labor									
Management									
Marketing/sales									
Administration									
Rent and utilities									
Taxes and fees									
Interest expense									
Fixed assets purchased									
Short-term debt repaid									
Long-term debt repaid									
Dividends									
Net uses of cash									
Net cash flow/period									
Cumulative cash flow									

	Period 1	*Period 2*	*Period 3*	*Period 4*	*Period 5*	*Period 6*	*Period 7*	*Period 8*	*Total*
Selected balance sheet accounts									
Beginning balance									
Cash									
Accounts receivable									
Inventory									
Fixed assets									
Total assets									
Accounts payable									
Short-term debt									
Long-term debt									
Equity									
Total liabilities & equity									
Additional data:									
Average days in receivables									
Average days in payables									
Average rate on loans									

Also, see *Toolkit CD-ROM* for an Excel worksheet of this form.

APPENDIX 5: Sample Business Plan

MERRILL ENTERPRISES, INC.: New Business Proposal

Table of Contents

*These supporting documents have been omitted.

Statement of Purpose

Merrill Enterprises, Inc., is seeking capital of approximately $400,000 to purchase an existing Class B or Class C FM radio station in the United States.

The acquired FM station will have tangible and intangible assets whose market value will be approximately $1 million. Merrill Enterprises

(Text continued on page 39)

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will make an equity investment of $10,000, which together with other equity and debt financing, will be sufficient cash reserves, and provide adequate working capital to expand an existing market share in listeners and advertising revenues. These funds will finance the transition through an expansion phase which will allow the station to operate as an ongoing, highly profitable business entity.

PART I: THE BUSINESS

Business Strategy

The overall strategy of Merrill Enterprises is to identify and acquire an FM station that has the potential to be a first-class technical facility and does not compete directly with one or more stations owned by the large conglomerates that control a dominant share of the market.

Only stations that satisfy these two conditions will be possible acquisition candidates.* The rationale for this acquisition policy is that billings (and ultimately profitability) are a function of listenership and ratings which, in turn, are functions partly of coverage and the ability of a station to be heard relative to its competitors. Consequently, a powerful technical facility is a necessary condition of future growth in any given market.

For various reasons, an acquisition candidate may not have realized its full technical and marketing capability. Merrill Enterprises will identify such stations and the changes required to realize full potential. Upon successful acquisition, Merrill Enterprises will implement these changes.

The market needed to sustain a technically powerful station must be a relatively large one in order to achieve high profitability. However, the particular market cannot be dominated by one (or a few) station(s) with access to substantial capital and managerial resources. Capturing market share from such a competitor will prove to be both difficult and risky as a long-term strategy.

Key Objectives, Policies, and Plans

The key corporate objectives are to acquire and operate an FM station in the second 50's market† which has the potential to produce:

1) Sales of approximately $2 million in five years (15 percent growth rate);

---

*The acquisition candidates may also include: 1) stations that have both AM/FM licenses and are being sold as a package; 2) AM stations that have a Construction Permit to establish an FM station.

†Market size is determined by ratings of the American Research Bureau, on the basis of net weekly circulation for the most recent year. The selling prices of FM stations in the first 50's markets will be beyond our purchase capability.

2) Operating profits of 50 percent of net revenues within five years of acquisition;

3) Profit before taxes of 15 percent of net revenues within five years of acquisition.

The principal policies are:

1. Acquisition Policy

Only stations with upside potential from technical and marketing changes will be considered. Given available financial resources and future objectives, FM stations with annual billings of approximately $400,000 to $500,000 will be possible candidates. At an industry multiple of 2 to 2 1/2 times sales, the price range will be approximately $800,000 to $1,250,000 for an FM station with these billings.

2. Marketing Policy

Our marketing policy is to identify the market segments and programming which provide the optimum coverage given the geographic scope of our radio signal.

This policy may seem overly general to individuals who are unfamiliar with the radio broadcasting business. Nevertheless, the general nature of this policy is its strength in that it recognizes the unique situations of most radio stations. It is flexible in spirit and recognizes that pat marketing formulas generally do not work when applied "across the board."

3. Technical Facility Policy

Our policy is to create and maintain the best technical FM facility in terms of coverage and ability to be heard relative to local competition. This policy requires the acquisition of a Class B or Class C station.

NOTE: The FCC grants commercial licenses to three types of FM stations. Class A stations are licensed throughout the United States. However, they are low powered with a maximum of 3 Kw of power. Both Class B and Class C stations are licensed in noncompeting sections of the United States and have considerably higher power capabilities which provide them with a competitive edge.

4. Financial Policy

Our principal financial policy is to limit debt financing within acceptable boundaries to provide:

1) Adequate cash flow for operations;

2) Above-average returns for equity investors.

The present market for FM stations is one which requires a buyer to have established lines of equity capital *before* entering negotiations for a specific site. FM stations with potential do not remain long enough on the market; consequently, prospective buyers must be capable of entering meaningful negotiations quickly and from a position of financial strength when an opportunity presents itself.

Key Skills and Resources

A quality broadcasting property is a scarce commodity. One reason they are scarce is because the FCC limits the supply of all broadcasting stations. But within the existing supply of stations, the acquisition of a station with a high-quality potential is also affected by the ability of potential owners to—

1) Find and identify a property with upside potential;
2) Negotiate a sale at a favorable price and terms;
3) Seek FCC licensing approval in an efficient and effective manner;
4) Identify and implement the steps needed to realize the station's full potential.

Merrill Enterprises has the expertise to successfully realize the above requirements. The principal skills possessed by Merrill Enterprises are the skills, capabilities, and experience embodied in its president, Mr. David Merrill.

The track record of Mr. Merrill speaks for itself (see Personal Resume in Section III*). He has demonstrated a strong management capability with the special ability to turn marginal FM stations into much improved performers. While he has had numerous successes in his 20-year career in the radio business, his current position as General Manager of one of the top hundred stations in the United States has demonstrated particularly that he can handle even the bleakest of situations and is capable of taking proper and decisive action when required.

Overall, Mr. Merrill brings together several skills not usually found in a single person in the radio broadcast business. He has an above-average knowledge of the technical aspects of broadcasting. He is one of the best FM marketing managers in the United States. He has numerous contacts throughout the industry, which will provide a source of acquisition candidates and management technical personnel. He has a working knowledge of FCC regulations and an established relationship with them. He has strong sales and sales management capability. Finally, he has developed the skills needed for general management.

*Omitted from this sample plan.

Furthermore, Mr. Merrill is willing to relocate anywhere in the United States where a high-potential FM radio station is discovered and acquired.

Management and Personnel

Mr. Merrill will be president and general manager of the acquired station. Prior to takeover, he will staff the station with the best available personnel.

Personal Objectives of Mr. David Merrill

Mr. Merrill's personal objectives are:

1) to apply his management experience and expertise in the FM radio business;
2) to obtain a majority equity position in an FM radio station in order to fully exercise his capabilities.

Relevant Industry Trends

A number of industry trends are emerging which are relevant to this investment proposal.

These trends include the following:

1) Several sources indicate that:
   a) FM stations have performed well above average as a group, especially those stations employing a "beautiful music" format (see "FMs Continue to Show Strength in Latest Arbitron Sweep." Section III*);
   b) FM stations have achieved their growth at the expense of AM radio stations (see "Cox Study." Section III*);
   c) FM stations have achieved a position of strong positive cash flow which is expected to improve even further by 199X ("Cox Study." Section III*).

2) Market surveys indicate that radio listening habits are becoming more diverse. This trend suggests that creative marketing, including program definition, will become even more critical in the future. (See "Arbitron Sweep Shows Listening Habits Diversifying." Section III*).

3) The expectation is that independent FM stations in the top 125 markets will experience a sales growth of 25% to 30% in 199X. (See "Doherty Memo." Section III*).

Excerpts from an FCC publication, "The Nature of American Broadcasting," present other trends relevant to this proposal. It is included in Section III*.

PART II: FINANCIAL DATA

Sources and Applications of Funds

The likelihood is that the search process for an FM station will uncover two kinds of potential acquisitions.

One kind is the FM station that has a facility with appropriate technical capability in place. The second kind is a station that does not have the appropriate facility but, for example, possesses a construction permit to establish the required plant and equipment. Our assumption is that the asking price for the former facility will be considerably higher than the station requiring incremental capital investment. Consequently, the application of funds will differ for the two different kinds of acquisitions.

Exhibit 1 shows a sources and applications statement assuming no incremental investment in plant and equipment.

Exhibit 2 presents a similar statement assuming additional plant and equipment are required to achieve FM Class B or C status.

Professional and ethical considerations will require Mr. Merrill to inform his present employers that he intends to actively seek an FM station for purchase. He will probably have to relinquish his present position at the time he announces his intentions.

However, Mr. Merrill estimates that it will require between six to twelve months to locate, negotiate a purchase, and obtain FCC approval for the transfer of ownership. During this interim period, Mr. Merrill requires a salary that will allow him to meet his existing financial commitments. This salary is figured at an annual rate of $45,000.

Balance Sheet, P&Ls, and Cash Flow

The following exhibits demonstrate the potential of Merrill Enterprises to generate cash and profits.

Exhibit 3 shows a simple, opening balance sheet.

Exhibits 4 and 5 present a balance sheet and income statement for a potential acquisition XYZ, which is an "average" operation according to industry statistics.

Exhibit 6 shows the effect of acquiring XYZ on the balance sheet of Merrill Enterprises.

Exhibit 7 presents the consequences of retiring XYZ's debt immediately after acqusition.

Exhibits 8-12 provide income statements, cash flows, and balance sheets for Merrill Enterprises after one year of operations.

Exhibit 13 provides a five-year projection of income. One major assumption is that the company attains its five-year goal of reducing operating expenses to 50 percent of sales. A second assumption is that a 25 percent growth in sales is realized in year three from marketing changes instituted by Mr. Merrill during the previous two years.

Exhibit 1
Sources and Applications of Cash
(No Incremental P&E)

Sources		
	Mr. David Merrill	$ 10,000
	Venture Capital	400,000
	Bank Loan	800,000
	Total	$1,210,000
Applications		
	Purchase Stock of Station	$1,050,000
	Working Capital	100,000
	Reserve for Contingencies	15,000
	Pre-purchase salary for Mr. Merrill	45,000
	Total	$1,210,000

Exhibit 2
Sources and Applications of Cash
(Incremental P&E Investment)

Sources		
	Mr. David Merrill	$ 10,000
	Venture Capital	400,000
	Bank Loan	800,000
	Total	$1,210,000
Applications		
	Purchase Stock of Station	$ 800,000
	Plant, Equipment & Renovations	250,000
	Working Capital	100,000
	Reserve for Contingencies	15,000
	Pre-purchase salary for Mr. Merrill	45,000
	Total	$1,210,000

Exhibit 3
Balance Sheet for September 1, 19X1

Assets		**Liabilities and Equity**	
Cash (Equity)	$ 410,000	Long-Term Debt	$ 800,000
Cash (Bank loan)	800,000	Equity	410,000
Total Assets	$1,210,000	Total Liabilities and Equity	$1,210,000

Exhibit 4
Balance Sheet for December 31, 19XI
of Acquisition Company XYZ

Assets		**Liabilities**	
Cash	$ 6,889	Accounts Payable	$ 41,667
Accounts Receivable	76,444	Notes Payable	13,050
Prepaids	2,640	Accrued Expense	14,711
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	$ 95,748	Total Current	$ 86,750
Net P&E	200,000	Net Long-Term Debt	86,286
Net Goodwill	103,527	Total Equity	226,239
Total Assets	$399,275	Total Liabilities and Equity	$399,275

Notes for Exhibit 4

The figures in Exhibit 4 are derived from the operations of an actual station that is considered a representative example.

Cash — Cash balances are traditionally low in the radio business. The equivalent of about 5.7 days is assumed in this example.

A/R — Projected at about 63 days. 435,000/360 × 63 = 76,444.

Deferred — Reciprocal Expenses and Revenues are trade accounts where radio advertising time is exchanged for goods and services. They are projected conservatively to show a net liability.

P&E — Plant and equipment. Estimated by Mr. Merrill.

Goodwill — Estimated from private source.

Accounts Payable — Projected at 35 days based on sales since information was not available for "purchases" nor "cost of goods sold."

Notes Payable — The current portion of long-term debt.

Exhibit 5
Income Statement for December 31, 19XI
of Acquisition Company XYZ

Sales	$435,000	100%
Agency Commissions	52,519	−12
Net Sales	382,481	88
Operating Expenses (includes Depreciation)	304,994	−70
Operating Income	77,487	18
Other Expenses (interest, amortization)	12,487	− 3
Profit before Taxes	65,000	15
Taxes	19,700	− 5
Net Profit	45,300	10
Depreciation	12,900	+ 3
Approximate Cash Flow	58,200	13

Notes for Exhibit 5

Agency commissions, operating expenses, other expenses, taxes, and depreciation in Exhibit 5 are derived from the operations of an actual station that is considered a representative example.

These calculations are supported by the National Association of Broadcasters (NAB) data which show that the average pre-tax profit of FM stations with sales in the $500,000 range is 14–15 percent of sales.

Exhibit 6
Balance Sheet for January 19X2
Merrill Enterprises, Inc.

(Buys Station XYZ for $1,050,000 with net tangible assets of $122,712.)

Cash	$ 160,000	A/P	$ 41,667
Cash	6,889	N/P	13,050
Accounts Receivable	76,444	Accrued Expense	14,711
Prepaids	2,640	Deferred Reciprocal Revenue	17,322
Deferred Reciprocal Revenue	9,775	Total Current	86,750
Total Current	255,748		
P&E	200,000	Long-Term Debt	86,286
		Long-Term Debt	800,000
Goodwill	927,288		
		Total Liabilities	973,036
		Equity	410,000
Total Assets	$1,383,036		$1,383,036

Notes for Exhibit 6

Net tangible assets = 122,712 = (from Exhibit 4)
(95,748 + 200,000) minus (86,750 + 86,286)

Cash = 160,000 = (1,210,000 – 1,050,000) + 6,889 from cash account of acquired company.

All other current assets and liabilities from acquisition company.

P&E = Plant and equipment subtracted from Exhibit 4

Goodwill = difference between selling price (1,050,000) and net tangible assets (122,712).

Exhibit 7
Balance Sheet for January 2, 19X2
Merrill Enterprises, Inc.

Given excess working capital position, assume Note Payable and respective long-term debt are retired immediately.

Cash	$ 67,553	A/P	$ 41,667
A/R	76,444	Accrued Expense	14,711
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	156,412	Total Current	73,700
P&E	200,000	Long-Term Debt	800,000
Goodwill	927,288	Equity	410,000
Total Assets	$1,283,700		$1,283,700

Notes for Exhibit 7

Cash balance of $166,889 reduced by 13,050 + 86,286 to $67,553.

Exhibit 8
Income Statement for December 31, 19X2
Merrill Enterprises

Sales (15% growth assumed)	$500	100%
Agency Commissions	60	12
Net Sales	440	88
Depreciation	20	4
Operating Expenses	305	61
Operating Income	115	23
Interest	45	9
Amortization	45	9
Pre-Tax Profit	25	5
Tax	4	1
Profit After Tax	21	4
Depreciation & Amortization	65	13
Cash Flow	86	17

Notes for Exhibit 8

This pro forma is actually quite conservative since it reflects no significant reduction of costs which Mr. Merrill states is usually possible when taking over most FM properties. For instance, it is not unusual to find a station that is overstaffed. Still, we have projected operating expenses plus depreciation at 65 percent of sales. At the pre-acquisition sales level of $435,000, this is equivalent to 75 percent of sales. ($325,000/435,000). Even under these conservative conditions, a profit after tax is realized plus a cash flow equivalent roughly to a 20 percent return on equity.

Exhibit 9
Cash Flow for 12 Months Ending December 31, 19X2
Merrill Enterprises

Sales	$500,000
Cash Inflows:	
Collection of January 1, 19X2 A/R	76,444
Cash Receipts from 19X2 sales (45-day lag)	437,500
Total Cash Inflows	513,944
Cash Outflows:	
Operating Expenses	305,000
Debt Service (interest only required)	45,000
Commissions (12 percent of sales)	60,000
Income Tax Estimates	4,000
Total Cash Outflows	414,000
Net Cash Flow	$ 99,944

Exhibit 10
Changes in Balance Sheet Derived from 12 Months P&L and Cash Flow Statements

Cash	+	$99,944	Acct's Pay. plug — 1956	
Acc'ts Rec.	–	13,944	Accrued + 1956 held at 12 days	
Plant & Equip.	–	20,000	Deferred Reciprocal Revenue —no change	
Goodwill	–	45,000	Long-Term Debt & Equity — no change	
Prepaids & Deferred Reciprocal Expense		0	Retained Earnings + $21,000	
Total		$21,000	Total	+$21,000

Notes for Exhibit 10

Cash is derived from net cash flow of Exhibit 9 which is slightly higher but more accurate than rough cash flow shown in Exhibit 8.

Accounts Receivable is also derived from Exhibit 9 (sales $500,000 – cash receipts of $437,500 – $76,444 January 1, 19X2 A/R).

Plant and equipment is depreciated straight-line over ten years ($200,000/10) – $20,000.

Goodwill is amortized over 20 years. Actual figure is $46,364, but this was rounded to $45,000.

No change was assumed for prepaids, deferred reciprocal expenses and revenues, long-term debt, equity.

For conservatism, accrued expenses were held at a rate equivalent to 12 days of sales over 360-day year.

Exhibit 11
Balance Sheet for December 31, 19X2
Merrill Enterprises

Cash	$ 167,497	Accounts Payable	$ 39,711
Accounts Receivable	62,500	Accrued Expense	16,667
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	242,412	Total Current	73,700
Plant & Equipment	180,000	Long-Term Debt	800,000
Goodwill	882,288	Equity	410,000
		Retained Earnings	21,000
	$1,304,700		$1,304,700

Exhibit 12
Balance Sheet for January 1, 19X3
Merrill Enterprises

Cash Position Reduced to Retire 1/8th of Long-Term Debt and Make Dividend Payment to Preferred Stockholders

Cash	$ 48,497	Accounts Payable	$ 39,711
Accounts Receivable	62,500	Accrued Expense	16,667
Prepaids	2,640		
Deferred Reciprocal Expense	9,775	Deferred Reciprocal Revenue	17,322
Total Current	123,412	Total Current	73,700
Plant & Equipment	180,000	Long-Term Debt	700,000
Goodwill	882,288	Equity	412,000
Total Assets	$1,185,700		$1,185,700

Notes for Exhibit 12

Cash accounts reduced to adjust for principal payment of long-term debt ($100,000) and dividend payment ($19,000). Acid test or liquidity ratio still about 1:0.

Exhibit 13
Five-Year Income Projection

Growth Rate:	15%	15%	25%	15%	15%
End of Year:	1	2	3	4	5
Sales	500	575	719	827	951
Agency Commissions	60	69	86	99	114
Net Sales	440	506	633	728	837
Expenses					
Depreciation	20	20	20	20	20
Other Operating*	305	334	395	430	475
Operating Income	115	152	218	278	342
Other Expenses					
Interest	45	45	45	45	45
Amortization	45	45	45	45	45
Profit Pre-Tax	25	62	128	188	252
Taxes	6	18	50	79	109
Net Profit	19	44	78	109	143
Depre. & Amort.	65	65	65	65	65
Cash Flow	84	109	143	174	208
*As a % of Sales	61%	58%	55%	52%	50%

Breakeven Analysis

Radio broadcasting is a relatively high fixed-cost business. The only variable cost element that changes month-to-month with sales is commissions. These commissions include payments to agency and internal sales personnel.

Consequently, the basic cost structure of the business is:

Sales	=	100%
Variable Costs	=	27%
Contribution		73%

Using a contribution margin of 73 percent, we can calculate a sales (profit) breakeven and a cash breakeven.

As noted in Exhibit 8, the percentage of agency commissions to total sales is 12 percent. The difference between 12 percent and 27 percent (total variable costs) represents commissions paid to representatives and manager overrides. This 15 percent amounts to $75,000, which is included in operating expenses of Exhibit 8. Once removed, total fixed costs are:

$$\$340,000 = (\$305,000 - 75,000) + 20,000 + 45,000 + 45,000$$

Consequently, "profit" breakeven is:

$$\$466,000 = \frac{\$340,000}{.73}$$

By removing non-cash expenses (depreciation and amortization of goodwill), a "cash" breakeven can be calculated as:

$$\$377,000 = \frac{\$340,000 - 20,000 - 45,000}{.73}$$

These breakevens represent, respectively, 93 percent and 75 percent of gross sales.

Risk Analysis

Compared to most new venture investments, the risks associated with the proposed venture are considerably lower.

One reason for this lower risk is that the product (FM broadcasting) is a known and successful medium. Also, FM and FM/AM combinations appear to be entering the growth phase of their product life cycles and supplanting the more mature AM radio broadcasting.

A second reason for lower risk is that the entrepreneur in question is deeply familiar with the proposed business. He has direct management experience with the product, as opposed to someone with a new product but no experience managing a business built around the product.

A third reason is that the proposal calls for the acquisition of an ongoing business, as opposed to a startup. This will maximize Mr. Merrill's strengths as quickly as possible.

Fourth, a minimum amount of capital will be exposed before an FCC licensing decision is reached. The sum in question is approximately $20,000 to $25,000 for Mr. Merrill's salary during this interim period. Also, the estimated probability of denial is extremely low given the FCC's goals.

TRADE AND PROFESSIONAL ORGANIZATIONS

This chapter contains names and addresses of leading governmental and professional trade organizations and associations roughly grouped to correspond to the chapter content of the *Accountant's Business Manual.* Where possible, Web site addresses have been added.

These organizations have been selected because they publish materials and provide information to their members and to the general public. These organizations are excellent sources for the most current practices and latest developments within their interest groups.

At the end of the chapter is a reference list of publications that provide additional information about the organizations listed here plus many other federal, state, and private agencies and organizations. These publications should be consulted as thorough, cross-reference finding sources for a wealth of information in business, government, economics, and finance.

BANKRUPTCY/ INSOLVENCY

Governmental

Administrative Office of the U.S. Courts, Bankruptcy Div.
Thurgood Marshall Federal Judiciary Bldg.
One Columbus Circle, N.E.
Washington, D.C. 20544
(202) 273-1900

Nongovernmental

American Bankruptcy Institute
44 Canal Center Plaza, Ste. 404
Alexandria, VA 22314
(703) 739-0800
www.abiworld.org

Association of Insolvency Accountants
132 W. Main, Ste. 200
Medford, OR 97501
(541) 858-1665

Budget and Credit Counseling Services
55 5th Ave.
New York, NY 10003
(212) 675-5070
(800) 475-1994 (outside NY area)
www.buccs.com

National Association of Bankruptcy Trustees
3008 Millwood Avenue
Columbia, SC 29205
(803) 252-5646

National Conference of Bankruptcy Judges
c/o Christine J. Molick
235 Secret Cove Dr.
Lexington, SC 29072
(803) 957-6225

National Foundation for Consumer Credit
c/o William Furmanski
8611 2nd Avenue, Suite 100
Silver Spring, MD 20910
(301) 589-5600

BUSINESS/ECONOMIC STATISTICS

Governmental

Bureau of Economic Analysis
Dept. of Commerce
14th St. & Constitution Ave., N.W.
Washington, D.C. 20230
(202) 606-9900
www.bea.doc.gov

Bureau of the Census
Dept. of Commerce
14th St. & Constitution Ave., N.W.
Washington, D.C. 20233
(301) 457-2794
www.census.gov

Council of Economic Advisers
Statistical Office
Old Executive Office Bldg., Rm. 419
Washington, D.C. 20500
(202) 395-5042
www.whitehouse.gov/WH/EOP/CEA/html/

Economic Development Administration
Department of Commerce
14th St. & Constitution Ave., N.W.
Washington, D.C. 20230
(202) 482-5112
www.doc.gov/eda/

Federal Reserve System
Research and Statistics
20th and Constitution Ave., N.W.
Washington, D.C. 20551
(202) 452-3300
www.federalreserve.gov

General Services Administration (GSA)
Office of the Administrator
18th St. & F Street, N.W.
Washington, D.C. 20405
(202) 501-0800
www.gsa.gov

International Trade Administration
Dept. of Commerce
14th St. & Constitution Ave., N.W.
Washington, D.C. 20230
(202) 482-5809
www ita.doc.gov/

Office of Management and Budget
Office of Economic Policy
Executive Office Bldg.
Washington, D.C. 20503
(202) 395-3080
www.whitehouse.gov/OMB/

Nongovernmental

American Economic Association
2014 Broadway, Ste. 305
Nashville, TN 37203-2418
(615) 322-2595
www.vanderbilt.edu/AEA

American Economic Development Council
9801 W. Higgins Rd., Suite 540
Rosemont, IL 60018-4726
(847) 692-9944

American Enterprise Institute for Public Policy Research
Economic Policy Studies
1150 17th St., N.W.
Washington, D.C. 20036
(202) 862-5914

American Institute for Economic Research
Division Street
Great Barrington, MA 01230
(413) 528-1216

Brookings Institution
1775 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 797-6000
www.brook.edu/

The Conference Board
845 Third Ave.
New York, NY 10022
(212) 759-0900
www.conference-board.org

Economic Policy Institute
1660 L St., N.W., Suite 1200
Washington, D.C. 20036
(202) 775-8810

Institute for Contemporary Studies
Latham Square
1611 Telegraph Ave., Ste. 902
Oakland, CA 94612
(510) 238-5010
www.icspress.com

National Association for Business Economics
1233 20th St., N.W., Suite 505
Washington, D.C. 20036
(202) 463-6223
www.nabe.com

National Bureau of Economic Research
1050 Massachusetts Ave.
Cambridge, MA 02138
(617) 868-3900

National Chamber Foundation
1615 H St., N.W.
Washington, D.C. 20062
(202) 463-5552

National Policy Association
1424 16 St., N.W., Suite 700
Washington, D.C. 20036
(202) 265-7685
www.npal.org

U.S. Chamber of Commerce
1615 H St., N.W.
Washington, D.C. 20062
(202) 659-6000
www.uschamber.com

BUSINESS ENTITIES/GENERAL INFORMATION

Governmental

Dept. of Commerce
Office of Business Liaison
14th St. & Constitution Ave., N.W.
Rm. 5062
Washington, D.C. 20230
(202) 482-3942
www.commerce.gov/

Federal Trade Commission
Office of Public Affairs
Sixth St. and Pennsylvania Ave., N.W.
Washington, D.C. 20580
(202) 326-2222
www.ftc.gov

National Institute of Standards & Technology
Public Inquiries Unit
Dept. of Commerce
100 Bureau Drive, Stop 3460
Gaithersburg, MD 20899-3460
(301) 975-3058
www.nist.gov

Nongovernmental

Accountants for the Public Interest
At the University of Baltimore
Thurnel Business Center, Rm. 155
1420 North Charles St.
Baltimore, MD 21201
(410) 837-6533

American Accounting Association
5717 Bessie Dr.
Sarasota, FL 34233
(941) 921-7747
www.aaa-edu.org

American Association of Attorney-CPAs
24196 Alicia Pkwy., Suite K
Mission Viejo, CA 92691
(714) 768-0336
www.attorney-cpa.com

American Businesspersons Association
Hillsboro Executive Center North
350 Fairway Drive, Ste. 200
Deerfield Beach, FL 33441-1834
(800) 221-2168
www.aba-assn.com

American Business Conference
1730 K St., N.W., Suite 1200
Washington, D.C. 20006
(202) 822-9300

American Business Women's Association
9100 Ward Pkwy.
P.O. Box 8728
Kansas City, MO 64114-0728
(816) 361-6621
www.abwahq.org

American Institute of CPAs
1211 Ave. of the Americas
New York, NY 10036-8775
(212) 596-6200
www.aicpa.org

American Management Association
1601 Broadway
New York, NY 10019-7420
(800) 262-9699
www.amanet.org

American Small Businesses Association
8733 IL Rte. 75E
Rock City, IL 61070
(800) 942-2722
www.asbaonline.org

American Society of Women Accountants
60 Revere Drive, Ste. 500
Northbrook, IL 60062
(800) 326-2165
www.aswa.org

American Woman's Society of Certified Public Accountants
401 N Michigan
Chicago, IL 60611
(800) 297-2721

Association of Certified Fraud Examiners
716 West Avenue
Austin, TX 78701
(800) 245-3321
www.cfenet.com

The Business Council
888 17th St., N.W., No. 506
Washington, D.C. 20006
(202) 298-7650

The Business Roundtable
1615 L St., N.W., Suite 1100
Washington, D.C. 20036-5610
(202) 872-1260
www.brtable.org

The Conference Board
845 Third Ave.
New York, NY 10022
(212) 759-0900
www.conference-board.org

Council of Better Business Bureaus
4200 Wilson Blvd., Suite 800
Arlington, VA 22203-1804
(703) 276-0100
www.bbb.org

Information Systems Audit and Control Association
3701 Algonquin Rd., Ste. 1010
Rolling Meadows, IL 60008
(847) 253-1545
www.isaca.org

Ethics Resource Center
1747 Pennsylvania Ave., N.W., Ste. 400
Washington, D.C. 20007
(202) 737-2258
www.ethics.org

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
(203) 847-0700
www.fasb.org

Financial Executives Institute
10 Madison Ave.
P.O. Box 1938
Morristown, NJ 07962-1938
(973) 898-4600

Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
(203) 847-0700
www.gasb.org

Institute of Certified Business Counselors
P O Box 70326
Eugene, OR 97401
(541) 345-8064

Institute of Internal Auditors
249 Maitland Ave.
Altamonte Springs, FL 32701-4201
(407) 830-7600
www theiia.org

Institute of Certified Management Accountants
10 Paragon Dr.
Montvale, NJ 07645
(800) 638-4427

Interamerican Accounting Association
275 Fountainbleau Blvd.
Miami, FL 33172
(305) 225-1991

International Association of Merger and Acquisition Consultants
600 Revere Dr., Ste. 500
Northbrook, IL 60062
(708) 480-9037

International Federation of Accountants
535 Fifth Ave., 26th fl
New York, NY 10017
(212) 286-9344
www.ifac.org

National Association of Certified Valuation Analysts
1111 E. Brickyard Rd., Ste 200
Salt Lake City, UT 84106
(801) 486-0600
www nacva.com

National Association of Corporate Directors
1707 L St., N.W., Suite 560
Washington, D.C. 20036
(202) 775-0509
www.nacdonline.org

National Association for Female Executives
P.O. Box 469031
Escondido, CA 92046-9925
(800) 634-6233
www.nafe.com

National Association of Manufacturers
1331 Pennsylvania Ave., N.W., Suite 1500N
Washington, D.C. 20004-1790
(202) 637-3000
www.nam.org

National Association of Minority Women in Business
906 Grand Ave., Suite 200
Kansas City, MO 64109
(816) 421-3335

National Association of State Boards of Accountancy
150 Fourth Ave. North, Ste 700
Nashville, TN 37219-2417
(615) 880-4200
www nasba.org

National Business League
107 Harbor Circle
New Orleans, LA 70126-1101
(504) 246-1166
www.thenbl.com

National Chamber Foundation
1615 H St., N.W
Washington, D.C. 20062
(202) 463-5552

National Chamber Litigation Center
1615 H St., N.W.
Washington, D.C. 20062-2000
(202) 463-5337
www uschamber.com/nclc/index.html

National Federation of Independent Business
53 Century Blvd., Suite 300
Nashville, TN 37214
(615) 872-5800
(800) 634-2669
www.nfib.org

National Industrial Council
1331 Pennsylvania Ave., N.W., Suite 600N
Washington, D.C. 20004
(202) 637-3052

National Minority Business Council
235 E. 42nd St.
New York, NY 10017
(212) 573-2385
www.nmbc.org

U.S. Chamber of Commerce
1615 H St., N.W.
Washington, D.C. 20062
(202) 659-6000
www.uschamber.com

U.S. Council for International Business
1212 Ave. of the Americas
New York, NY 10036
(212) 354-4480

EMPLOYMENT REGULATIONS AND INSURANCE/WORKERS' COMPENSATION

Governmental

Bureau of Labor Statistics
Office of Publications
Dept. of Labor
2 Massachusetts Ave., N.W., Rm. 4110
Washington, D.C. 20212
(202) 606-5900
www.bls.gov/

Employment and Training Administration
Federal Unemployment Insurance Service
Dept. of Labor
200 Constitution Ave., N.W.
Washington, D.C. 20210
(202) 219-7831
www doleta.gov

Employment Standards Administration
Workers' Compensation Programs
Dept. of Labor
200 Constitution Ave., N.W
Washington, D.C. 20210
(202) 219-7503
www dol.gov/dol/esa/

Equal Employment Opportunity Commission
1801 L St., N.W.
Washington, D.C. 20507
(202) 663-4900
www.eeoc.gov

Dept. of Labor
200 Constitution Ave., N.W.
Washington, D.C. 20210
(202) 219-5000
www.dol.gov

Occupational Safety and Health Administration
Dept. of Labor
200 Constitution Ave., N.W.
Washington, D.C. 20210
(202) 219-8151
www.osha.gov

Nongovernmental

American Compensation Association
14040 N. Northsight Blvd.
Scottsdale, AZ 85260
(480) 951-9191
www.acaonline.org

American Insurance Association
1130 Connecticut Ave., N.W Ste. 1000
Washington, D.C. 20036
(202) 828-7100
www.aiadc.org

ERISA Industry Committee
1400 L St., N.W., Suite 350
Washington, D.C. 20005
(202) 789-1400
www.eric.org

International Association of Industrial Accident Boards and Commissions
1201 Wakarusa, Bldg. C-3
Lawrence, KS 66049
(785) 840-9103
www.iaiabc.org

International Foundation & International Society of Employee Benefit Plans
18700 W. Bluemound Rd.
P.O. Box 69
Brookfield, WI 53008
(414) 786-6700

Interstate Conference of Employment Security Agencies/Center for Employment Security and Research
444 N. Capitol St., N.W
Ste. 142
Washington, D.C. 20001
(202) 434-8020
www.icesa.org

National Association of Manufacturers
1331 Pennsylvania Ave., N.W., Suite 1500N
Washington, D.C. 20004-1790
(202) 637-3000
www.nam.org

Employee Benefits Research Institute
2121 K St., N.W., Ste. 600
Washington, D.C. 20037-1896
(202) 659-0670
www.ebri.org

National Foundation for Unemployment Compensation and Workers Compensation
1201 New York Avenue, N.W. Suite 750
Washington, D.C. 20005
(202) 682-1517
www.uwcstrategy.org/national

Society for Human Resource Management
1800 Duke St.
Arlington, VA 22314
(703) 548-3440
www.shrm.org

EMPLOYMENT OF FOREIGN NATIONALS

Governmental

Employment and Training Administration
U.S. Employment Service
Dept. of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210
(202) 219-0157
www.doleta.gov

Executive Office for Immigration Review
Department of Justice
Public Affairs Office
5107 Leesburg Pike
Ste. 2400
Falls Church, VA 22041
(703) 305-0289
www.usdoj.gov/eoir/

Immigration and Naturalization Service
Justice Department
425 I St., N.W.
Washington, D.C. 20536
(800) 375-5253
www.ins.usdoj.gov

Office of Special Counsel for Immigration-Related Unfair Employment Practices
Department of Justice
P.O. Box 27728
Washington D.C. 20038-7728
(800) 255-7688
www.usdoj.gov/crt/osc/

Office of Refugee Resettlement
Dept. of Health and Human Services
370 L'Enfant Promenade, S.W.
Washington, D.C. 20447
(202) 401-9246

Nongovernmental

American Council on International Personnel
515 Madison Ave., 15th Fl.
New York, NY 10022
(212) 688-2437
www.acip.com

ESTATES AND TRUSTS

American Council for Capital Formation
1750 K St., N.W., Suite 400
Washington, D.C. 20006-2302
(202) 293-5811
www.accf.org

Association for Advanced Life Underwriting
1922 F St., N.W.
Washington, D.C. 20006
(202) 331-6081
www.aalu.org

National Association of Charitable Estate Counselors
6218 Beachway Drive
Box 1776
Falls Church, VA 22041
(800) 986-4483

National Association of Estate Planners and Councils
270 S. Bryn Mawr Ave.
P.O. Box 46
Bryn Mawr, PA 19010-2196
(610) 526-1389
www.naepc.org

INSURANCE

Nongovernmental

American Academy of Actuaries
1100 17th St., N.W., 7th Fl.
Washington, D.C. 20036
(202) 223-8196
www.actuary.org

American Association of Insurance Services
1745 S. Naperville Rd.
Wheaton, IL 60187-8132
(800) 564-2247
www.aais.org

American Council of Life Insurance
1001 Pennsylvania Ave., N.W.
Washington, D.C. 20004-2599
(202) 624-2000
www.acli.com

American Insurance Association
1130 Connecticut Ave., N.W. Ste. 1000
Washington, D.C. 20036
(202) 828-7100
www.aiadc.org

American Insurance Services Group
85 John St.
New York, NY 10038
(212) 669-0455
www.aisg.org

Society of Financial Service Professionals
270 S. Bryn Mawr Ave.
Bryn Mawr, PA 19010-2195
(610) 526-2500
www.financialpro.org

Associated Risk Managers International
816 Congress Ave., Ste. 990
Austin, TX 78701
(512) 479-6886
www.arminet.com

Health Insurance Association of America
555 13 St., N.W., Suite 600E.
Washington, D.C. 20004-1109
(202) 824-1600
www.hiaa.org

Independent Insurance Agents of America
127 S. Peyton St.
Alexandria, VA 22314
(703) 683-4422

Insurance Accounting and Systems Association
P.O. Box 51340
Durham, NC 27717
(919) 489-0991
www.iasa.org

Insurance Information Institute
110 William St.
New York, NY 10038
(800) 331-9146
www.iii.org

Insurance Institute of America
720 Providence Road
Malvern, PA 19355-0716
(215) 644-2100
www.aicpcu.org

Insurance Services Office, Inc.
7 World Trade Center
New York, NY 10048-1119
(800) 888-4476
www.iso.com

International Insurance Council
900 19th St., N.W., Ste. 250
Washington, D.C. 20006
(202) 682-2345

Life Insurance Marketing and Research Association
P.O. Box 208
Hartford, CT 06141
(860) 688-3358
www.limra.org

Life Office Management Association
2300 Windy Ridge Pkwy., Ste. 600
Atlanta, GA 30339-8443
(770) 951-1770
www.loma.org

Life Underwriter Training Council
7625 Wisconsin Ave.
Bethesda, MD 20814
(301) 913-5882

Million Dollar Round Table
325 W. Touhy
Park Ridge, IL 60068
(847) 692-6378
www.agents-online.com

Mortgage Insurance Companies of America
727 15th St., N.W., 12th Fl.
Washington, D.C. 20005
(202) 393-5566

National Association of Health Underwriters
1000 Connecticut Ave., N.W., Suite 810
Washington, D.C. 20036
(202) 778-8767
www.nahu.org

National Association of Independent Insurers
2600 River Rd.
Des Plaines, IL 60018
(708) 297-7800

National Association of Insurance Brokers
1300 I St., N.W., Suite 490E
Washington, D.C. 20005
(202) 783-4400

National Association of Insurance Commissioners
120 W. 12th St., Suite 1100
Kansas City, MO 64105
(816) 842-3600
www.naic.org

National Association of Insurance and Financial Advisors
1922 F St., N.W.
Washington, D.C. 20006-4387
(202) 331-6000
www.naifa.org

National Association of Mutual Insurance Companies
3601 Vincennes Rd.
P.O. Box 68700
Indianapolis, IN 46268
(317) 875-5250
www.namic.org

National Association of Professional Insurance Agents
400 N. Washington St.
Alexandria, VA 22314
(703) 836-9340
www.pianet.com

Risk and Insurance Management Society
655 3rd Ave., 2nd Fl.
New York, NY 10017
(212) 286-9292
www.rims.org

Society for Risk Analysis
1313 Dolly Madison Blvd., Ste. 402
McLean, VA 22101-3926
(703) 790-1745
www.sra.org

Society of Actuaries
475 N. Martingale Rd., Ste. 800
Schaumburg, IL 60173-2226
(847) 706-3500
www.soa.org

CPCU Society
720 Providence Rd.
P.O. Box 3009
Malvern, PA 19355-0709
(800) 932-2728
www.cpcusociety.org

Society of Insurance Financial Management
P.O. Box 61
Hollowville, NY 12530-0061
(518) 851-9780

Society of Insurance Research
691 Crossfire Ridge
Marietta, GA 30064
(770) 426-9270
www.sirnet.org

INVESTMENT

Governmental

International Finance Corporation
2121 Pennsylvania Ave., N.W.
Washington, D.C. 20433
(202) 477-1234
www.ifc.org

International Trade Administration
Dept. of Commerce
14th St. & Constitution Ave., N.W.
Washington, D.C. 20230
(202) 482-5809
www.ita.doc.gov/

Overseas Private Investment Corporation
Foreign Investment Insurance Program
1100 New York Avenue
Washington, D.C. 20527
(202) 336-8799

Nongovernmental

American Association of Individual Investors
625 N. Michigan Ave., Suite 1900
Chicago, IL 60611
(312) 280-0170
www.aaii.com

American Financial Services Association
919 18th St., N.W.
Washington, D.C. 20006
(202) 296-5544
www.americanfinsvcs.org

Association for Investment Management and Research
5 Boar's Head Lane
P.O. Box 3668
Charlottesville, VA 22903-0668
(804) 980-3668
www.aimr.org

Emergency Committee for American Trade
1211 Connecticut Ave., N.W., Suite 801
Washington, D.C. 20036
(202) 659-5147

Independent Investor Protective League
P.O. Box 5031
Ft. Lauderdale, FL 33310
(954) 749-1551

Institute of Certified Financial Planners
3801 East Florida Ave., Ste. 708
Denver, CO 80210-2571
(303) 759-4900

International Association for Financial Planning
5775 Glenridge Dr., N.E. Suite B-300
Atlanta, GA 30328-5364
(404) 845-0011
www.iafp.org

Investment Company Institute
1401 H St., N.W., 12th Fl.
Washington, D.C. 20005
(202) 326-5800
www.ici.org

Investment Counsel Association of America
1050 17th St., N.W., Suite 725
Washington, DC 20036
(202) 293-4222
www.icaa.org

National Association of Investors Corporation
P.O. Box 220
Royal Oak, MI 48068
(877) 275-6242
www.better-investing.org

National Association of Small Business Investment Companies
666 11th St., N.W., No. 750
Washington, D.C. 20001
(202) 628-5055
www.nasbic.org

National Investor Relations Institute
8045 Leesburg Pike, Ste. 600
Vienna, VA 22182
(703) 506-3570
www.niri.org

National Venture Capital Association
1655 N. Fort Myer Dr., Suite 850
Arlington, VA 22209
(703) 524-2549
www.nvca.org

Registered Financial Planners Institute
2001 Cooper Foster Park Rd.
Amherst, OH 44001
(216) 282-7176
www.rfpi.com

Small Business Assistance Center
554 Main St., P.O. Box 15014
Worcester, MA 01615-0014
(508) 756-3513

OBTAINING FINANCING

Nongovernmental

American Bankers Association
1120 Connecticut Ave., N.W
Washington, D.C. 20036
(202) 663-5000
www.aba.com

American Council for Capital Formation
1750 K St., N.W., Suite 400
Washington, D.C. 20006
(202) 293-5811
www.accf.org

American Council of State Savings Supervisors
P.O. Box 34175
Washington, D.C. 20043-4175
(703) 922-5153

Bank Administration Institute
1 N. Franklin St., Ste. 1000
Chicago, IL 60606
(312) 553-4600
www.bai.org

Bankers' Round Table
805 15th St., N.W., Ste. 600
Washington, D.C. 20005
(212) 289-4322
www.bankersround.org

Commercial Finance Association
225 W. 34th St., Ste. 1815
New York, NY 10122
(212) 594-3490
www.cfa.com

Consumer Bankers Association
1000 Wilson Blvd., Ste. 3012
Arlington, VA 22209-3908
(703) 276-1750

Eastern Finance Association
c/o Prof. Donald A. Nast
Dept. of Finance
Florida State University
Tallahassee, FL 32306-1110
(850) 644-4220
www.easternfinance.org

Financial Managers Society
230 W. Monroe, Suite 2205
Chicago, IL 60606
(312) 578-1300
www.fmsinc.org

International Society of Financiers
P.O. Box 18508
Asheville, N.C. 28814
(704) 252-5907
www.isofin.com

Mortgage Bankers Association of America
c/o Janice Stango
1125 15th St., N.W.
Washington, D.C. 20005
(202) 861-6500

National Accounting and Finance Council
2200 Mill Rd.
Alexandria, VA 22314
(703) 838-1915

National Association of Development Companies
6764 Old MacLean Village Dr.
McLean, VA 22101
(703) 748-2575
www.nadco.org

National Association of Small Business Investment Companies
666 11th St., N.W., No. 750
Washington, D.C. 20001
(202) 628-5055
www.nasbic.org

National Venture Capital Association
1655 N. Fort Myer Dr., Suite 850
Arlington, VA 22209
(703) 524-2549
www.nvca.org

Robert Morris Associates/ Association of Lending and Credit Risk Professionals
One Liberty Pl.
1650 Market St., Suite 2300
Philadelphia, PA 19103-7398
(215) 446-4000

Savings and Community Bankers of America
900 19 St., N.W., Suite 400
Washington, D.C. 20006
(202) 857-3100
www.acbankers.org

PENSIONS/SOCIAL SECURITY

Governmental

Joint Board for the Enrollment of Actuaries
Dept. of the Treasury
Washington, D.C. 20220
(202) 622-7129

Dept. of Labor
Pension and Welfare Benefits Administration
200 Constitution Ave., N.W.
Washington, D.C. 20210
(202) 219-8921
www.dol.gov/dol/pwba/

Pension Benefit Guaranty Corporation
1200 K St., N.W.
Washington, D.C. 20005
(202) 326-4000
www.pbgc.gov

Social Security Administration
Central Operations
6401 Security Blvd.
Baltimore, MD 21235
(410) 965-1234
www.ssa.gov

Nongovernmental

American Academy of Actuaries
1100 17th St., N.W., 7th Fl.
Washington, D.C. 20036
(202) 223-8196
www.actuary.org

American Association of Retired Persons
601 E St., N W
Washington, D.C. 20049
(202) 434-2277
www.aarp.org

American Enterprise Institute for Public Policy Research
1150 17th St., N W.
Washington, D.C. 20036
(202) 862-5914

American Society of Pension Actuaries
4350 N. Fairfax Dr., Ste. 820
Arlington, VA 22203
(703) 516-9300
www.aspa.org

Association of Private Pension and Welfare Plans
1212 New York Ave., N.W., Suite 1250
Washington, D.C. 20005-3987
(202) 289-6700
www.appwp.org

Council of Institutional Investors
1730 Rhode Island Ave., N.W., Suite 512
Washington, D.C. 20036
(202) 822-0800
www.ciicentral.com

Council on Employee Benefits
c/o Goodyear Relief Association
1212 New York Avenue, N.W., Suite 1225
Washington, D.C. 20005
(202) 408-3192
www.ceb.org

ESOP Association
1726 M St., N.W., Suite 501
Washington, D.C. 20036
(202) 293-2971
www.the-esop-emplowner.org

Employee Benefit Research Institute
2121 K St., N.W., Suite 600
Washington, D.C. 20037
(202) 659-0670
www.ebri.org

Employers Council on Flexible Compensation
927 15th St., N.W., Suite 1000
Washington, D.C. 20005
(202) 659-4300
www.ecfc.org

International Foundation of Employee Benefit Plans
P.O. Box 69
18700 W. Bluemound Rd.
Brookfield, WI 53008-0069
(262) 786-6710, ext. 8216
www.ifebp.org

National Association of Manufacturers
Employee Benefits Committee
1331 Pennsylvania Ave., N.W., Suite 1500N
Washington, D.C. 20004-1790
(202) 637-3000
www.nam.org

National Committee to Preserve Social Security and Medicare
10 G St., N.E., Ste. 600
Washington, D.C. 20003
(800) 966-1935
www.ncpssm.org

National Council of Real Estate Investment Fiduciaries
2 Prudential Plz.
180 N. Stetson Ave., Ste. 2515
Chicago, IL 60601
(312) 819-5890
www.ncreif.com

National Employee Benefits Institute
1000 N. Water
Milwaukee, WI 53203
(800) 558-7258

National Organization of Social Security Claimants' Representatives
6 Prospect St.
Midland Park, NJ 07432-1691
(800) 431-2804

Pension Real Estate Association
95 Glastonbury Blvd.
Glastonbury, CT 06033
(860) 657-2612
www.prea.org

Pension Research Council
The Wharton School of the Univ. of Pennsylvania
3641 Locust Walk, 304 CPC
Philadelphia, PA 19104-6218
(215) 898-7620
www.wharton.upenn.edu

Pension Rights Center
918 16th St., N W., Suite 704
Washington, D.C. 20006
(202) 296-3776

Small Business Council of America
4800 Hampden Lane, 7th Fl.
Bethesda, MD 20814
(301) 656-7603

SECURITIES

Governmental

Commodity Futures Trading Commission
203 K St., N.W.
Washington, D.C. 20581
(202) 254-6387
www.cftc.gov

Federal Reserve System
Board of Governors
20th St. and Constitution Ave., N.W.
Washington, D.C. 20551
(202) 452-3257
www.federalreserve.gov

Securities and Exchange Commission
Office of Investor Education and Assistance
405 Fifth St., N.W.
Washington, D.C. 20549
(202) 942-7040
www.sec.gov

Nongovernmental

American Stock Exchange
86 Trinity Pl.
New York, NY 10006
(212) 306-1000
www.amex.com

Association for Investment Management and Research
560 Ray C. Hunt Dr.
P.O. Box 3668
Charlottesville, VA 22903-0668
(800) 247-8132
www.aimr.com

Chicago Board Options Exchange
400 S. LaSalle St.
Chicago, IL 60605
(312) 786-5600

Chicago Stock Exchange
One Financial Pl.
440 S. LaSalle St.
Chicago, IL 60605
(312) 663-2980
www.chicagostockex.com

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
(203) 847-0700
www.fasb.org

Futures Industry Association
2001 Pennsylvania Ave., N.W., Suite 600
Washington, D.C. 20006
(202) 466-5460
www.fiafii.org

Industry Council for Tangible Assets
P.O. Box 1365
Severna Park, MD 21146-8365
(410) 626-7005

Investment Company Institute
1401 H St., N.W., 12th Fl.
Washington, D.C. 20005
(202) 326-5800
www.ici.org

National Association of Securities Dealers
1735 K St., N.W.
Washington, D.C. 20006
(202) 728-8000
www.nasdr.com

National Futures Association
200 W. Madison St.,
Suite 1600
Chicago, IL 60606
(800) 621-3570
www.nfa.futures.org

National Investor Relations Institute
8045 Leesburg Pike, Ste. 600
Vienna, VA 22182
(703) 506-3570
www.niri.org

New York Society of Security Analysts
1 World Trade Center,
Ste. 4447
New York, NY 10048
(212) 912-9249
www.nyssa.org

New York Stock Exchange
11 Wall St.
New York, NY 10005
(212) 656-3000
www.nyse.com

Public Securities Association & The Bond Market Association
40 Broad St., 12th Fl.
New York, NY 10004
(212) 809-7000
www.psa.com

Securities Industry Association
120 Broadway, 35th Fl.
New York, NY 10271-0080
(212) 608-1500
www.sia.com

Security Traders Association
One World Trade Center,
Suite 4511
New York, NY 10048
(212) 524-0484
www.securitytraders.org

SMALL BUSINESS

Governmental

Minority Business Development Agency
Office of External Affairs
Department of Commerce
Washington D.C. 20230
(202) 482-4547

Small Business Administration
409 3rd St., S.W.
Washington, D.C. 20416
(202) 205-6600
www.sba.gov

U.S. Chamber of Commerce
Small Business Institute
1615 H St., N.W.
Washington, D.C. 20062
(202) 463-5503
www.uschamber.org

Nongovernmental

American Small Businesses Association
8738 IL Rte. 75E
Rock City, IL 61070
(800) 942-2722
www.asbaonline.org

American Woman's Economic Development Corporation
71 Vanderbilt Ave., Ste. 320
New York, NY 10169
(212) 692-9100
www.onlinewbc.org

Association of African-American Women Business Owners
3363 Alden Place, N.E.
Washington, D.C. 20019
(202) 399-3645
www.angelfire.com/biz2/aawboa

Association of Small Business Development Centers
3108 Columbia Pike, Ste. 300
Arlington, VA 22204
(703) 271-8700
www.asbdc-us.org

Best Employers Association
2515 McCabe Way
Irvine, CA 92614
(949) 756-1000

Center for Entrepreneurial Management
180 Varick St., Penthouse Ste.
New York, NY 10014
(212) 633-0060

Center for Family Business
P.O. Box 24219
Cleveland, OH 44124
(216) 442-0800

AGN International—North America, Inc.
2851 S. Parker Rd., Ste. 850
Aurora, CO 80014
(800) 782-2272
www.agn-na.org

International Association for Business Organizations
P.O. Box 30149
Baltimore, MD 21270
(410) 581-1373
www.worldhomebiz.com

Interracial Council for Business Opportunity
550 Fifth Ave., No. 2202
New York, NY 10018-2202
(212) 779-4360

National Association of Investment Companies
733 15th St., N.W., Ste. 700
Washington, D.C. 20005
(202) 289-4336

National Association for the Self-employed
P.O. Box 612067
DFW Airport
Dallas, TX 75261-2067
(800) 232-6273
www.nase.org

National Association of Small Business Investment Companies
666 11th St., N.W., No. 750
Washington, D.C. 20001
(202) 628-5055
www.nasbic.org

National Association of Women Business Owners
1411 K St., N.W.
Washington, D.C. 20005
(800) 556-2926
www.nawbo.org

National Business League
107 Harbor Circle
New Orleans, LA 70126-1101
(504) 246-1166
www.thenbl.com

National Federation of Independent Business
53 Century Blvd., Ste. 300
Nashville, TN 37214
(800) 634-2669
www.nfib.org

National Small Business United
1156 15th St., N.W.,
Suite 1100
Washington, D.C. 20005
(202) 293-8830
www.nsbu.org

Small Business Council of America
4800 Hampden Lane, 7th Fl.
Bethesda, MD 20814
(301) 656-7603
www.sbca.net

STATE BOARDS OF ACCOUNTANCY

Alabama State Board of Public Accountancy
RSA Plaza Ste. 236
770 Washington Ave.
Montgomery, AL 36130-0375
Att: J. Lamar Harris, CPA,
Executive Director
(334) 242-5700
FAX: (334) 242-2711

Alaska State Board of Public Accountancy
Dept. of Commerce and Economic Development
Div. of Occupational Licensing
Box 110806
Juneau, AK 99811-0806
Att: Stephen Snyder, Licensing Examiner
(907) 465-2580
FAX: (907) 465-2974
www.dced.state/ak.us/occ/pcpa.htm

Arizona State Board of Accountancy
3877 North Seventh St., Suite 106
Phoenix, AZ 85014
Att: Ruth R. Lee, Executive Director
(602) 255-3648
FAX: (602) 255-1283
www.accountancy.state.az.us/

Arkansas State Board of Accountancy
101 E. Capitol, Suite 430
Little Rock, AR 72201
Att: James E. George, Executive Director
(501) 682-1520
FAX: (501) 682-5538
www.state.ar.us/asbpa/index.cgi

California State Board of Accountancy
2000 Evergreen St., Suite 250
Sacramento, CA 95815-3832
Att: Carol Sigmann, Executive Officer
(916) 263-3680
FAX: (916) 263-3675
www.dca.ca.gov/cba/

Colorado State Board of Accountancy
1560 Broadway, Suite 1340
Denver, CO 80202
Att: Robert T. Longway, Program Administrator
(303) 894-7800
FAX: (303) 894-7790
www.dora.state.co.us/accountants/

Connecticut State Board of Accountancy
Secretary of the State
30 Trinity St.
Hartford, CT 06115
Att: David Guay, Executive Director
(860) 509-6179
FAX: (860) 509-6247
www.sots.state.ct.us/SBOA/SBOAindex.html

Delaware State Board of Accountancy
Cannon Building, Suite 203
P.O. Box 1401
Dover, DE 19903
Att: Sheila H. Wolfe, Administrative Assistant
(302) 739-4522
FAX: (302) 739-2711

District of Columbia Board of Accountancy
Dept. of Consumer and Regulatory Affairs/Occupational Licensing Administration
Rm. 7W45
941 N. Capitol Street, N.W.
Washington, D.C. 20022
Att: Harriette E. Andrews, Administrator
(202) 442-4461
FAX: (202) 442-4528
www.dcra.org/acct/dcbahome.htm

Florida Board of Accountancy
2610 N.W. 43rd St., Suite 1A
Gainesville, FL 32606-4599
Att: Martha P. Willis, Division Director
(352) 955-2165
FAX: (352) 955-2164
www.state.fl.us/dbpr/html/cpa/

Georgia State Board of Accountancy
237 Coliseum Drive
Macon, GA 31217-3858
Att: Barbara Kitchens, Executive Director
(912) 207-1400
FAX: (912) 207-1410
www.sos.state.ga.us/ebd-accountancy/

Guam Territorial Board of Public Accountancy
P.O. Box 5753
Hagatna, GU 96932
Attn: Lisa A. Leon Guerrero, Administrative Director
(671) 735-2559
FAX: (671) 734-3461

Hawaii Board of Public Accountancy
Dept. of Commerce and Consumer Affairs
P.O. Box 3469
Honolulu, HI 96801-3469
Att: Laureen Kai, Executive Officer
(808) 586-2696
FAX: (808) 586-2689

Idaho State Board of Accountancy
P.O. Box 83720
Boise, ID 83720-0002
Att: Barbara R. Porter, Executive Director
(208) 334-2490
FAX: (208) 334-2615
www.state.id.us/boa/

Illinois Board of Examiners
University of Illinois at Urbana-Champaign
505 E. Green, Room 216
Champaign, IL 61820-5723
Att: Joanne Vician, Executive Director
(217) 333-1565
FAX: (217) 333-3126
www.illinois-cpa-exam.com

Illinois Department of Professional Regulation
Public Accountancy Section
320 W. Washington St., 3rd Fl.
Springfield, IL 62786
Att: Daniel Harden, Board Liaison
(217) 785-0800
FAX: (217) 782-7645
www.state.il.us/dpr/

Indiana Board of Accountancy
IN Prof. Lic. Agc., IN Gov. Ctr. S
302 West Washington St., Rm. E034
Indianapolis, IN 46204-2700
Att: Nancy Smith, Exam Coordinator
(317) 232-5987
FAX: (317) 232-2312
www.ai.org/pla/accountancy/

Iowa Accountancy Examining Board
1918 S.E. Hulsizer Ave.
Ankeny, IA 50021-3941
Att: William Schroeder, Executive Secretary
(515) 281-4126
FAX: (515) 281-7411
www.state.ia.us/iacc/

Kansas Board of Accountancy
900 S.W. Jackson St., Suite 556
Topeka, KS 66612-1239
Att: Susan L. Somers, Executive Director
(785) 296-2162
FAX: (785) 291-3501
www.ink.org/public/ksboa/

Kentucky State Board of Accountancy
332 West Broadway, Suite 310
Louisville, KY 40202-2115
Att: Susan G. Stopher, Executive Director
(502) 595-3037
FAX: (502) 595-4281
www.state.ky.us/agencies/boa/

State Board of CPAs of Louisiana
Pan American Life Center
601 Poydras St., Suite 1770
New Orleans, LA 70130
Att: Michael A. Henderson, CPA, Executive Director
(504) 566-1244
FAX: (504) 566-1252

Maine State Board of Accountancy
Dept. of Professional and Financial Regulation
Office of Licensing and Registration
State House Station #35
Augusta, ME 04333-0035
Att: Cheryl S. Hersom, Board Administrator
(207) 624-8627
FAX: (207) 624-8637
www.state.me.us/pfr/led/account/index.htm

Maryland State Board of Public Accountancy
Division of Occupational & Professional Licensing
500 N. Calvert St., Rm. 308
Baltimore, MD 21202-3651
Att: Sue Mays, Executive Director
(410) 333-6322
FAX: (410) 333-6314
www.dllr.state.md.us/license/occprof/account.html

Massachusetts Board of Public Accountancy
Division of Registration
239 Causeway St.
Boston, MA 02114
Att: Leo H. Bonarrigo, CPA, Executive Secretary
(617) 727-3074
FAX: (617) 727-2197
www.state.ma.us/reg/boards/pa/default.htm

Michigan Board of Accountancy
Dept. of Commerce and Industry Services
P.O. Box 30018
Lansing, MI 48909-7518
Att: Suzanne U. Jolicoeur, Licensing Administrator
(517) 241-9249
FAX: (517) 241-9280
www.cis.state.mi.us/bcs/acct/home.htm

Minnesota State Board of Accountancy
85 East 7th Pl., Suite 125
St. Paul, MN 55101
Att: Dennis J. Poppenhagen, Executive Secretary
(612) 296-7937
FAX: (612) 282-2644

Mississippi State Board of Public Accountancy
653 North State St.
Jackson, MS 39202-2304
Att: Susan M. Harris, CPA, Executive Director
(601) 354-7320
FAX: (601) 354-7290
www.msbpa.state.ms.us/

Missouri State Board of Accountancy
3605 Missouri Blvd.,
P.O. Box 613
Jefferson City, MO 65102-0613
Att: Ken L. Bishop, Executive Director
(573) 751-0012
FAX: (573) 751-0890
www.ecodev.state.mo.us/pr/account/staff.htm

Montana State Board of Public Accountants
Montana Dept. of Commerce
Div. of Prof. & Occupational Licensing
Arcade Bldg., Lower Level
111 North Jackson,
P.O. Box 200513
Helena, MT 59620-0513
Att: Susanne M. Criswell, Administrator
(406) 444-3739
FAX: (406) 444-1667
www.com.state.mt.us/license/pol/pol_boards/pac_board/board_page.htm

Nebraska State Board of Public Accountancy
P.O. Box 94725
Lincoln, NE 68509-4725
Att: Annette Harmon, Executive Director
(402) 471-3595
FAX: (402) 471-4484
www.nol.org/home/BPA

Nevada State Board of Accountancy
200 South Virginia St., #670
Reno, NV 89509
Att: N. Johanna Bravo, Executive Director
(702) 786-0231
FAX: (702) 786-0234
www.state.nv.us/accountancy/contact.html

New Hampshire Board of Accountancy
57 Regional Dr.
Concord, NH 03301
Att: Louise O. MacMillan, Assistant to the Board
(603) 271-3286
FAX: (603) 271-2856

New Jersey State Board of Accountancy
P.O. Box 45000
Newark, NJ 07101
Att: Kevin B. Earle, Executive Director
(973) 504-6380
FAX: (973) 648-3355
www.state.nj.us/lps/ca/nonmed.htm

New Mexico State Board of Public Accountancy
1659 University Blvd., Ste. 400A
Albuquerque, NM 87102
Att: William J. Heath, Executive Director
(505) 841-9108
FAX: (505) 841-9113
www.rld.state.nm.us/b&c/accountancy/index.htm

New York State Board for Public Accountancy
State Education Dept.
Cultural Education Center, Rm. 3013
Albany, NY 12230
Att: Daniel J. Dustin, Executive Secretary
(518) 474-3836
FAX: (518) 473-6282
www.op.nysed.gov/cpa.htm

North Carolina State Board of CPA Examiners
1101 Oberlin Rd., Suite 104
P.O. Box 12827
Raleigh, NC 27605-2827
Att: Robert N. Brooks, Executive Director
(919) 733-4222
FAX: (919) 733-4209
www.cpaboard.state.nc.us

North Dakota State Board of Accountancy
2701 S. Columbia Rd.
Grand Forks, ND 58201
Att: Jim Abbott, Executive Director
(701) 775-7100
FAX: (701) 775-7430
www.state.nd.us/ndsba/

Accountancy Board of Ohio
77 South High St., 18th Fl.
Columbus, OH 43266-0301
Att: Robert J. Rotaru, Executive Director
(614) 466-4135
FAX: (614) 466-2628
www.state.oh.us/acc/

Oklahoma Accountancy Board
4545 Lincoln Blvd., Suite 165
Oklahoma City, OK 73105-3413
Att: Diana Collinsworth, Executive Director
(405) 521-2397
FAX: (405) 521-3118

Oregon State Board of Accountancy
3218 Pringle Rd., S.E. #10
Salem, OR 97302-6307
Att: Carol Rives, Administrator
(503) 378-4181
FAX: (503) 378-3575
www.boa.state.or us/boa.html

Pennsylvania State Board of Accountancy
P.O. Box 2649
Harrisburg, PA 17105-2649
Att: Dorna J. Thorpe, Board Administrator
(717) 783-1404
FAX: (717) 787-7769
www.dos.state.pa.us/bpoa/accbd.htm

Puerto Rico Board of Accountancy
Old San Juan Station, Box 3271
San Juan, PR 00904-3271
Att: Carmen Carreras-Perez, Esq., Director
(787) 722-4816
FAX. (787) 722-4818

Rhode Island Board of Accountancy
Dept. of Business Regulation
233 Richmond St., Suite 236
Providence, RI 02903-4236
Att: Rosemary B. Snyder, Executive Secretary
(401) 222-3185
FAX: (401) 222-6654

South Carolina Board of Accountancy
P.O. Box 11329
Columbia, SC 29211-1329
Att: Robert W. (Robin) Wilkes, Jr., CPA, Administrator
(803) 896-4492
FAX: (803) 896-4554
www.llr.state.sc.us/bac.htm

South Dakota Board of Accountancy
301 East 14th St., Suite 200
Sioux Falls, SD 57104-5022
Att: Lynn Bethke, Executive Secretary
(605) 367-5770
FAX. (605) 367-5773
www.state.sd.us/dcr/accountancy/

Tennessee State Board of Accountancy
500 James Robertson Pkwy., 2nd Fl.
Nashville, TN 37243-1141
Att: Darrel E. Tongate, CPA, Executive Director
(615) 741-2550
FAX: (615) 532-8800
www.state.tn.us/commerce/tnsba/

Texas State Board of Public Accountancy
333 Guadalupe Tower III, Suite 900
Austin, TX 78701-3900
Att: William Treacy, Executive Director
(512) 305-7800
FAX: (512) 305-7875
www.tsbpa.state.tx.us/

Utah Board of Accountancy
P.O. Box 146741
Salt Lake City, UT 84114-6741
Att: Dan S. Jones, Esq., Administrator
(801) 530-6720
FAX: (801) 530-6511

Vermont Board of Public Accountancy
Office of Professional Regulation
26 Terrace St., Drawer 9
Montpelier, VT 05609-1101
Att: Nancy Morin, Administrator
(802) 828-2191
FAX: (802) 828-2496
www.vtprofessionals.org/accountants/

Virgin Islands Board of Public Accountancy
No. 1A Gallows Bay Mkt. Place
P.O. Box 3016
Christiansted
St. Croix, VI 00822
Att: Pablo O'Neill, CPA, Secretary
(809) 773-4305
FAX: (809) 773-9850

Virginia Board for Accountancy
3600 West Broad St.
Richmond, VA 23230-4917
Att: David E. Dick, Assistant Director
(804) 367-8507
FAX. (804) 367-2475
www.state.va.us/dpor/acc_main.htm

Washington State Board of Accountancy
210 East Union, Suite A (98501)
P.O. Box 9131
Olympia, WA 98507-9131
Att. Dana M. McInturff, CPA, Executive Director
(360) 753-2586
FAX. (360) 664-9190
www.cpaboard.wa.gov/

West Virginia Board of Accountancy
200 L & S Bldg.
812 Quarrier St.
Charleston, WV 25301-2695
Att: JoAnn Walker, Executive Director
(304) 558-3557
FAX: (304) 558-1325
www.state.wv.us/wvboa/

Wisconsin Accounting Examining Board
1400 E. Washington Ave.
P.O. Box 8935
Madison, WI 53708-8935
Att: Alfred Hall, Director
(608) 266-3423
FAX: (608) 267-3816

Wyoming Board of Certified Public Accountants
2020 Carey Avenue, Ste. 100
Cheyenne, WY 82001
Att: Peggy Morgando, Executive Director
(307) 777-7551
FAX: (307) 777-3796
http://spacr.state.wy.us/b&cc/cpa

STATE SOCIETY EXECUTIVE DIRECTORS

Alabama Society of CPAs
Bryan M. Hassler, Exec. Dir.
1103 South Perry St.
Montgomery, AL 36103
(334) 834-7650
FAX: (334) 834-7310
www.ascpa.org

Alaska Society of CPAs
Linda Plimpton, Exec. Dir
341 W. Tudor, Suite 105
Anchorage, AK 99503
(907) 562-4334
FAX: (907) 562-4025
www.akcpa.org

Arizona Society of CPAs
Cindie Hubiak, Exec. Dir
2120 N. Central Ave., Ste.100
Phoenix, AZ 85004
(602) 252-4144
FAX: (602) 252-1511
www.ascpa.com

Arkansas Society of CPAs
Barbara S. Angel, Exec. Dir
11300 Executive Center Dr
Little Rock, AR 72211-4352
(501) 664-8739
FAX. (501) 664-8320
www.arcpa.org

California Society of CPAs
John Plymer, Interim Director
275 Shoreline Dr.
Redwood City, CA 94065-1412
(650) 802-2600
FAX: (650) 802-2661
www.calcpa.org

Colorado Society of CPAs
Mary E. Medley, Exec. Dir.
7979 E. Tufts Ave., Suite 500
Denver, CO 80237-2843
(303) 773-2877
FAX: (303) 773-6344
www.cocpa.org

Connecticut Society of CPAs
Arthur J. Renner, Exec. Dir.
845 Brook St., Bldg. 2
Rocky Hill, CT 06067-3408
(860) 280-1100, ext. 214
FAX: (860) 280-1101
www.cs-cpa.org

Delaware Society of CPAs
Dana L. Rubinstein, Exec. Dir.
The Commons
3512 Silverside Rd.
Wilmington, DE 19810
(302) 478-7442
FAX: (302) 478-7412
www.dscpa.org

Greater Washington (D.C.) Society of CPAs
Robert Uttenweiler, Exec. Dir.
1023 15th St., N.W., 8th Fl.
Washington, D.C. 20005-2602
(202) 789-1844
FAX: (202) 789-1847
www.gwscpa.org

Florida Institute of CPAs
Lloyd A. Turman, Exec. Dir.
P.O. Box 5437
Tallahassee, FL 32314-5437
(850) 224-2727
FAX: (850) 222-8190
www.ficpa.org

Street address: 325 West College Ave.
Tallahassee, FL 32301

Georgia Society of CPAs
James P. Martin, Jr., Exec. Dir.
3340 Peachtree Rd., N.E.,
Suite 2700
Atlanta, GA 30326-1026
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FAX: (404) 237-1291
www.gscpa.org

Guam Society of CPAs
Jerold W. Filush, Exec. Dir.
361 South Marine Drive
Tamuning, Guam 96911
(671) 646-3884
FAX: (671) 649-4265

Hawaii Society of CPAs
Kathy Castillo, Exec. Dir.
P.O. Box 1754
900 Fort St., Suite 850
Honolulu, HI 96806
(808) 537-9475
FAX: (808) 537-3520
www.hscpa.org

Idaho Society of CPAs
Melissa Nelson, Exec. Dir.
250 Bobwhite Court, Suite 240
Boise, ID 83706
(208) 344-6261
FAX: (208) 344-8984
www.idcpa.org

Illinois CPA Society
Martin Rosenberg, Exec. Dir.
222 South Riverside Plaza,
Ste. 1600
Chicago, IL 60606
(312) 993-0407, ext. 204
FAX: (312) 993-9432
www.icpas.org

Indiana CPA Society
Gary M. Bolinger, Pres. & CEO
8250 Woodfield Crossing Blvd.,
Suite 305
Indianapolis, IN 46240-0069
(317) 726-5000
FAX: (317) 726-5005
www.incpas.org

Iowa Society of CPAs
Stanton Bonta, Exec. Dir.
950 Office Park Rd., Suite 300
West Des Moines, IA 50265-2548
(515) 223-8161
FAX: (515) 223-7347
www.iacpa.org

Kansas Society of CPAs
T.C. Anderson, Exec. Dir.
400 SW Croix
P O Box 5654
Topeka, KS 66605-0654
(785) 267-6460
FAX: (785) 267-9278
www.kscpa.org

Kentucky Society of CPAs
Bernard W. Gratzer, Exec. Dir.
1735 Alliant Avenue
Louisville, KY 40299-0326
(502) 266-5272
FAX: (502) 261-9512
www.kycpa.org

Society of Louisiana CPAs
Grady Hazel, Exec. Dir.
2400 Veterans Blvd.,
Suite 500
Kenner, LA 70062-4739
(504) 464-1040
FAX: (504) 469-7930
www.lcpa.org

Maine Society of CPAs
Wendy A. Whiting, Exec. Dir.
153 U.S. Route 1, Suite 8
Scarborough, ME 04074-9053
(207) 883-6090
FAX: (207) 883-6211
www.mecpa.org

Maryland Association of CPAs
Thomas J. Hood, Exec. Dir.
P.O. Box 4417
Lutherville, MD 21094
(410) 296-6250
FAX: (410) 296-8713
www.macpa.org

Street address:
1300 York Rd., Suite 10, Bldg. C
Lutherville, MD 21093

Massachusetts Society of CPAs
Theodore J. Flynn, Exec. Dir.
105 Chauncy St., 10th Fl.
Boston, MA 02111
(617) 556-4000
FAX: (617) 556-4126
www.mscpaonline.org

Michigan Association of CPAs
Peggy A. Dzierzawski, Pres. & CEO
5480 Corporate Dr., Ste. 200
P.O. Box 5068
Troy, MI 48007-5068
(248) 267-3700
FAX: (248) 267-3737
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IRS PRACTICE AND PROCEDURE

1. MISSION AND ORGANIZATION OF THE INTERNAL REVENUE SERVICE

The Internal Revenue Service (IRS) is a branch of the Treasury Department. The commissioner of the IRS is the top official. From the national office in Washington, D.C., the commissioner oversees operations and sets policy.

As part of the IRS Restructuring and Reform Act of 1998 (1998 Act) the IRS mission statement provides that:

> [4] The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity and fairness.

There are ten service centers that process returns and conduct correspondence examinations. Taxpayers and tax practitioners have most of their dealings with district offices. Thirty-three district offices, ten service centers, and three computing centers serve the four regional offices: Northeast, Southeast, Midstates, and Western. Each regional office is headed by a regional commissioner charged with supervising district directors. Office and field audits, collections, and investigations are conducted by divisions of the district offices. The components of the typical district office are these:

— Office of the district director

— Taxpayer service division

— Examination division

— Collection division

— Criminal investigation division

— Employee plans and exempt organizations division

The office of the chief counsel of the IRS is a division of the Treasury Department. Legal counsel are located in each region. Many district offices also have legal counsel. One of the tasks of the counsel's office is to resolve the taxpayer's administrative appeals.

Tax examiners, also called office auditors, conduct their examinations within the IRS office, by correspondence, or by office appointment. Revenue agents handle field examinations at a tax practitioner's or taxpayer's place of business. Revenue officers are agents of the collection division. Special agents handle criminal investigations.

1.1 Restructuring the IRS

The 1998 Act revises the three-tier structure of national, regional, and district offices. The new focus is on four groupings of taxpayers involved in similar activities: individuals, tax-exempts, small businesses, and large businesses. A nine-member board will oversee the IRS, particularly its law enforcement and collection procedures—two IRS activities that the U.S. Senate found to be problem-prone. Furthermore, steps have been taken to reinforce the independence of the appeals function within the IRS.

2. PRACTICE BEFORE THE IRS

Any person may prepare a tax return for himself or herself or for any other person. If that return is audited, the preparer, without further credentials or qualification, may appear to explain the return and represent the taxpayer before tax examiners, revenue agents, or other examining officers of the district audit division. Authorization from the taxpayer is required. Authorization should be indicated on Form 2848. Tax return preparers who are not CPAs, attorneys, or enrolled agents cannot represent the taxpayer at any level of proceedings beyond the examination level, even if they hold the taxpayer's power of attorney. They cannot, for example, appear before the appeals division. They cannot execute documents that limit or bind the taxpayer's rights of action, such as waivers of time limits, consents to immediate assessment of tax, or closing agreements assenting to a deficiency.

The IRS assigns a centralized authorization file number (CAF) to each person granted "representative authority." The centralized file indicates the extent of a representative's authority. A tax preparer who is assigned more than one CAF should choose one of the numbers to use exclusively in subsequent communications with the IRS.

Tax return preparers are assigned a unique number that must be indicated on every return or correspondence (IRC Sec. 6109 and Prop. Reg. 105237-99).

2.1 Persons Authorized to Practice Before the IRS

Corporations may be represented by their officers, partnerships by their partners, and estates or trusts by their fiduciaries.

Treasury Department Circular 230 (hereafter called Circular 230) explains who has the right to practice before the IRS and specifies

standards of conduct. This circular is available at most local IRS offices or through the toll-free "forms" number listed in most telephone directories.

2.1.1 Attorneys

Any attorney not currently under suspension or disbarment may practice before the IRS provided that a written document, stating that the attorney is currently admitted as an attorney, and a power of attorney (Form 2848), signed by the taxpayer and the attorney, are filed with the IRS. This written document should fully specify the addresses and identification numbers of the attorney and the taxpayer. In addition, attorneys can gain limited authority to receive and inspect tax information from the IRS by filing an authorization and declaration (Form 8821) that has been signed by the client and the attorney. Attorneys must, however,

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apply to the Tax Court and other federal courts and be admitted to them before representing clients in those courts.

2.1.2 CPAs

Certified public accountants not currently under suspension may practice before the IRS provided that Form 2848 has been filed with the IRS. CPAs may not, however, perform any activity that constitutes the practice of law, including most aspects of tax litigation such as the filing of a petition or pleading with any court. A CPA may be admitted to practice before the Tax Court, as may any person, by passing an examination on court procedures.

2.1.3 Enrolled persons

Any person, even though he or she is not an attorney or CPA, may seek to pass an IRS examination on technical aspects of taxation, thus gaining the right to be designated an enrolled person (also called an enrolled agent). Enrolled persons may represent taxpayers, just as may attorneys or CPAs. They may not practice law, nor may they practice before the Tax Court. The examination for enrollment is given in September. Application for the September exam must be made on Form 2587 by August 15. A sample examination is in IRS Publication 693.

Former IRS employees who were engaged in applying and interpreting tax matters for a minimum of five years may apply to become enrolled agents by filing a Form 23 within three years of leaving the IRS (no examination is necessary).

Regulations require enrolled persons to complete continuing education courses prior to renewal of their enrollment. (Bar associations and state licensing boards now require continuing education of CPAs and attorneys.)

2.1.4 Limited practice

Any person whose presence is determined to be necessary to explain facts may appear before the IRS as a witness.

2.1.5 Authorizations and powers of attorney

IRS employees are required to verify the authority of any person who seeks access to a taxpayer's records or who wishes in any manner to represent a taxpayer. The extent of this authority should be indicated by the taxpayer on IRS Form 2848, which may be filed by FAX. IRS Form 8821 can be used to authorize disclosure of information. If the taxpayer's authorization is on file, IRS employees are told to extend the "courtesy of having all arrangements in furtherance of the matter"

made through the representative. Additionally, the representative has a right to be present when the client is interviewed and to receive copies of all written communication from the IRS (Internal Revenue Manual Sec. 4055). The taxpayer must also be present at an IRS interview if required to do so by an IRS summons.

IRS Form 8821 (tax information authorization) replaces now-obsolete Form 2848-D. With Form 8821, the taxpayer authorizes another person to inspect in an IRS office or to receive by mail all tax information, notices, or other written communication related to a specifically identified tax matter. No authority to represent the taxpayer is granted. A newly filed information authorization revokes one previously filed concerning the same tax matters.

IRS Form 2848 (power of attorney and declaration of representative) can be used to grant to a representative the power to

— Inspect and receive tax information, notices, and communications.

— Receive (but not negotiate) the taxpayer's refund check.

— Sign a tax return, in certain cases, on behalf of the taxpayer (Regs. Sec. 1.6012-1(a)(5)).

— Execute waivers and offers of waivers of restrictions on assessment or collection of deficiencies in tax, or waivers of notice of disallowance of a claim for refund or credit.

— Execute consents extending the statute of limitations.

— Execute a closing argument (IRC Sec. 7121).

— Delegate authority or substitute another representative, if expressly authorized to do so by the taxpayer.

Form 2848 may be executed on behalf of the taxpayer by an attorney-in-fact designated as such in a non-IRS document such as a general, limited, or durable power of attorney. A taxpayer must be present in an IRS interview if required to do so by an IRS summons.

According to a report by the Cincinnati IRS Service Center, the most common reasons for IRS rejection of a power of attorney are

— Lack of signature of representative or failure to indicate status, such as CPA, attorney, or enrolled agent.

— Failure to provide all necessary information required by Form 2848.

— Failure to include the title of a person signing for a business.

— Tax period not clearly identified.

— Omitting EIN or SSN for the taxpayer.

2.1.6 Privileged communications

The attorney-client privilege is extended to provide confidentiality between a taxpayer-client and any individual authorized to practice before the IRS. The privilege applies in noncriminal proceedings before the IRS and in federal courts if the IRS is a party. Certain communications relating to tax shelters are not included in this privilege.

2.2 Persons Who May Not Practice Before the IRS

According to Circular 230, officers and employees of the United States in the executive, legislative, or judicial branch of the government may practice before the IRS only to represent a member of the person's immediate family or any other person or estate for which the person serves as guardian, executor, administrator, trustee, or other personal

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fiduciary (18 U.S.C. 205). No member of Congress or resident commissioner (elect or serving) may practice in connection with any matter for which he or she directly or indirectly receives, agrees to receive, or seeks any compensation. Officers and employees of any state or subdivision whose jobs entail passing upon, investigation of, or dealing with tax matters of their state or subdivision may not practice if their employment may disclose facts or information applicable to federal tax matters.

2.3 Rules Governing Conduct

2.3.1 Circular 230

Rules of practice before the IRS are spelled out in Circular 230. Disreputable acts or violations of regulations may lead to suspension or disbarment. Such acts include but are not limited to the following:

— Conviction of any criminal offense

— Giving false or misleading information

— False advertising or other impermissible forms of solicitation of clients

— Willfully failing to make a federal tax return

— Misappropriation of, or failure to properly and promptly remit funds received from a client for the purpose of payment of taxes or other obligations due the United States

— Disbarment or suspension of his or her professional license

— Aiding or abetting another person to practice before the IRS who is not properly qualified to do so

— Contemptuous conduct in connection with practice before the IRS (Circular 230; Subpart C)

— Conviction of any offense involving dishonesty or breach of trust

— Charging an unconscionable fee

— Charging a contingent fee for preparing an original return

An unconscionable fee is based on a percentage of the refund shown on a return or of the taxes saved or that otherwise depends on the result obtained by the preparer. Such a fee may not be charged for preparation of an *original* return. If a preparer anticipates that a claim for refund or an amended return will receive substantive review by the IRS, a contingent fee may be charged. See also Sec. 2.4 Tax Preparer's Liability.

2.3.2 AICPA tax standards

The American Institute of Certified Public Accountants' (AICPA's) Division of Federal Taxation has adopted standards for tax practice through the Statements on Responsibilities in Tax Practice (SRTP). The office of the IRS director of practice reportedly views the SRTPs as extensions and interpretations of Circular 230. The current eight statements, adopted in August 1988, can be summarized as follows:

SRTP No. 1—Tax Return Positions A tax return position is one that the CPA has specifically advised the client to follow or one about which the CPA who signs the return has knowledge of all material facts. The position may be on a tax return or on a claim for refund.

The CPA should not recommend a position unless he or she has a *good-faith belief that the position has a realistic possibility of being sustained administratively or judicially* on its merits if challenged. (No position should be taken merely to obtain leverage in negotiating a settlement.) Nevertheless, a CPA may recommend a position not fulfilling these requirements if the position is not frivolous and is adequately disclosed on the return. A frivolous position is one that is knowingly advanced in bad faith and is patently improper, for example, a position that cannot be sustained but is advanced in the hope of winning the "audit lottery." According to the IRS, disclosure may be made on Form 8275. The CPA should advise the client about the potential penalties that might result from taking such a position.

According to Interpretation No. 1-1 of SRTP No. 1, a CPA must have a good-faith and honest belief that a tax return position is *warranted by existing law* or can be supported by a *good-faith argument for an extension, modification, or reversal of existing law* through administrative or judicial means. The likelihood of audit or other detection must not be taken into account when evaluating the client's tax position.

The standard of realistic possibility is less stringent than that of both the substantial authority and the more-likely-than-not standards applicable to substantial understatements of liability under the Internal Revenue Code (IRC Sec. 6662). It is more strict than the reasonable basis standard under Treasury regulations issued before the Revenue Reconciliation Act of 1989.

A CPA may find it possible to rely on certain sources of tax authority that would not meet the substantial authority criteria and to demonstrate that a tax return position possessed a realistic possibility of being sustained. These additional sources include well-reasoned treatises, articles in recognized professional tax publications, and other sources commonly used by tax advisors and return preparers. The relative weight of each authority depends on its persuasiveness, relevance, and source.

Additionally, a CPA may conclude that the realistic possibility standard has been met when the position is *supported only by a well-reasoned construction of the applicable statutory provision.*

Example: The client has obtained from its attorney an opinion on the tax treatment of an item and requests that the CPA rely on the opinion. The CPA may rely on that opinion if satisfied as to the source, relevance, and persuasiveness of the legal opinion.

In evaluating the realistic possibility standard, a CPA's decision process should include

— Establishing relevant facts.

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— Developing questions from those facts regarding possible tax positions.

— Searching acceptable sources for authoritative answers.

— Answering the questions and weighing the authorities.

— Arriving at a conclusion supported by authority.

The realistic possibility standard of SRTP No. 1 is incorporated by the Omnibus Budget Reconciliation Act of 1989 into amended Internal Revenue Code Section 6694(a), which reads as follows:

> If (1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits, and (2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, such person shall pay a penalty of $250 with respect to such return or claim.

SRTP No. 2—Answers to Questions on Returns Before signing as preparer, *the CPA should make a reasonable effort to obtain from the client and provide appropriate answers* to all questions. In this context, the term "questions" includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question. Omitting an answer is not justified by its potential damage to the client. If reasonable grounds exist for omission of an answer, the CPA is not required to provide an explanation of the reason for the omission. Reasonable grounds include the following:

— The information is not readily available and the answer is not significant in terms of taxable income or loss or the tax liability.

— Genuine uncertainty exists regarding the meaning of the question in relation to the particular return.

— The answer is voluminous; in such cases, assurance should be given on the return that the data will be supplied upon examination.

SRTP No. 3—Need to Verify Supporting Data or to Consider Other Information The CPA *may rely on information furnished by the client or by third parties unless it appears to be incorrect, incomplete, or inconsistent.* The CPA may rely on unsupported data from the client in the form of lists of information such as dividend, contribution, and medical expenses unless the data appear to be faulty. If a condition is imposed with regard to a tax treatment—for example, that there be documentation substantiating a deduction—the CPA should inquire to determine whether the taxpayer has met the condition.

The CPA should make use of the client's prior years' tax returns wherever feasible. There is no requirement that the CPA examine underlying documentation.

SRTP No. 4—Use of Estimates *The client has responsibility for the estimated data and should be the one who provides it.* (Note: Presumably this means that when the CPA aids the client in preparing the estimate, the estimate must be adopted by the client as his or her responsibility.) Appraisals or valuations are not considered to be estimates.

The CPA *may prepare and sign a tax return* involving the use of a taxpayer's estimates *if it is impracticable to obtain exact data, and the estimated amounts are reasonable.* Estimates should not be presented in a manner to imply greater accuracy than exists. (Note: Presumably this means that cash contributions for which no exact amount can be calculated should be stated as, for example, $500 rather than $505.62.)

To avoid misleading the IRS about the accuracy of an item, in unusual circumstances the use of an estimate must be disclosed. Examples of unusual circumstances include the following.

— The taxpayer has died or is ill and is thus unable to provide the estimates.

— The taxpayer has not received a K-1 from a flow-through entity such as a partnership.

— Litigation is pending that impacts the return, for example, a bankruptcy proceeding.

— Fire or computer failure destroyed the relevant records.

SRTP No. 5—Departure from a Position Previously Concluded This rule concerns tax return positions that depart from the treatment accorded to a similar item in an administrative or court proceeding regarding a prior tax return. "Administrative proceeding" includes an examination by the IRS or an appeals conference relating to a return or a claim for refund.

Unless the taxpayer is bound to a specified treatment in the later year, for example, by a formal closing agreement, *a different treatment may be recommended* by the practitioner.

After giving consideration to the fact that the taxpayer gave consent in an earlier proceeding or to the existence of an unfavorable court decision, *the CPA may prepare and sign a tax return containing this different treatment* as long as this is done consistently with SRTP No. 1 requiring that the CPA have a good faith belief in the sustainability of the position.

SRTP No. 6—Knowledge of Error in a Tax Return or of the Client's Failure to File *The CPA should inform the client promptly upon becoming*

aware of an error or failure to file and should recommend the measures to be taken. The advice may be given orally.

If the client fails to take what the CPA believes to be appropriate action, *the CPA should consider whether to prepare the return and whether to continue a professional relationship* with the client. (Treasury Circular 230 similarly requires that a practitioner inform the client when an error has been found.) The CPA may inform the IRS *only with the client's permission or when required to do so by law.*

Excluded from this statement are instances in which (1) the original position taken by the client satisfied SRTP No. 1, (2) the matter in question has no more than an insignificant effect on the client's tax, or (3) an erroneous method of accounting was continued in the prior year under circumstances that required the permission of the IRS to change.

SRTP No. 7—Knowledge of Error: Administrative Proceedings When a CPA becomes aware of an error in a return that is the subject of an administrative proceeding, such as an examination by the IRS or an appeals conference, these actions are appropriate:

The CPA should inform the client promptly upon becoming aware of an error and should recommend the measures to be taken, whether or not the CPA prepared or signed the return that contains the error. The advice can be given orally. The CPA should not inform the IRS without the client's permission unless required to do so by law.

The CPA should request the client's agreement to disclose the error to the IRS. The decision, however, is the client's responsibility. If the CPA believes the IRS might view the error as evidence of fraud the client should be advised to consult legal counsel before taking any action. Lacking the client's agreement to disclose the error to the IRS, the CPA should consider withdrawing from representation of the client.

Because of possible conflict of interest between the CPA and the client, the CPA should consider consulting his or her own legal counsel.

SRTP No. 8—Form and Content of Advice to Clients Advice given to a client need not follow a standard format but should reflect professional competence and serve the client's needs.

There is no responsibility to update previously given advice unless there is a specific agreement or unless the CPA is assisting in implementing the advice, although the CPA may choose to do so.

A CPA should inform the client that advice reflects professional judgment based on the existing situation, that subsequent developments could affect previous professional advice, and that the advice is based on facts as stated to the CPA and on tax authorities that are subject to change.

2.3.3 AICPA Code of Professional Conduct

Contingent Fees. Rule 302 of the Code of Professional Conduct of the AICPA states that

> A member in public practice shall not prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

Contingent fees are fees established for the performance of any service within an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.

Fees are not regarded as contingent if they are fixed by courts or other public authorities, or, in tax matters, if the fees are determined based on the result of judicial proceedings or on the findings of governmental agencies.

A fee is considered to be "determined based on the findings of governmental agencies" if the member can demonstrate a reasonable expectation at the time of a fee arrangement of substantive consideration by an agency with respect to the member's client. Such an expectation is not reasonable in the case of preparation of original tax returns.

Examples of Contingent-Fee Situations. The following are examples, not all-inclusive, of circumstances where a contingent fee would be permitted.

— Representing a client in an examination by a revenue agent of the client's federal or state income tax return.

— Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.

— Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation ($1 million at March 1991) or state taxing authority.

— Requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests.

— Requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority

review process for hearing all taxpayer arguments relating to assessed value.

— Representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

The following is an example of a circumstance where a contingent fee would not be permitted:

— Preparing an amended federal or state income tax return for a client claiming a refund of taxes because a deduction was inadvertently omitted from the return originally filed. There is no question as to the propriety of the deduction; rather the claim is filed to correct an omission.

Discreditable Acts. Rule 501 of the AICPA's Code of Professional Conduct states that a member shall not commit an act discreditable to the profession. Disciplinary actions under this rule have been taken against AICPA members in connection with income tax violations. For example, a practitioner was given a ninety-day membership suspension for assisting a client in preparing a return that included an improper depreciation deduction related to a tax shelter.

Disciplinary Actions by the AICPA, State Boards of Accountancy, and State CPA Societies. The Bylaws of the AICPA provide for a professional ethics division and for a trial board to hear charges of violations of the bylaws or of the Code of Professional Conduct. Disciplinary actions against members are reported in the *CPA Letter,* the semimonthly newsletter of the AICPA. A membership can be suspended without a hearing, and then terminated upon final conviction, for any of these offenses:

— A crime punishable by imprisonment for more than one year

— The willful failure to file any income tax return that the member, as an individual taxpayer, is required by law to file

— The filing of a false or fraudulent income tax return on the member's or a client's behalf

— The willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client (AICPA Bylaws 7.3.1)

2.3.4 Conduct of IRS employees

The IRS must terminate an employee (absent direct intervention by the IRS Commissioner as explained below) if there is a final administrative or judicial determination that, in the course of his or her official duties, the employee committed any of the following acts:

1. Willfully failed to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets
2. Provided a false statement under oath with respect to a material matter involving a taxpayer or a taxpayer representative
3. Violated the rights of a taxpayer, taxpayer representative, or other employee of the IRS under the U.S. Constitution or under specified civil rights acts
4. Falsified or destroyed documents to conceal mistakes made by any employee with regard to a matter involving a taxpayer or taxpayer representative
5. Assaulted or battered a taxpayer, taxpayer representative, or other employee of the IRS, but only if there is a criminal conviction or a final civil judgment to that effect
6. Violated the 1986 IRC, Treasury regulations, or IRS policies (including the IRS Manual) for the purpose of retaliating against or harassing a taxpayer or other employee of the IRS
7. Willfully misused the provisions of IRC Sec. 6103 (regarding confidentiality of returns and return information) for the purpose of concealing information from congressional inquiry
8. Willfully failed to file any tax return required under the IRC on or before the required date, unless the failure is due to reasonable cause and not willful neglect
9. Willfully understated federal tax liability, unless such understatement is due to reasonable cause and not willful neglect
10. Threatened to audit a taxpayer for the purpose of extracting personal gain or benefit

2.4 Tax Preparer's Liability

2.4.1 Definition of "tax return preparer"

The term *tax return preparer* (TRP) applies to any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax or claim for refund of tax. Income tax return preparers must manually sign the returns they prepare and must include their name and identification number. To be classified as a TRP a person must prepare all or a substantial portion of the return, but the person does not have to be the one physically to enter the figures on the form or schedule, nor does entering these figures automatically make a person a TRP (IRC Sec. 7701). Anyone may be held to be a TRP (even if he or she does not sign the return) who

— Provides advice that reduces filling out a return to a mere clerical task.

— Provides tax advice about completed transactions directly relating to a specific entry on a return.

— Recommends substantial changes in a draft of a return (even if the draft was prepared by the taxpayer) and the taxpayer follows the recommendations.

— Reviews the return, concludes no changes are required, and mails in the return under the taxpayer's instructions.

— Makes entries on one return—for example, a partnership return—that constitute a substantial portion of a partner's return, thus becoming a TRP with regard to both the partnership and the partner's return.

Example: An attorney who prepared Forms 1065 for three limited partnerships was held also to be a preparer of the tax returns of the limited partners themselves. (*Randall S. Goulding v. U.S.*, 92-1 USTC 50,174 (7th Cir., 1992), aff'g D.C. 89-1 USTC 9309.) In a case with somewhat similar facts, however, the accountant who prepared the Schedules K-1 for partners was not deemed a preparer of the partners' individual returns. The court reasoned that the single figure signifying the partnership's losses should not be considered a substantial portion of a partner's return when judged in comparison with the complexities of a partner's complete return. (*Adler and Drobny, Ltd, an Illinois Professional Corporation, and Sheldon Drobny v. U.S.*, 92-2 USTC 50,378, N.D. Ill., 3/24/92.)

(Text continued on page 15)

On the other hand, merely typing or photocopying the return does not make one a preparer, and neither does preparing a return

— For an employer, officer of the employer, or for a fellow employee, or for one or more general partners in a partnership in which the preparer is a general partner or an employee.

— As a fiduciary.

— For a friend, relative, or neighbor with no agreement for compensation (either stated or implicit), even though a favor or gift is received in return.

If more than one person worked on a return (or claim for refund), a determination of who is the preparer will be made according to rules of substantial preparation.

2.4.2 Substantial preparation

Each schedule, entry, or portion of a return or claim for refund is reviewed separately to determine who is the preparer. One who renders advice concerning the existence, characterization, or amount of a schedule or entry is subject to IRS regulation as an income tax preparer for that return, including the penalties to which preparers are subject, if the item is a substantial portion of the return. It is not necessary that the person signed the return.

There is a quantitative test to determine when a schedule, entry, or portion of a return is substantial: An item is not substantial if it is less than $2,000, or is less than $100,000 while also less than 20 percent of adjusted gross income (Treas. Reg. 301.7701-15).

2.4.3 What constitutes an income tax return

Preparer penalties relate only to the preparation of certain specified forms that constitute tax returns (Treas. Reg. 301.7701-15(c)):

— Individual or corporate income tax return

— Fiduciary income tax return for an estate or trust

— Undistributed capital gains tax return for a regulated investment company

— Charitable remainder trust return

— Return for a transferor of stock or securities to a foreign entity

— S corporation return

— Partnership return for a Domestic International Sales Corporation (DISC)

— Refund claim for a credit against any income tax
— Information return on behalf of a person or entity that is not a taxable entity but reports information that may be reported on the return of a taxpayer.

On the other hand, these are not "tax returns" for purposes of determining preparer penalties:

— Gift or estate tax return
— Returns for excise tax or tax collected at the source on wages
— Individual or corporate declaration of estimated tax
— Application for an extension of time to file an individual or corporate return
— An informational statement on Form 990, Form 1099, or a similar form

2.4.4 Potential penalties facing preparers

Penalties on preparers of $50 per instance ($25,000 maximum per year) may be assessed under IRC Sec. 6695 for failure to

— Furnish a copy of the return or refund claim to the taxpayer.
— Sign a return or claim when required to do so.
— Include the preparer's identifying number.
— Retain for three years copies of all returns and refund claims or a list of taxpayers, identification numbers, and type of filing.
— File an annual information return reporting names of employees who prepare returns for other than the employer.

Certain offenses carry significantly larger penalties:

— Negotiating or endorsing taxpayer refund checks: $500 (IRC 6695(f))
— Assisting in organizing a tax shelter, or making a false or fraudulent or a gross valuation overstatement: $1,000 (IRC 6700)
— Aiding and abetting an understatement of tax liability in connection with a corporation: $10,000; other returns or claims: $1,000 (IRC Sec. 6701)
— An understatement of tax liability due to a position (of which the preparer knew or should have known), for which there was not a realistic possibility of being sustained on its merits and not disclosed as provided in IRC Sec. 6662(d) or the position was frivolous: $250 (IRC 6694(a)) (Discussed more fully in section 2.5)

— An understatement of tax liability due to a willful attempt to understate liability by a preparer or a reckless or intentional disregard of rules or regulations: $1,000 (IRC Sec. 6694(b))

— Disclosing or using information received in connection with the preparation of a return: $250 (IRC Sec. 6713)

— Willfully failing, while acting as a "responsible person," to collect or pay over any tax: penalty is the amount of the tax (IRC Sec. 6672)

In addition to the items on this list, a preparer might be charged with a related crime, for which a jail sentence could be imposed, for example, disclosure or use of tax return information: $1,000 fine or imprisonment not more than one year (IRC Sec. 7216).

Generally, a TRP may rely on information supplied by the taxpayer client. Only when the information appears incorrect, inconsistent, or incomplete must inquiries be made. In one instance a preparer had to pay a penalty when he knew that in a prior year a similar deduction had been attempted but denied upon audit, even though that prior return had been prepared by another.

If the law requires specific conditions in order for a deduction to be properly claimed, a TRP must inquire about the conditions. For example, if travel and entertainment expenses, or business use of a listed asset, are claimed, the TRP should ask if the taxpayer has the records to substantiate the deduction. The preparer may accept the taxpayer's affirmative answer and need not examine the records. Neither is it necessary, under law, for the preparer to examine information returns the taxpayer has received, such as Forms 1099, but many preparers feel it is prudent to do so.

TRPs paid penalties in the following instances:

— The alternative minimum tax was overlooked by a TRP who admitted no knowledge of its existence.

— Through negligence, the amount of a net operating loss was overstated when carried back to prior years. Penalties were paid for each prior year.

— A net operating loss carryforward was mistakenly and negligently overstated, causing penalties to the TRP involved in the calculation.

— The TRP allowed a client to claim five dependents while knowing the client had only two.

— The TRP ignored a bookkeeper's comment that shareholders' personal expenses had been paid from corporate funds.

2.4.5 Recordkeeping

Preparers, or their employers, must retain for a three-year period following the close of the return period a record of the name, Social Security number, and place of work of each employed preparer. (The return period is defined as a twelve-month period beginning on July 1 of each year.) These records must be made available for inspection by the district director. The penalty is $50 for each failure to retain and make available a record, plus a $50 penalty for each missing but required item. The maximum penalty for any return period is $25,000 (IRC Sec. 6695).

2.4.6 Procedures for assessing penalties

The IRS must assess a penalty within three years after the improperly handled return. There are no limitations if willful understatement of tax liability has occurred. Computer-generated account information called PINEX (Penalty and Interest Notice Explanation) is available from IRS service centers and district offices.

The IRS issues a thirty-day letter as notification of a proposed penalty. Burden of proof is on the preparer as to whether he or she intentionally or willfully disregarded rules or regulations. The IRS bears the burden of proof concerning the preparer's willful attempt to understate tax liability.

If a penalty for understatement of tax is assessed (and the preparer either chooses against an administrative remedy or receives an adverse administrative determination), the preparer has two alternatives:

— Pay the amount assessed and file a claim for refund.

— Pay 15 percent of the amount assessed within thirty days of the demand for payment and file a claim for refund of the amount paid within the same thirty-day period.

2.4.7 Injunctions against preparers

Injunctions are sometimes sought by the IRS in federal district court to prohibit improper conduct by a preparer. Penalties may or may not have already been assessed. Violations related to the following activities may be the basis for the injunction:

— Conduct subject to disclosure requirement penalties

— Conduct subject to the understatement of tax liability penalties

— Conduct subject to criminal penalties under the Internal Revenue Code

— Misrepresentation of eligibility to practice before the IRS
— Misrepresentation of experience or education as a tax preparer
— Guaranteeing payment of a tax refund or allowance of a credit
— Engaging in other fraudulent or deceptive conduct that interferes with administration of the tax laws

2.5 Understatement Penalties

Internal Revenue Code Sec. 6694 aims a penalty at a preparer if there is an understatement of liability due to a tax position for which there was not a realistic possibility of being sustained on its merits *and* the position was not properly disclosed *or* the position was properly disclosed but was frivolous. (Circular 230 defines *frivolous* as patently improper.) According to Circular 230 a preparer may not advise a client to take a tax position, nor himself or herself prepare the portion of the return on which the position is taken unless

— The preparer determines that the position satisfies the realistic possibility standard; or
— The position is not frivolous and the preparer advises the client of (1) any opportunity to avoid the accuracy-related penalty of IRC Sec. 6662 by adequately disclosing the position and (2) the requirements for adequate disclosure.

A preparer also must advise his or her client of penalties reasonably likely to apply to a tax position that has been advised, prepared, or reported by the preparer. The preparer must inform the client of opportunities of avoiding these penalties by disclosure and of the means for disclosure. The advice recommended in this paragraph must be given even if the preparer is not subject to a penalty as a consequence of the tax position.

The following are situations in which no additional disclosure need be made.

1. Schedule A, Itemized Deductions:
    a. Medical and Dental Expenses, lines 1-4.
    b. Taxes, lines 5-9. Line 8 must list each type of tax and the amount paid.
    c. Interest Expense, lines 10-14. Not applicable to (i) disallowed investment interest unless Form 4952 is completed, or (ii) amounts disallowed under IRC Sec. 265 (i.e., interest related to tax-exempt income).
    d. Contributions, lines 15-18. Not applicable to (i) donations where the taxpayer receives a substantial benefit, (ii) noncash

contributions in excess of $500 unless Form 8283 is attached, or (iii) any contribution of $250 or more unless contemporaneous written substantiation is obtained.

e. Casualty and Theft Losses, line 19. Form 4684 listing each item for which a loss is claimed must be attached to the return.

2. Certain Trade or Business Expenses:
   a. Casualty and Theft Losses. Same as item 1(e) above.
   b. Legal Expenses. Amount must be stated and cannot be a capital, personal, or nondeductible lobbying or political expenditure.
   c. Specific Bad Debt Charge-off. Amount written off must be stated.
   d. Repair Expenses. Amount claimed must be stated and cannot be characterized as a capital or personal expenditure.
   e. Taxes (other than foreign taxes). Amount claimed must be stated.
3. Other Items:
   a. Moving Expenses. Form 3903 or 3903-F must be attached to the return.
   b. Sale or Exchange of Main Home. Form 2119 must be attached to the return.
   c. Employee Business Expenses. Form 2106 or 2106 EZ must be attached to the return. Does not apply to club dues or travel expenses for any non-employee accompanying the taxpayer.
   d. Fuels Credit. Form 4136 must be attached to the return.
   e. Investment Credit. Form 3468 must be attached to the return.

An employer (or partnership) can be assessed penalties for *participation* in the negligent, intentional, willful conduct of the person who is technically considered to be the preparer (Regs. Sec. 1.6694-1(a)(1)). A penalty connected with understatement of a taxpayer's liability is not imposed on an employer solely because he or she employs a preparer who becomes subject to penalty. The penalty applies to an employer who knows the employee is understating tax and does not attempt to prevent it (IRC Sec. 6701(c)). Congressional comments suggest negligence might be attributed to a supervisor or reviewer who had responsibility for determining that rules and regulations were being followed but failed to do so. (S. Rep. No. 938, Pt. 1, 94th Cong., 2d Sess. 355 (1976).)

If any part of the understatement of tax liability (or overstatement of a claim for refund) is due to a willful attempt by a tax preparer to understate liability or to the preparer's willful or intentional disregard of tax provisions, the penalty is $1,000 for each return or claim (IRC

Sec. 6694(b)(1),(2)). A preparer who received but then ignored information furnished by the taxpayer or by others might be held liable for this penalty.

2.5.1 Effect of understatement of tax liability

If there is no understatement, there can be no penalty. The IRS does not attempt to assert a penalty if there is no more than a relatively immaterial understatement (Revenue Procedure 80-40, 1980 CB 774). No penalty for understatement applies if a final determination of the tax indicates there is no understatement, and any penalties that have been collected will be refunded.

2.5.2 Multiple penalties

In certain cases a preparer may create multiple opportunities for penalty. A negligent claim of a net operating loss in one year may create an understatement of tax liability in each of the carryover years. An understatement on a partnership return that flowed through to be a substantial portion of many limited partners' returns could subject the preparer of the partnership returns to understatement penalties on each of the limited partners' returns.

2.5.3 Negligent disregard for rules and regulations

Guidelines have been issued by the IRS as to what constitutes "negligence" in the context of the former version of IRC Sec. 6694(a). Congressional committee reports indicate that conduct previously considered to be negligent should continue to be penalized after 1989. The relevant definition is this: *Negligence* refers to a lack of due care or a failure to do what a reasonable and prudent person would do under the circumstances (Rev. Proc. 80-4 1980-2 CB 774); (*Brockhouse v. U. S.*, 749 F.2d 1248 (7th Cir. 1984)); IRM Sec. 4297.2). The revenue procedure cited states the IRS considers the nature, frequency, and materiality of errors when determining if negligence has occurred. These factors need to be considered by preparers seeking to avoid negligence:

— Negligence does not result where the code section is so complex or highly technical that a competent TRP might misapply it.

— Isolated clerical or mathematical errors are not negligence, but the failure to detect conspicuous examples of these does constitute negligence.

— Ignorance or oversight of a rule or regulation does constitute negligence.

— Information supplied by the taxpayer may be relied upon by a preparer unless it appears incorrect, incomplete, or contradictory.

2.5.4 Normal business practices

The IRS does not assert a negligence penalty if the preparer's *normal business practices* indicate the error would rarely occur and these practices were followed in preparing the faulty return (Treas. Reg. 1.6694-1(a)(5)). Repeated errors of the same type, or a pattern of errors, indicate negligence. Revenue Procedure 80-40 (1980-2 CB 774, 775) cites the following as desirable office practices:

— Worksheets to accumulate data from the taxpayer

— Checklists to indicate returns and schedules suggested by the information

— Review of prior two years' returns

— Supervision of preparation by experienced persons and establishment of means for researching difficult questions

— Review procedures for completed returns

(Text continued on page 21)

— Sign-off sheets to indicate compliance with prescribed office procedures

While it applies to taxpayers—rather than to tax practitioners—the following case helps clarify the concept of normal business practice. The Tenth Circuit has reversed and remanded a Bankruptcy Court decision, allowing the imposition of the failure to file penalty where a taxpayer had insufficient and overworked staff. Despite the fact that the taxpayer was expending over half of its payroll on in-house accounting services, the court determined the failure to timely file was not due to reasonable cause and the failure to file penalty applied (*In re Craddock v. U.S.*, 98-1 USTC 50,392, CA-10, 5/1/98, rev'g. and rem'd. 95-2 USTC 50,475).

2.5.5 Substantial authority

Tax return positions for which the taxpayer has substantial authority are treated as if properly shown on the return, and no substantial understatement penalty is asserted against a preparer. The Omnibus Budget Reconciliation Act of 1989 expanded upon the list of authorities in Regs. Sec. 1.6661-3(b)(2) upon which a taxpayer may rely. The complete list of authorities includes

— Internal Revenue Code and other statutory provisions.

— Temporary and final regulations.

— Court cases.

— Administrative pronouncements (including revenue rulings and revenue procedures).

— Tax treaties and regulations thereunder and Treasury Department explanations of treaties.

— Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of the bill's managers.

— Proposed regulations.

— Private letter rulings.

— Technical advice memoranda.

— Actions on decisions.

— General counsel memoranda.

— Information releases or press releases, notices, and any other similar documents published by the IRS in the Internal Revenue Bulletin.

— General explanations of tax legislation prepared by the Joint Committee on Taxation (called the "Blue Book").

Additionally, the 1989 Omnibus Budget Reconciliation Act required the IRS to publish, not less frequently than annually, a list of tax return positions for which the IRS believes there is no substantial authority and which affect a significant number of taxpayers. The purpose of this list is to assist taxpayers in determining whether a position should be disclosed to avoid the penalties for substantial understatement provided in IRC Sec. 6662(d). Thus, a taxpayer might choose to disclose having taken a position enumerated on the list in order to avoid imposition of the substantial understatement penalty. Disclosure of a tax return position should be on Form 8275-R.

3. IRS PROCEDURE FOR EXAMINING RETURNS

3.1 Initial Review and Screening

The review process begins with routine checks for obvious errors, such as mathematical mistakes and omissions of signatures and Social Security numbers, for all returns filed. These procedures constitute only a cursory review and fall far short of an audit. An audit, also referred to as an examination, may require the taxpayer to respond to questions or to provide supporting data or documentation for elements of his or her tax return. Because of the large volume of returns filed each year, the IRS cannot possibly audit every return filed; only about 2 percent of all returns are audited. To ensure that IRS audit time is expended productively, the IRS uses several techniques for selecting which returns to audit.

Economic reality audits, also called financial status audits, are permitted only if there exists a prior, reasonable indication of likelihood of unreported income. IRC Sec. 7602(e). Such audits proceeded through the use of questions probing the taxpayer's lifestyle, such as, "Where do you go on vacation?" and "What cars do you own?"

3.2 Selection for Audit

3.2.1 Discriminate Function System (DIF)

After the initial checks, information about individual returns is stored on magnetic tape and sent to the national computer center in Martins-

burg, West Virginia. Here the information is processed by computers and rated for potential errors by a selection program known as the Discriminate Function System (DIF). DIF is a statistical system that assigns numerical values to various items on the return and then produces a composite score for each return. The formulas for developing the DIF score are kept secret from the public. The standards used in developing these formulas are based on the results of examinations from previous years, particularly the results of the TCMP program (see section 3.2.3, which follows). If the composite score indicates that a reasonable chance for error exists in a return, the return can usually be treated by correspondence from an IRS service center. Returns with scores indicating a greater possibility of error are considered for possible office or field examinations.

3.2.2 Manual identification

If a return is singled out by DIF or by other means, experienced IRS auditors apply what can be called a "sniff" test. Various aspects of the return are considered, including the taxpayer's occupation and amounts and types of deductions claimed.

3.2.3 Taxpayer Compliance Measurement Program (TCMP)

In mid-October of 1995, the IRS announced indefinite suspension of the TCMP program. The DIF standards used to determine which returns would be audited were constantly updated using information received from an examination program called the Taxpayer Compliance Measurement Program (TCMP). TCMP selects random returns and subjects them to a thorough audit that examines every aspect of the return. Taxpayers may be required to furnish the examiner with canceled checks, broker's statements, bank receipts, and any other item that might be needed to verify every entry on the return. Full compliance with TCMP audits is mandatory but time-consuming and expensive for the taxpayer. The only excuses permitted for avoiding a TCMP audit are the following:

— The taxpayer is outside the United States and unavailable for an interview.

— The taxpayer cannot be located.

— The taxpayer is too ill, has become incompetent, or has died, and the guardian or executor cannot be located.

3.2.4 IRS instructions to classifiers and auditors

IRS instructions are contained in the *Internal Revenue Manual* (IRM). Excerpts from the manual are available from commercial publishers. Reviewers and auditors are told to consider

— Comparative size of an item in relation to income and other expenses.

— Evidence of intent to mislead, such as missing or incomplete information.

— Beneficial effect of the manner of reporting—for example, expenses are recorded on a business schedule rather than treated as an itemized deduction.

— Relationships such as lack of dividend income while there are sales of securities.

3.3 Chances of Selection

The chance that a return will be selected for audit is determined by several factors, among which is total positive income (TPI). TPI is the sum of all positive income values appearing on a return. Higher amounts of TPI increase a taxpayer's chance of being selected for audit. In recent years, the probability of audit has ranged from 1 to 4 percent for Form 1040 filers, depending on the level of TPI.

Corporations having assets of $1 million or less face a 3 percent or less chance of selections. For corporations with assets over $100 million, the audit percentage is greater than 50 percent.

3.4 Items That May Trigger an Audit

While the actual items that may cause the computer or an examiner to flag a return for audit are not in the public record, there is general agreement among accountants that the following situations tend to increase the chance of audit:

— Deduction for items obviously not authorized by law

— Medical deductions without any insurance reimbursements

— Large casualty-loss deductions

— Large noncash contributions, particularly when out of proportion with the taxpayer's income

— Large deductions for travel and entertainment expenses not consistent with the nature of the taxpayer's business

— Large interest expense in relation to amount of income reported
— Standard deduction used with high gross and low net income
— Occupations normally more lucrative than indicated by the return
— Return on an investment significantly lower than expected
— Taxpayer's occupation known for its opportunity for receiving income in cash
— Taxpayer under investigation by the Bureau of Narcotics
— Amended returns claiming large refunds in connection with tax shelters.

3.5 How to Reduce the Likelihood of an Audit

The following may reduce the likelihood of an audit:

— Attach all correct W-2 forms. Your client should be instructed to check W-2s as closely as possible and immediately request a corrected W-2 if an error appears.
— Report as a separate identifiable item every Form 1099, even if several come from the same payor.
— If the client requests a replacement for an incorrect Form 1099, but it has not been received by the filing date, report the incorrect amount, then deduct it, report the result as the proper amount and state that a corrected Form 1099 has been requested. Use the same procedure for a Form 1099 for which the payor reports income in the wrong year.
— Be sure the payor's name on the return is identical to the name on the Form 1099.
— Show detail of computations of significant items that might be questioned, such as calculation of basis.
— Explain allocations between personal and business use such as might appear between Schedule C and Schedule A.

3.6 Safeguards During an Audit (IRC Sec. 7520)

Either before or at the initial interview with the taxpayer, the IRS must provide an explanation of the audit process and the taxpayer's rights, and an explanation of the collection process and the taxpayer's rights, if the interview relates to collection.

At any time during an interview (other than an interview initiated by an administrative summons), the taxpayer can terminate the interview by clearly stating to the IRS a desire to consult with an attorney, CPA, enrolled agent, enrolled actuary, or other authorized representative. The IRS has reaffirmed that taxpayers do not have to answer "economic reality" questions such as types of automobiles owned and the frequency and cost of vacations.

An authorized representative with a written Power of Attorney executed by a taxpayer can represent the taxpayer at an audit. The taxpayer is not required to accompany the representative, unless an administrative summons has been issued to the taxpayer. The IRS can notify the taxpayer that the representative is responsible for unreasonable delay or hindrance of the IRS examination.

If requested to do so in advance, the IRS must allow the taxpayer to make an audio recording of an in-person interview. The audio recording must be made at the taxpayer's own expense and with the taxpayer's own equipment.

The IRS itself may record an in-person interview if

— The taxpayer is informed prior to the interview.
— The IRS provides the taxpayer with a transcript or copy of the recording upon the request (and cost) of the taxpayer.

Regulations are to provide that it is generally not reasonable for the IRS to require a taxpayer to attend an examination at an IRS office other than the office located closest to the taxpayer's home. Regulations also are to be written to specify that it is generally not reasonable for the IRS to audit a taxpayer at his or her place of business if the business is so small that doing so essentially requires the taxpayer to close the business. The IRS would still be able to go to the place of business to establish facts that require a direct visit, such as inventory and asset verification.

3.7 Advance Warning of an Audit

An entry labeled "examination indicator" in the taxpayer's individual master file sometimes can give warning of an impending audit. See also section 8.2.4 of this chapter.

4. TYPES OF EXAMINATIONS

4.1 Examinations In or From an IRS Office

4.1.1 Correspondence examination

Examination is by correspondence when information concerning questionable items can be readily furnished by mail. Examples of items a taxpayer might be asked to verify by mail include

— Interest.

— Taxes.

— Charitable contributions.

— Medical and dental expenses.

From the taxpayer's point of view, drawbacks to a correspondence audit are said to be that the IRS examiner cannot hear oral arguments and cannot judge the sincerity of the taxpayer. Also, the examiner has the opportunity to review documents at his or her convenience, thus providing time to formulate other questions. On the other hand, in a face-to-face meeting, the agent can initiate a new line of questioning if it appears warranted.

Taxpayers believing the matter cannot be settled satisfactorily by correspondence can request an appointment. If a notice setting up an appointment for an office interview is received, a written request—together with documents supporting the taxpayer's position—can be made that the audit be handled by correspondence.

4.1.2 Office examination

The IRS may request that the taxpayer appear in an IRS office to discuss and provide documentation for matters such as the following:

— Income from tips, pensions, annuities, rents, royalties

— Determination of gain or loss as capital or ordinary income

— Deductions for employee business expenses

— Determination of the basis of property

— Bad-debt deductions

— Questions regarding low income in comparison to exemptions and deductions

The scope of an office examination is normally limited to the items listed on the appointment letter. If necessary to do so, the examiner can be reminded that the taxpayer came prepared to support only those matters listed in the letter.

4.2 Field Examinations

For the majority of business returns, and for some large and complex individual returns, the predominant type of audit is the field audit. The examination usually takes place at the taxpayer's place of business. The revenue agent has full license to examine all books, records, and documents necessary to determine the accuracy of the return. No items

on the return are shielded from inquiry. Federal payroll returns and excise tax returns may be examined at the same time. Often all open (unaudited) years of corporation returns as well as the personal returns of officers are audited. Field audits can take several days or weeks. In some cases, it may be possible, by written request, to change the audit location to the office of the taxpayer's authorized representative, if books and records are maintained there or are transferred there for purposes of the audit.

4.3 Team Examinations

In the case of large corporations, a team of revenue agents may be permanently assigned to examine the tax returns and supporting documentation.

4.4 Select Employee Plans Return Examination (SEPRE)

SEPRE is an investigation for determining if problems exist in the returns of tax-exempt organizations. Tax-exempt organizations are supervised by the employee plans and exempt organization division of the district office to make sure that organizations adhere to the conditions of their tax-exempt status.

4.5 Repetitive Examinations

It has been policy in recent years for the IRS to reduce the incidence of repetitive examinations. This policy is now codified in the Taxpayer Bill of Rights. The IRS will not conduct an examination on an item if there were no changes involving the item during the examinations of the two preceding years, it is unlikely that a change will be made for the year in question, and no significant issues were overlooked during previous years. The agent responsible for the examination may not have access to the returns of the two preceding years, in which case the taxpayer should bring the facts to the agent's attention. If the examination is part of the Taxpayer Compliance Measurement Program (TCMP), these provisions do not apply and the return must be examined.

4.6 Audits of Partnerships

4.6.1 Consistency of treatment of partnership items

The tax treatment of partnership items is determined at the partnership level in a unified partnership proceeding. Special rules provide for notice and other types of participation by the individual partners. All entities required to file returns as partnerships are handled under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) rules, with the exception of partnerships with

— Ten or fewer partners who are either natural persons (but not nonresident aliens) or estates (husband and wife are considered one partner for this purpose).

— Each partner's share of any partnership item being the same as his or her distributive share of every other partnership item.

If one of these small partnerships so desires, it can elect to be governed by the TEFRA provisions. TEFRA requires that all partners treat partnership items as they were treated on the partnership return. In an attempt to reduce inconsistencies, the IRS requires that a copy of the information in the partnership return be given to each partner. A partner who decides to treat a partnership item in a way inconsistent with the partnership return must disclose the inconsistency to the IRS on Form 8082. A partner's return should also make a disclosure if the partnership (1) fails to file a return or (2) provides the partner with incorrect information. If an inconsistency in reporting—for example, attempting to expense the partner's share of an item that was capitalized on the partnership return without the partner's filing a notice of inconsistent treatment—leads to a deficiency in tax payment, the IRS makes an adjustment to the partner's return so that it is in conformance with the treatment on the partnership return. Any additional tax resulting from this adjustment is immediately assessed and collected as though it were a mathematical error—that is, without the issuance of a notice of deficiency to the partner. At that point the partner's recourse is to file a claim for refund and sue in U.S. Claims Court. Any underpayment due to inconsistency in reporting, coupled with the taxpayer's failure to file Form 8082, will be treated as intentional or negligent disregard of the rules and regulations and therefore will be subject to penalty.

4.6.2 Partnership audit procedures

To commence an audit of a partnership, the IRS issues a notice of commencement of an administrative proceeding. This notice is sent to

every partner. Audits of partnerships impact all partners, but one specific partner, called the tax matters partner (TMP), should be designated by the partnership to be its primary representative. If a TMP is not selected by the partnership, the IRS will choose the partner with the largest profit interest in the tax year in question (in case two or more partners have the same profit interest, the TMP will be chosen alphabetically). Within thirty days of selecting a TMP the IRS must notify all partners entitled to receive notice under IRC Sec. 6223(a) of the selected TMP's name and address. Partners entitled to receive notice are those whose names appear on the partnership returns as well as those whose names and addresses have been timely furnished to the IRS. The TMP is responsible for keeping all partners informed of the proceedings of the audit and has sole authority to seek judicial review of an audit adjustment. IRC Section 6231(a)(7) defines a tax matters partner.

Any partner entitled to notice is known as a notice partner. No partner can be a notice partner unless the IRS has received name, address, and indication of interest in profits at least thirty days before it mails a notice to the TMP. The term "notice partner" does not include partners with less than a 1 percent interest in partnerships consisting of more than 100 partners. In these partnerships, notice to the TMP is considered to be notice to each partner. Thus, the IRS is not obligated to send individual partners, except the TMP, any of the notices. Any group of partners having together a 5 percent or greater interest in profits, however, may designate one of their group as a notice partner.

4.6.3 Notices to partners

The IRS must mail notices to every notice partner as well as to the TMP when it begins the audit proceedings. At the conclusion of the audit, a notice of final partnership administrative adjustments (FPAA) is mailed to the notice partners. The notice of the start of the proceeding must be mailed to the other partners no later than 120 days before the notice of the final adjustment is mailed to the TMP. In other words, there must be a lapse of 120 days between these two events. Notice of the FPAA may be mailed to the other partners no later than sixty days after this notice is mailed to the TMP. If, when any notice is mailed, it is too late for a notice partner to join in any judicial proceeding, this partner, while not joining in the proceeding, may still elect to have any decision or agreement apply to him or her and the group the partner represents. Otherwise, partnership items affected in the proceeding are, to that partner, treated as nonpartnership items. If an item is treated as a nonpartnership item, determination of its treatment at the

partnership level is not applicable. Nonpartnership items may not be brought into issue by the IRS or by the partner in a partnership proceeding, and partnership items may not be raised in a nonpartnership-item proceeding. Items become nonpartnership items on the date

— The IRS enters into a settlement agreement with the partner.

— The IRS fails to make a timely mailing to a partner concerning a partnership proceeding.

— The partner files suit after the IRS has denied his or her request.

— The IRS notifies a partner that a partnership item is to be treated as a nonpartnership item.

4.6.4 Participation by a partner in an administrative proceeding

Any partner may choose to participate in a proceeding relating to the tax treatment of a partnership item. A settlement agreement between the IRS and one or more partners is binding on the parties to that agreement for the taxable year. Any other partner may obtain the same treatment by requesting it before the expiration of 150 days after the day the FPAA is mailed to the TMP.

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4.6.5 Agreements binding on partners

If the TMP enters into a settlement agreement, all partners except notice partners (and members of a 5 percent group who have designated from their group a notice partner) are bound by the agreement. Any partner not wishing to be bound may file a statement with the IRS stating that the TMP does not have authority to enter into such a settlement agreement in this partner's behalf. The time for filing this statement is to be determined by the commissioner.

4.6.6 Provision of judicial review

Once notice of an FPAA is mailed to the TMP, ninety days are allowed to petition for a redetermination. The petition may be addressed to the Tax Court, the U.S. district court, or the U.S. Claims Court. Except for the Tax Court, petitions require that the additional tax due be paid to the commissioner. Any notice partner, upon failure of the TMP to do so within the prescribed ninety-day period, may file the petition and has sixty additional days to do so. The first petition filed takes precedence over all such petitions, and the later ones will be dismissed.

4.6.7 Computational adjustments

Adjustments of mathematical or clerical errors can be corrected by the IRS as partnership items, thus affecting the partners, without applying the usual deficiency procedures. Within sixty days after such a correction notice is mailed to him or her, however, a partner may request that the IRS not make the correction.

4.6.8 Credits or refunds

A partner may not file suit for a credit or refund arising out of a partnership item without first filing a request for administrative adjustment (RAA). The RAA must be filed within three years after the later of the date of actual filing of the partnership return or the last day prescribed for filing the return without regard to extensions. The RAA must be filed before IRS notice of an FPAA. If the RAA is not fully allowed, the TMP may file a petition for adjustment of the disallowance with the tax, district, or claims court. This petition must be filed after expiration of six months from the filing of the RAA but within two years of the filing. See IRC Section 6227(c) for rules regarding filings of RAA by partners on their own behalf.

4.6.9 Limitation periods for assessments and refund claims

Assessments relating to a partnership item

— May not be filed before close of the 150th day after mailing to the TMP notice of an FPAA.

— May not be filed until completion of proceedings in Tax Court (if begun within the 150-day period).

— Must be made within three years following the later of the date of actual filing or the last day prescribed for filing of a partnership return (unless extended by the commissioner).

— May be made within six years if a false return has been filed.

— May be made within six years if partnership income that exceeded 25 percent of stated gross income was omitted.

For refund claims or claims for credit, the time limitations are generally the same as for assessments. When an RAA is timely filed, however, the period with respect to such a request does not expire until the period has expired for filing suit.

4.7 Audits of S Corporations

New audit procedures were created by the Subchapter S Revision Act of 1982. The intent is to follow the partnership model (see section 4.6) in a unified corporate proceeding. Each shareholder must be given notice and an opportunity to participate in administrative or judicial proceedings. Shareholders must treat corporate items consistently with their treatment on the S corporation's return. Rules relating to assessments, limitation periods, and appeals follow the partnership rules (see IRC Sections 6241, 6242, and 6243).

5. HOW TO PREPARE FOR AN EXAMINATION

The IRS' audit procedures handbook can be ordered from Commerce Clearing House in three volumes entitled *Internal Revenue Manual: Audit.*

5.1 Preparing for Office or Field Examinations

In many office examinations and in most field examinations, the taxpayer is wise to have an accountant or other authorized representative present in place of the taxpayer. Note, however, that IRC Section 7602(a)(2) allows the IRS to summon the taxpayer to appear. This potential use of the administrative summons continues in force despite the Taxpayer Bill of Rights.

If an audit has begun without the presence of the taxpayer's professional adviser, the taxpayer can terminate the interview and request a new appointment at which the adviser will be present. The advantages to a taxpayer of professional representation center around the professional's

— Knowledge of tax law and interpretation.

— Familiarity with the audit process and the rules of disclosure.

— Ability to exhibit professional behavior toward the IRS agent.

Tax professionals should make clear to their clients, at the time a return is prepared, whether representation in an examination is included in the fee for preparing the return or will be extra. Normally, because of the difficulty in forecasting the amount of time required to represent a client in an audit, this service is billed separately when needed. Even if not appearing at the examination, the professional tax adviser may provide valuable assistance by putting together the documentation that will be needed at the interview.

5.1.1 Obtaining a copy of a tax return

Use IRS Form 4506 to request a copy of a tax return together with W-2 Forms. Form 4506 should be mailed to the office of the IRS where the return was originally filed. There is a small charge. An abbreviated version of a return, called a transcript, is available at no cost.

5.2 Burden of Proof: Documenting the Taxpayer's Position

The burden of proof for items in the return is on the taxpayer. Evidence, such as receipts and canceled checks, should be organized for presentation to the examiner. Important items of documentation should be photocopied in advance since examiners frequently request them. Original documents should be retained in case they will be needed in litigation.

Items about which doubt exists should be thoroughly traced to source documents. Ordinarily, inadvertent omissions or mistakes that are clearly minor in their effect can safely be admitted to the agent unless their total impact suggests a pattern of disregard of the rules. On the other hand, if the taxpayer provides the IRS with a voluntary admission of *fraud* plus the documentation to back it up, the taxpayer is in a precarious position. If a taxpayer has been dishonest in any but the most trivial matters, he or she should consult a criminal tax lawyer prior to attending an IRS audit.

In court proceedings, provided the taxpayer has met certain conditions, the burden of proof is on the IRS. For further reference, see 26 USC 60501, IRS Announcement 90-142 (1990-53 IRB 1), and IRS Publication 1544, "Rules for Reporting Large Cash Payments."

5.3 Beginning the Examination

Reassurance should be sought from the IRS examiner that a *civil* examination is in progress. If more than one examiner is present, each should be asked to identify his or her position in the IRS. There have been instances in which IRS special agents investigating fraud have apparently failed to identify themselves adequately or to give the IRS' modified form of the Miranda warning before the taxpayer made damaging admissions. The taxpayer's experienced tax lawyer will ordinarily be able to get this evidence suppressed in court. In most cases, however, the special agent will identify himself or herself properly. Upon any suspicion or suggestion that the IRS is considering a fraud investigation, the taxpayer should answer no questions and provide no documents until he or she has consulted a criminal tax attorney.

5.3.1 Tips for conduct

Experienced tax practitioners agree on the following tips for behavior during an examination:

— Contact the IRS agent before the audit to try to see the case with his or her eyes.

— Review the facts and the law relevant to the case well in advance of the audit date; know facts and the law better than the IRS agent.

— Organize documentation for presentation to the auditor.

— Advise the client on proper, respectful behavior or suggest that he or she not be present.

— Establish a courteous yet businesslike rapport with the agent.

Some practitioners advise allowing the agent to direct the audit; others try to lead the agent. The best approach is probably dependent on the personalities of the participants. Answer questions briefly, completely, and substantiate them by evidence.

Present only evidence asked for by the agent; do not give open access to the taxpayer's files or records.

5.3.2 Negotiation and settlement

Settlement with the examining revenue agent is usually advisable in order to resolve a case at the lowest level of inquiry. Revenue agents

technically have no authority to make settlements with the taxpayer. They do, however, have discretion in determining the adequacy of documentation of factual issues. Negotiation may be entered into regarding items for which the agent proposes an adjustment.

If the issue in question is solely legal, rather than factual, the agent will take the IRS' stated position. Once this stance has been taken, any attempt at a different settlement will lead to an impasse.

In an effort to assist IRS personnel in settling cases, the national office can provide technical advice memorandums (TAMs), either during the examination or during an appeal. The revenue agents have instructions on how to obtain a technical advice memorandum. A request for a TAM may be made by the agent or the taxpayer.

5.4 Market Segments Specialization Program

The IRS Examination Division has prepared a series of industry-specific audit guides. This program, called the Market Segments Specialization Program (MSSP), is intended to tell revenue agents and tax auditors how certain industries operate. The following are *Market Segment Specialization Papers* and *Understanding Papers* issued through September 1999.

Air Charters
Alaska Commercial Fishing Industry
Architects
Artists and Art Galleries
Attorneys
Auto Body and Repair Industry
Automobile Industry
Aviation
Bail Bond Industry
Bars and Restaurants
Beauty and Barber Shops
Bed & Breakfasts
Carpentry and Framing
Cattle Industry
Coal
Commercial Banking Industry
Commercial Printing Industry
Computers, Electronics, and High Technology
Entertainment Industry
Farming
Farm Labor—Noncash Remuneration
Foreign Athletes & Entertainers
Furniture Manufacturing
Garment Contractors
Garment Manufacturers
Gasoline Retailer Industry
Grain Farmers
Hardwood Timber Industry
Independent Used Car Dealers
Limousine Industry—Classification of Workers
Manufacturing Industry
Ministers
Mobile Food Vendors
Mortuaries
Moving Industry—Classification of Workers
Music Industry
Net Operating Losses for Individuals

Oil & Gas Industry
Passive Activity Losses
Pizza Industry
The Port Project
Reforestation Industry
Rehabilitation Tax Credit
Retail Liquor Industry
RTC Debt Cancellation
Scrap Metal Industry
Taxicabs
Television Industry—
Classification of Workers
Tip Rate Agreement—Gaming
Industry
Tip Reporting—Food Service
Industry
Tip Reporting—Hairstyling
Industry
Tobacco Industry
Tour Bus Industry
Trucking Industry
Veterinary Medicine
Water Transportation Ports
Wine Industry

6. CRIMINAL AND CIVIL TAX FRAUD

Civil tax fraud differs from *criminal* tax fraud in that the latter is punishable by *imprisonment,* by fines, or by both. Civil tax fraud, on the other hand, is punishable exclusively by a monetary penalty. An example is the 75 percent civil penalty provided in IRC Sec. 6663 for underpayments of tax that are due to fraud.

IRS special agents—members of the Criminal Investigation Division (CID)—seek first of all to discover and build a case for the prosecution of criminal fraud. According to the Internal Revenue Manual, CID is responsible for recommending and supporting with evidence whatever civil penalties may also be appropriate. If the criminal case fails, the IRS may propose civil fraud penalties. Acquittal of the criminal charges does *not* bar further pursuit of the taxpayer for civil fraud penalties. (*Helvering v. Mitchell,* 303 U.S. 391 (1938); *Spear v. Commissioner,* 91 T.C. 63 (1988)).

Some federal tax crimes are felonies, carrying possible incarceration for longer than one year. Assisting in the preparation of a false tax return (IRC Sec. 7206(2)), for example, is a felony. It carries a maximum three-year jail sentence.

Certain other federal tax crimes are misdemeanors, punishable by imprisonment for one year or less. Failure to file a return, IRC Sec. 7203, is an example of a misdemeanor, carrying a possible maximum jail term of one year.

The standard of persuasion (also called the standard of proof) for any criminal conviction is that of proof of guilt *beyond a reasonable doubt.* In a civil case, ordinarily, proof need be only by a *preponderance of the evidence.* (That phrase is interpreted to mean that the great weight and

merit of the evidence (over half) is against the defendant.) In U. S. Tax Court, however, Rule 142 requires that the government sustain its burden of proof of fraud by *clear and convincing evidence,* a more demanding standard than *preponderance* but less than *reasonable doubt.* (For further discussion of the Tax Court's standard see *Amos v. Commissioner,* 43 T.C. 50 (1964), aff'd, 360 F.2d 358 (4th Cir. 1965)).

Whenever fraud is an element of the offense, the government has the burden of proof. Because the standard of criminal proof, once achieved by the government, is higher than that for civil proof, the IRS will ordinarily recommend the 75 percent civil fraud penalty of IRC Sec. 6663 whenever a taxpayer is found guilty of a tax crime (or pleads no contest).

"Willfulness," an element of all of the major Internal Revenue Code tax crimes (and also an element in those statutes that prescribe civil penalties for fraud), refers to an intent to perform the illegal act—a voluntary, intentional violation of a known duty. An act done inadvertently or by mistake, on the other hand, is not a crime. For example:

> A tax practitioner who for training purposes directed an employee to prepare a refund claim for a hypothetical client would not be guilty of a crime if a different employee inadvertently filed the claim with the IRS.

Some IRC sections specify civil penalties only, and the element of willfulness or intent to evade taxes is not pertinent. An example is IRC Sec. 6698 concerning failure to file a partnership return. In the case of a violation of these and similar statutes, penalties against a taxpayer or tax practitioner may be assessed by the IRS in a manner similar to the assessment of taxes. If the IRS cannot be convinced to remove the penalty administratively, the burden of proof in court is on the person against whom the penalty was assessed.

The 1998 act shifts the burden of proof in any court proceeding to the IRS on issues of fact if the taxpayer

— Introduces creditable evidence.

— Complies with any required substantiation requirements.

— Maintains adequate records.

— Cooperates with the IRS' reasonable requests for witnesses, documents, and meetings.

6.1 How Fraud Investigations Are Initiated

Most fraud investigations arise by referral from an IRS agent who is examining a tax return, but they may also be prompted by a tip from

a taxpayer's spouse, neighbor, employee, or from a lead supplied by another government program, such as drug enforcement. A referral is a transfer to IRS special agents working from the criminal investigation division (CID) of an IRS district office. CID special agents conduct fraud examinations.

6.2 How to Detect That a Fraud Referral Has Been Made

Criminal division referral should be suspected if the revenue agent abruptly postpones or suspends the examination while being vague about the reason, particularly if preceding this action by

— Discovering false statements made by the taxpayer during interviews concerning income, deposits, or lifestyle.

— Interviewing the taxpayer's customers, employees, suppliers, bankers, and stockbrokers.

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— Showing interest in beginning-of-the-year cash balances and asking probing questions about cash expenditures.

— Requesting cash-related documentation such as deposit slips, bank and brokerage statements, and canceled checks.

— Asking for permission to go through the taxpayer's files.

— Requesting photocopies of income-related items such as sales and accounts receivable records, shipping records, and bank statements.

— Asking for written statements of net worth, sources of cash, or expenditures of cash.

If a fraud referral is suspected, the taxpayer should immediately consult an experienced criminal tax attorney prior to making any statements or providing any documents to the IRS.

6.3 Cash Reporting Requirements

Any person in a trade or business who receives more than $10,000 in cash, either in a single transaction or in related transactions, must report these transactions to the IRS on Form 8300. Financial institutions and casinos report on Forms 4789 and 8362. A "person" is an individual, company, corporation, partnership, association, or estate.

"Cash" consists of coins and currency, whether of U.S. or foreign issue. Not presently included in the definition are bank checks, travelers checks, bank drafts, wire transfers, or any other instrument not usually accepted as money. However, the 1990 Revenue Reconciliation Act extends the definition of cash to certain monetary instruments, other than personal checks, that will be specified in upcoming regulations. Until these regulations are issued, only coin and currency need be reported.

"Related transactions" are those that occur within a twenty-four-hour period. If more than twenty-four hours pass between receipts of cash, and the total is greater than $10,000, the transactions must be reported if the recipient knows or has reason to know that each is one of a series of connected transactions.

Form 8300 must be filed within fifteen days of receipt of a payment. After filing, a new count of cash receipts begins. Additional receipts of over $10,000 must also be reported.

Persons reporting cash receipts must give a written statement to each payer named on any Form 8300, showing the name and address of the person reporting and the amount reported. This statement must be sent by January 31 of the year following the year in which the cash that triggered the IRS filing was received. A copy of Form 8300 must be retained for five years.

Civil and criminal penalties for intentional or willful disregard are provided in the amount of $25,000 ($100,000 for corporations) or the amount of cash received in the transaction or related transactions (but no more than $100,000), and sentencing up to five years in prison, or both. Civil penalties apply for any failure to

— File a correct Form 8300.

— Provide the required statement to those named in the form.

— Comply with other information reporting requirements.

Criminal penalties apply in any instance of willful or intentional

— Failure to file a report.

— Filing a false or fraudulent report.

— Stopping or trying to stop a report from being filed.

— Structuring a transaction to make it appear unnecessary to file a report.

Voluntary filings may be made of cash transactions under $10,000 if the transaction appears suspect. Questionable cases may be discussed with the local IRS Criminal Investigation Division or by phoning 1-800-272-2877. A transaction is suspect if

— It provides an indication of possible illegal activity.

— It indicates an attempt by the payer to convince the recipient not to file Form 8300, or to file a false or incomplete form.

— The payer's appearance, demeanor, statements, or any other facts or circumstances arouse the suspicion of the recipient.

For further reference, see 26 USC 60501, IRS Announcement 90-142 (1990-53 IRB 1), and IRS Publication 1544, "Rules for Reporting Large Cash Payments."

7. RESULTS OF THE EXAMINATION

7.1 Consent to Assessment: Form 870

When the IRS revenue agent has completed the examination, the taxpayer or authorized representative has an opportunity to discuss the proposed adjustments and to argue, for example, that the taxpayer's substantial compliance justifies acceptance of inadequately substantiated amounts. Experienced tax practitioners believe they can do a better job

here than the taxpayer can. The IRS agent may act in a more conciliatory fashion when dealing with a fellow professional who may be perceived as a peer seeking a common goal, that of reaching a mutually agreeable and prompt resolution.

If the taxpayer and the agent reach an agreement as to liability, the agent will ask the taxpayer to sign a waiver, Form 870. Form 870 sets forth the taxpayer's name, taxable year, amount of tax due (including any penalties incurred) or amount of refund due to the taxpayer. This agreement at the district office level is not binding on either the taxpayer or the IRS, but the agent's recommendations will normally be accepted. The taxpayer who subsequently wishes to change position must pay the assessment and file a claim for a refund.

Taxpayers ordinarily sign the waiver if the assessment is based on obvious errors that they made in the return. Small assessments are best not disputed under the guise of standing up for a principle. (Interest charges stop running thirty days after signing of the waiver.) On the other hand, no taxpayer who feels the assessment is seriously overstated should sign the waiver.

If the taxpayer and the agent cannot agree on all the issues in question, they may still be able to reach a partial agreement and execute a waiver. A partial agreement allows computation of dollar amounts for at least some previously unresolved issues, calculation of the additional tax, and cessation of interest. The taxpayer must decide whether to yield on uncertain issues and save money on interest payments or take a chance that a better agreement can be reached on all issues at the appeals level.

Signing Form 870 does not prevent later filing for a claim for refund for any concessions the taxpayer agreed to but then decided were erroneous. Form 870-AD is an agreement form used in the appeals division. It specifies the taxpayer's agreement that "no claim for refund or credit shall be filed or prosecuted for the year(s) [covered by the agreement] other than for amounts attributed to carrybacks provided by law." Although there have been court decisions to the contrary, signing Form 870-AD makes it very unlikely that a taxpayer will be able to recover on a concession that is subsequently viewed as unwise.

Form 4549, Income Tax Examination Changes, is a similar agreement used in the audit division. If this agreement is signed, the taxpayer consents to immediate assessment and loses the right to challenge the liability in the Tax Court.

7.2 Extending the Statute

If negotiations at the examination stage (or later) continue until the statute of limitations runs out, the IRS agent may ask the taxpayer to

extend the statute. Form 872 extends the statute for assessment of taxes under examination to a time specified in the form. Form 872-A, Special Consent to Extend the Time to Assess Tax, extends the statute for an indefinite period. The taxpayer's consent to an indefinite extension on Form 872-A can be terminated *only* by use of the specific procedures stated in the form. Termination occurs ninety days after the date on which Form 872-T is mailed or 150 days after the date on which the IRS mails a notice of deficiency. (Form 872-T terminates the consent given on Form 872-A.)

Extending the statute extends the period during which negotiation or compromise can take place. Extension for a period of time different from that requested by the IRS can be requested and could possibly be of value to the taxpayer. If the taxpayer refuses to agree to extend the statute, the IRS normally issues a notice of deficiency requiring payment or the filing of a petition to the Tax Court within ninety days.

7.3 IRS Review of Agreed Cases

Although most agreed cases are not changed later, returns for these cases are subject to review by the district office. This provides the IRS with a safety valve to guard against improper agreements by inexperienced agents. A district examination case that has been closed will not be reopened except in the case of fraud, collusion, concealment, or misrepresentation of a material fact, or if there has been an error in the agreement based on the IRS position at the time of the agreement.

8. ASSESSMENT AND COLLECTION OF TAX

8.1 Assessment

The first step in the collection process is the assessment of the tax owed to the government. To assess means to create an account receivable on the government's books. Any tax, interest, or penalty the taxpayer owes to the government becomes an account receivable.

Regional service centers have assessment officers who sign summary records of assessment for each taxpayer for every taxable period. The date the summary assessment is signed is considered the date of the assessment. Taxpayers who wish to receive a copy of their assessments may do so upon request.

8.2 What the IRS May Assess

The IRS has the authority to assess the amount of tax shown on the return, with adjustments made for any mathematical or clerical errors appearing on the return. Additional tax may be assessed if there is a deficiency. (Also, certain penalties are assessable.)

8.2.1 Deficiency

A deficiency is defined as the portion of an income tax liability (including estate, gift, and other tax liabilities) for a taxable period that exceeds the tax previously paid with respect to the taxpayer's return for that particular period. If the IRS determines that a deficiency is present, the IRS must mail a notice of deficiency to the taxpayer by either certified or registered mail. Once the notice has been received, the taxpayer has the right to file a petition with the Tax Court asking that the deficiency be redetermined. If the taxpayer chooses to file such a petition, the IRS cannot assess the deficiency until the Tax Court issues a ruling on the case. If the taxpayer fails to file such a petition within ninety days of having received a notice of deficiency (150 days if the notice was addressed to a taxpayer outside the United States) or if the taxpayer waives the right to formal notice of the determination of a deficiency, the IRS may assess the deficiency.

8.2.2 Exceptions to the regular deficiency notice procedure

In several situations the IRS can follow a procedure other than the deficiency notice procedure described in section 8.2.1:

— *Mathematical and clerical errors.* If the IRS discovers mathematical or clerical errors on a return made after 1976, it must mail the taxpayer notice of assessment of the additional tax and allow the taxpayer sixty days after receipt of the notice to file a request for abatement of the assessment. During the sixty-day period, the IRS can make no efforts to collect the assessment. If the taxpayer chooses to file a request for abatement of the assessment, the IRS must abate the assessment and make any reassessments using the regular notice of deficiency procedure.

— *Voluntary payments before assessment.* The taxpayer may make a voluntary payment to prevent the accumulation of interest. Once the IRS receives the payment, it may assess the tax for the purpose of balancing its books. If the taxpayer wishes to take the case to the Tax Court, he or she must wait until after the IRS issues a notice of deficiency before submitting the payment, because making the

payment before the notice is received would eliminate the deficiency and cause the Tax Court to lose its jurisdiction over the case.

— *Appeals of Tax Court decisions.* If a deficiency in tax is found by the Tax Court, the tax will be assessed and collection efforts will begin even if the Tax Court's decision is not yet final. Collection may be deferred if the taxpayer posts a bond.

— *Bankruptcies and receiverships.* In the case of bankruptcies and receiverships, assessments are made immediately.

— *Waiver of restrictions.* The taxpayer who chooses to waive the restrictions on assessment may do so by filing Form 870 (Form 4549 if the matter is in the audit division, or Form 870-AD if the matter is at the appeals office). Filing a waiver of restriction allows the IRS to assess the deficiency immediately and terminates interest charges beginning thirty days after the effective date of the waiver. (See section 7.1.)

8.2.3 Statute of limitations on assessment

The general statute of limitations on assessments is three years after the later of the date the return was filed or the date the return was due. Before expiration of the three-year period, the taxpayer may consent to extend the period of assessment (except for estate taxes). Extensions may benefit taxpayers who expect that they can eventually negotiate a favorable settlement with the IRS. If a taxpayer refuses to consent to the extension, the IRS will issue a ninety-day letter (notice of deficiency) to protect itself against expiration of the assessment period. Taxpayer consent is indicated on Form 872. In the following situations, the statute is extended to six years:

— Omission of more than 25 percent of gross income

— Failure to report foreign personal holding company income

— Failure to provide the information requested on Schedule 1120 PH by a domestic personal holding company

In addition, deficiencies that result from the deduction of a carryback of a net operating loss can be assessed within the time period applicable to the year in which the net operating loss originated. If a false or fraudulent return has been filed with the intent to evade tax, or if no return is filed, there is no limitation on the period for assessment. Subsequent, voluntary filing of an amended return showing correct information does not limit the open-ended assessment period if the original return was false.

8.2.4 Individual master file

The IRS maintains an accounting for each taxpayer, showing debit and credit activity. An entry in this file, labeled "examination indicator," may signal that an audit is likely. A copy of this Individual Master File is available from the local district office.

8.3 Collection

If the taxpayer fails to take advantage of opportunities to appeal an IRS decision to assess additional tax (see section 9), the IRS will use its powers of levy to collect the tax (IRC Section 6331(b)). The power of levy gives the government the right to seize and sell an asset.

Within sixty days after the expiration of the period begun with the mailing of a ninety-day deficiency letter, the IRS issues a notice and demand for payment. Collection cannot be enjoined by the taxpayer if the assessment itself is valid. At this point, the taxpayer can pay the tax and file a claim for refund with the IRS. If the claim is disallowed, the taxpayer can file an action in U.S. district court or in U.S. Claims Court. Alternatively, the taxpayer may file a petition with the U. S. Tax Court prior to making payment.

If the taxpayer fails to pay, the additional tax plus penalties and interest become a lien on property owned by the taxpayer or acquired after the lien is effective. The IRS has ten years to collect. The lien is not valid against certain claims, such as mortgages and other recorded liens, until a notice of tax lien (Form 668) is filed. The taxpayer has thirty days after the mailing of the notice of lien in which to demand a hearing before an appeals officer who has had no prior involvement in the case.

A notice of levy (Form 668-A) must be either (1) given to the taxpayer in person, (2) left at the taxpayer's home or usual place of business, or (3) sent to the taxpayer by registered or certified mail. The notice must be provided at least thirty days prior to seizure of the asset and must describe the procedures for sale and the appeals process available to the taxpayer, including that of a pre-levy hearing (IRC Sec. 6331(a)).

Levies against personal property are valid when notice is given to the holder of the property, such as a bank that holds the taxpayer's checking or savings account. Notice to the taxpayer may be made afterward. The effect of a levy is to transfer "constructive possession" of the property to the government, and any subsequent attempted assignment of the property by the taxpayer is invalid. A levy covers property owned by the taxpayer at the date of the levy or later acquired. A levy on salary or wages continues in effect until the liability is satisfied or the statutory

period (usually six years) expires. Once the property has been levied upon, the taxpayer may redeem it by purchase from the IRS (satisfying the tax deficiency) prior to public sale. Real property may be redeemed by the former owner within 180 days after its public sale by payment of the sale price plus 20 percent per annum to the purchaser (IRC Sec. 6337(b)). Certain property is exempt from IRS seizure, including

— Clothing, food, fuel, and schoolbooks

— Furniture and personal effects (limit of $6,250)

— Books and tools used in a trade, business, or profession (limit of $3,125)

— Salary, wages, or other income to the extent ordered by a court to support minor children

— Payments for disabilities in connection with military service

— Certain federal or state public assistance payments, such as supplemental income for the aged or blind

— Other items specified in IRC Sec. 6334(a) and Treas. Reg. Sections 301.6334-1 through 301.6334-7

Ordinarily, the taxpayer's principal residence is exempt from levy unless an IRS district director or assistant director personally approves the levy in writing and the Secretary of the Treasury finds that collection is in jeopardy (IRC Sec. 6334). A federal judge or magistrate also must approve the levy in writing.

According to IRS policy, levies are not made against qualified pension plan benefits or IRAs, or against Social Security, Medicare, or welfare payments (Internal Revenue Manual 5331.6). This IRS policy is subject to change.

Exemptions provided by state law are not effective to prevent levy for the collection of any federal tax.

8.4 Safeguards Against IRS Seizure

— No levy can be made on property if the estimated amount of expenses to be incurred during sale exceeds the fair market value of the property (IRC Sec. 6331).

— A levy must not be made on a day when the owner of the property is required by summons to appear before the IRS, unless collection of the tax is in jeopardy (IRC Sec. 6331).

— After receiving official notice of levy, banks and other financial institutions cannot release garnished accounts for twenty-one days (IRC Sec. 6332).

— Levies must be released if the liability is satisfied, release facilitates collection, an installment agreement has been signed, economic hardship results, or the fair market value of the property exceeds the liability. Determination of economic hardship must be expedited in the case of tangible personal property essential to the taxpayer's trade or business (IRC Sec. 6343).

— The taxpayer's residence cannot be seized for a liability of $5,000 or less.

— The IRS cannot seize the taxpayer's business unless other assets are not sufficient to cover the liability.

— At the taxpayer's request, seized property must be sold within sixty days (IRC Sec. 6335).

— Jeopardy assessments or jeopardy levies must be explained in writing and reviewed by the IRS within thirty days if the taxpayer requests (IRC Sec. 7429).

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— Civil actions to review the reasonableness of jeopardy assessments and levies may be brought in federal district court or, in certain circumstances, in Tax Court (IRC Sec. 7429).

8.5 Compromise

After assessment, but before payment (or levy), one additional recourse may be available. It may be to the taxpayer's advantage to attempt a compromise with the IRS. In exchange for a speedy and relatively certain settlement, the IRS may be willing to accept less than the full amount of liability. Acceptance of an offer in compromise (Form 656) is discretionary with the IRS.

A compromise must have as its basis doubt about either liability or collectibility. A compromise offer based on doubt about liability will be rejected by the IRS if the liability has been determined by the Tax Court or by the IRS appeals office. An offer to compromise based on collectibility must be accompanied by a statement on Form 433-A of the taxpayer's assets, liabilities, income, and living expenses, since the taxpayer's argument is that he or she will be unable to pay the amount of tax that was assessed. (Form 433-B is used for businesses.) No compromise is accepted unless the taxpayer agrees to extend the period of limitation on collection for the time the offer is under consideration, plus one year (Treas. Reg. Sec. 301.7122-1(f)).

Taxpayers who owe $10,000 or more are subject to new collection and budget rules. If there are no readily available assets to sell or borrow against, the taxpayer's monthly gross income less necessary living expenses is calculated to yield a minimum acceptable installment payment. The housing and transportation component of necessary living expenses is dependent upon local conditions. National standard expenses have been calculated to cover other necessary expenses such as housekeeping supplies, clothing and clothing services, personal care products and services, food and miscellaneous. Dollar amounts are derived from the Bureau of Labor Statistics Consumer Expenditure Survey and are updated periodically (see Internal Revenue Manual, Sec. 5323). The Survey can be obtained from the Bureau of Labor Statistics, 2 Massachusetts Avenue, Room 3985, Washington, D.C. 20212, (202) 606-6900.

The taxpayer will be expected to offer to pay the net realizable value of his or her equity in the assets. This value is equal to the quick-sale value of all assets minus debts that have priority over the IRS. For nonliquid assets, such as real estate or closely held business interests, quick-sale value is 80 percent of fair market value. Additionally, the taxpayer will be expected to pay the present value of five years of future

income less certain necessary expenses. Recent guidance regarding offers in compromise can be found in proposed and temporary regulations (Reg. 116991-98; T.D. 8829).

8.6 Installment Payment (IRC Sec. 6159)

The IRS is authorized to enter into a written agreement with any taxpayer allowing satisfaction of a tax liability through payments under an installment plan, if it facilitates the collection of the liability.

IRS Divisions of Appeals, Employee Plans and Exempt Organizations, Examination, Problem Resolution, Returns Processing (in service centers), and Taxpayer Service are authorized to make installment agreements up to $10,000. Their authority extends over individual, corporate accounts involving Form 1120, and out-of-business sole proprietor accounts. Larger amounts are addressed by the Collection Division. If the aggregate liability does not exceed $10,000, the taxpayer has filed all returns for the past five years, the taxpayer is financially unable to pay, and the agreement requires full payment within three years, the IRS is required to enter into an installment agreement.

It is not necessary for a taxpayer to be assessed a deficiency before opening the possibility of installment payment. On IRS Form 9465, Installment Agreement Request, the taxpayer proposes a monthly payment at any time he or she is unable to satisfy the tax liability. A small fee is imposed by the IRS for such an agreement. The IRS will respond within thirty days, approving or denying the request or asking for more information.

Interest and penalties continue to accrue until the liability is satisfied. (Financial sources other than the Treasury may provide the taxpayer with lower rates of interest.)

Generally, an agreement entered into will remain in effect for the term of the agreement. On thirty days' notice, however, the government may alter or terminate the agreement if it finds the following:

— The taxpayer provided information prior to the date of the agreement which was inaccurate or incomplete.

— The collection of the tax is in jeopardy.

— The financial condition of the taxpayer has significantly changed.

8.7 Dischargeability of Taxes in Bankruptcy

8.7.1 Individuals

The discharge of a particular tax obligation depends on the nature of the tax, the priority status granted to tax obligations under the Bankruptcy Code, and the chapter of the Bankruptcy Code under which the

case is filed or to which a case may later be converted. 11 U.S.C. §523(a) details debts of an individual, including various taxes, that, unless paid, are not discharged in a bankruptcy proceeding under Chapter 7, Chapter 11, Chapter 12, or by a debtor who receives a "hardship" discharge under Chapter 13. See 11 U.S.C. §1328(b).[1]

Taxes exempted from discharge include instances when a debtor failed to file a required return, filed a late return within two years of filing the bankruptcy petition, filed a fraudulent return, or willfully attempted to evade such tax. In a case filed under Chapter 13 and upon completion by the debtor of all payments under the plan, the court will grant the debtor discharge of all debts provided for in the plan, including taxes (including those related to unfiled returns or fraud) (See 11 U.S.C. §1328(a)). Prepetition penalties and interest related to taxes that are not discharged are likewise not discharged.

Priority taxes under 11 U.S.C. §507(a)(2) that are exempted from discharge relate to taxes incurred by a debtor in an involuntary proceeding between the date the involuntary petition is filed and the date the Bankruptcy Court enters an order for relief. Priority taxes under 11 U.S.C. §507(a)(7) that are exempted from discharge include the following:

— Income taxes due within three years of the filing of the petition, assessed within 240 days of the filing of the petition, or unassessed but assessable as of the filing of the petition. See 11 U.S.C. §507(a)(7)(A).

— Property taxes. See 11 U.S.C. §507(a)(7)(B).

— Withholding taxes, such as income tax or FICA and "collected" taxes, such as telephone excise tax, airport ticket tax, and windfall profits tax. See 11 U.S.C. §507(a)(7)(C).

— Certain employment taxes, such as FICA and federal and state unemployment taxes due on wages earned or paid before the petition is filed. See 11 U.S.C. §507(a)(7)(D).

— Excise taxes for a return, if required, that are past due within three years of the filing of the petition. See 11 U.S.C. §507(a)(7)(E).

— Certain customs duties. See 11 U.S.C. §507(a)(7)(F).

— Penalties that represent compensation for actual pecuniary loss for a governmental unit involving a tax listed in items A through F above. See 11 U.S.C. §507(a)(7)(G).

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[1]Material in this section is adapted from AICPA, Tax Division, *Bankruptcy Tax Practice Reference Guide.* New York: AICPA, 1992.

8.7.2 Partnerships and corporations

In a case filed under Chapter 7, 11 U.S.C. §727(a)(1) provides that only an individual can be granted a discharge. As such, partnerships and corporations involved in a proceeding under Chapter 7 are not granted a discharge. Therefore, if shareholders keep dormant a corporate shell for later reactivation, the unpaid tax liabilities remain in existence.

In a case filed under Chapter 11, 11 U.S.C. §1141(d) provides that upon confirmation of a plan of reorganization—unless otherwise provided for in the plan, in the order confirming the plan, or in that subsection of the statute—a debtor is discharged from any debt that arose before the date of confirmation. The historical notes to 11 U.S.C. §1141 clearly indicate that nondischargeable taxes in such reorganizations are priority taxes under 11 U.S.C. §507, and postpetition payments are due under agreements reached with the tax authorities before the commencement of the case.

In a case filed under Chapter 12, 11 U.S.C. §1228(a) provides that after completion by the debtor of all payments under the plan, the debtor is discharged from all debts provided for by the plan, except any debt (e.g., taxes as described above) specified in 11 U.S.C. §523(a). Since the "family farmer" debtors eligible to file under Chapter 12 include partnerships and corporations, it would appear that this discharge, which is not as comprehensive as that under Chapter 11, applies to partnerships and corporations that are eligible and choose to file under Chapter 12 instead of Chapter 11.

9. APPEALS PROCESS

Upon a taxpayer's disagreement with a revenue agent's determination of deficiency, a review and appeals process begins. When the taxpayer declines to sign Form 870 or Form 4549, the agent prepares a report that is reviewed by a supervisor and then sent to a technical branch of the district office examination division. (See section 7.1.) In most cases, the technical reviewer approves the findings of the agent and the taxpayer is sent a "thirty-day letter."

9.1 The Thirty-Day Letter

The thirty-day letter informs the taxpayer of proposed changes in tax liability. In addition, the thirty-day letter invites the taxpayer to a hearing before the appeals office, a division of the Office of the Regional Counsel

that is answerable to the Secretary of the Treasury rather than to the Commissioner of the IRS.

Tax practitioners who are on record as the taxpayer's representative receive the letter instead of the taxpayer if a power of attorney (Form 2848) or information authorization form (Form 8821) is on file. As the name implies, the taxpayer has thirty days to respond to a thirty-day letter.

Upon receipt of a thirty-day letter that proposes a deficiency, the taxpayer may request a conference with the appeals office. An oral request is sufficient if the deficiency resulted from a field examination in which the proposed deficiency is $2,500 or less or from an office or correspondence examination. If the deficiency resulted from a field examination in which the proposed amount exceeded $2,500 but did not exceed $10,000, a simple recitation of disputed issues to the appeals office is sufficient to get consideration. The dollar limits are calculated to include proposed additional tax, including penalties, proposed overassessment, and claimed refund (or, in an offer in compromise, the total amount of assessed tax, penalty, and interest sought to be compromised) (Code of Federal Regulations [CFR], 601.106(a)(iii)).

If the proposed amount arising from a field examination is over $10,000, a formal written "protest" must be filed. Additionally, a written protest is required in cases involving all employee plan and exempt organization cases and all partnership and S corporation cases. When a formal protest is required, it must contain

— A statement that the taxpayer wishes to appeal the findings of the IRS agent.

— The taxpayer's name, address, and identification number.

— Identification of the years or periods involved.

— An itemized schedule of the proposed adjustment with which the taxpayer disagrees.

— A statement of facts that support the taxpayer's position, declared to be true under penalties of perjury.

— A statement of the law or other authority relied upon by the taxpayer.

If an authorized tax representative submits the protest, it must state whether he or she knows personally that the statement of facts is true and correct. Guidance regarding protests is given in IRS Publication 5, *Appeals Rights and Preparation of Protests.*

IRS field examiners must inform taxpayers of the IRS's rebuttal position in protested cases, according to the executive director of the IRS Office of Coordinated Examination Programs. In cases where unagreed issues are being forwarded to the IRS Appeals Division, the

Examination Division will provide taxpayers with the IRS's rebuttal position on the issues in question. Taxpayers wishing early referral to the Office of Appeals should consult Rev. Proc. 99-28.

9.1.1 The appeals office

The appeals office normally receives a case within thirty days of filing of a protest. It is policy to acknowledge receipt of the case within twenty-five days. A conference at the appeals office will then be offered within ninety days of receipt. Conferences are scheduled for both docketed and undocketed Tax Court cases. Approximately 85 to 90 percent of cases it receives are agreed and resolved by the appeals office, about 80 to 90 percent of them within one year.

Hearings at the appeals office are informal sessions in which no sworn testimony is taken. In matters in which facts are being alleged, however, affidavits may be required or it may be required that facts be declared to be true under the penalties of perjury. Practitioners who attend hearings without the taxpayer must have a power of attorney.

9.1.2 The appeals officer

Nationally, there are about 1,500 appeals officers. Many of them are CPAs or attorneys, reporting to regional (legal) counsel's office. They have the job of settling legal and factual issues raised by agents without resorting to litigation. They will not reopen issues that have been agreed upon by the taxpayer and the agent. They may, however, raise new issues if they feel there is a substantial reason for doing so—a possibility to be weighed when considering an appeal.

Appeals officers can request technical advice from the national office if either they or the taxpayer desires. The appeals officer is obligated to follow technical advice that is favorable to the taxpayer but may still negotiate if the advice is unfavorable to the taxpayer. If the taxpayer reaches an agreement with the appeals officer, the taxpayer signs Form 870-AD. If no agreement can be reached, a notice of deficiency (ninety-day letter) is issued and the taxpayer is invited to start proceedings in Tax Court. Even if an appeals officer reaches an agreement with a taxpayer, the agreement is not binding on the IRS unless approved by the associate chief or chief of the appeals branch office.

9.1.3 Binding arbitration

In Announcement 2000-4 (2000-2 IRB 1), the IRS states it is beginning a two-year test of a binding arbitration procedure as mandated under IRC Sec. 7123(b)(2). This announcement includes a model arbitration

agreement to be used for factual issues already in the Office of Appeals administrative process. At the time of this writing, a public hearing was scheduled to be held before the IRS on April 5, 2000. Written comments from the public for the National Director of Appeals' consideration were due on May 5, 2000.

9.2 The Ninety-Day Letter

The ninety-day letter is the notice of deficiency received by a taxpayer who makes no response to a thirty-day letter, who requests immediate assessment in order to go to court, or who has reached no settlement in the appeals office. A taxpayer receiving a ninety-day letter has ninety days to file a petition with the Tax Court (150 days if it was addressed to a taxpayer outside the United States). The taxpayer who chooses to appear before the Tax Court does not first have to pay the proposed deficiency. If the taxpayer fails to respond in time to the ninety-day letter, the deficiency is assessed and the taxpayer loses the right to have his or her case reviewed by the Tax Court. A taxpayer who chooses to have the case reviewed by the U.S. district court or the U.S. Claims Court must pay the tax and then file for a refund.

9.3 Appeals Before the Courts

9.3.1 The U.S. Tax Court

Ordinarily, the Tax Court presents the taxpayer's only opportunity for entry into court without first paying the alleged deficiency. Timing is critical when petitioning the Tax Court. The petition must be received by the court no more than ninety days from the date the deficiency notice was mailed to the taxpayer.

If the case had been to the appeals office before the ninety-day letter was issued, IRS regional counsel has jurisdiction from the time the taxpayer files a petition in Tax Court. If the case had not been to the appeals office, regional counsel will refer it there. If the appeals office sees no prospect for settlement, and the deficiency is more than $10,000, the case will promptly be returned to regional counsel for trial preparation. If the deficiency is $10,000 or less, the appeals office will retain jurisdiction for at least six months, which period may be extended

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if there appears to be likelihood of settlement. In most cases it will be to the taxpayer's benefit to achieve settlement as rapidly as possible.

When jurisdiction of a case passes to IRS regional counsel, all relevant facts and legal positions will be pieced together to develop the case for trial. Once the case is developed, regional counsel may attempt settlement with the taxpayer, regardless of prior settlement attempts by the IRS appeals division.

In contrast to other U.S. courts, representation before the U.S. Tax Court is not limited to attorneys. A taxpayer can represent himself or herself before the Tax Court or may be represented by anyone authorized to practice before the Tax Court (see section 2.1). Only tax cases are heard in Tax Court, and the court is accustomed to the complexities of the Internal Revenue Code. Cases heard by the Tax Court can be appealed to the U.S. Court of Appeals and may be heard in some instances by the U.S. Supreme Court.

For cases involving disputes of $10,000 or less for a taxable year, the taxpayer has the option of choosing to use the Small Tax Case Procedure. This procedure uses special trial judges whose decisions cannot be appealed. Results cannot be used as a precedent for any other case. Overall, the Small Tax Case Procedure is quicker, less expensive, and less formal; however, there can be no appeal. Recent statistics indicate that the IRS achieves a clear victory in 45 to 60 percent of the cases, regardless of the forum (Tax Court, district court, or Claims Court), although "split decisions" carrying some benefit to the taxpayer are more common in Tax Court. (The booklet *Election of Small Tax Case Procedure and Preparation of Petitions* is available from the Clerk of the Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.) Once a taxpayer has filed a petition to the Tax Court it cannot be withdrawn, except with IRS counsel's agreement.

9.3.2 The U.S. District Court and the U.S. Claims Court

If a taxpayer has paid the assessed tax and has filed a claim for a refund, but the claim either has been denied with a notice of disallowance or has not been acted upon within six months from the date it was filed, the case may be taken to a U.S. district court or the U.S. Claims Court. In almost all district courts and the Claims Court, the government is represented by attorneys from the tax division of the Department of Justice.

District courts provide a taxpayer with the opportunity to have the case decided upon by a jury. In addition, since the district court is a local court, its members are likely to be familiar with local conditions and circumstances that may have a bearing on the outcome of the case.

The U.S. Claims Court is not a local court, but the trial may be held in or near the taxpayer's home city. Since the judge in a Claims Court case will hear evidence at several locations for the convenience of parties involved, the Claims Court can often ease problems created by having witnesses residing in widely scattered locations.

Decisions made by a district court can be appealed to the respective courts of appeal and ultimately, under the proper circumstances, to the Supreme Court. Decisions made by the Claims Court can be appealed to the U.S. Court of Appeals for the federal circuit and to the Supreme Court. Experienced tax attorneys choose a court based upon their experience with the court and subjective judgments about what is best for the taxpayer.

10. OBTAINING A REFUND

10.1 Claims Procedures

A taxpayer who has made an overpayment of taxes to the IRS is eligible for a refund. Overpayments exist when the taxpayer makes a tax payment exceeding his or her correct tax liability and include payments of taxes assessed or collected after the expiration of the period of limitations on assessment. If the IRS learns of an overpayment, either through notification by the taxpayer or through an audit, it will credit or refund the overpayment provided that the statute of limitations for filing claims (IRC Sec. 6511) has not expired.

Filing a refund claim puts the IRS on notice that there may be an overpayment. No lawsuit for a refund may be brought unless a timely and valid refund claim is filed. Although the IRS has issued denials, many tax practitioners believe filing a refund claim can sometimes trigger an audit, particularly if the refund is large or is made in connection with a tax shelter. A claim for refund may be made by

— Form 1040X or 1120X, Amended Returns, in the case of individual or corporate income tax.

— A regular tax form marked *Amended* and showing overpayment of income taxes.

— A letter to the appropriate IRS official stating all information necessary for the IRS to determine the nature of the claim.

— Form 870 showing an overpayment, solicited by a revenue agent and signed by the taxpayer.

— A Tax Court petition, or protest, containing allegations that a refund is due, partially mitigating a proposed deficiency and stating the reasons therefor.

10.2 Speedy or Quick Refund Procedures

Taxpayers may avail themselves of an expedited refund procedure referred to as "speedy" or "quick" because the IRS must either pay the refund or deny the application within ninety days from the later of either the date the application was filed or the last day of the month the return was due (considering extensions). If the IRS later audits the tax year, the refund may be denied retroactively, and the taxpayer may have to return the refund.

The forms to be filed are Form 1045, for an individual, or Form 1139, for a corporation. Technically, these forms constitute applications for a tentative carryback adjustment when a prior taxable year has been affected by

— A net operating loss carryback.

— An investment credit carryback.

— A work-incentive program carryback.

— A capital loss carryback.

10.3 Interest on Refunds and Underpayments

For refunds originating in the current-year tax return, there is a forty-five-day interest-free period starting with the due date or the filing date, whichever is later. For refunds based on a claim—the usual case—interest is payable to the taxpayer from the date of the overpayment to a date as much as forty-five days prior to the refund check date.

For an overpayment arising from a carryback, interest is payable to the taxpayer from the due date for filing the loss-year return (without regard to extensions) to a date not more than thirty days preceding the date of the refund check (IRC Sec. 6611(a), (b)(2), and (f)).

For periods beginning after July 22, 1998, the interest rate on overpayments and underpayments is equalized. For the same amount of tax due and owed the interest rate for the taxpayer is effectively zero.

10.4 Protective Refund Claim

A claim for refund must be filed within three years from the time the return was filed or two years from the time of payment of the tax. The claim must set forth in detail the basis for the refund (Treas. Reg. Sec. 301.6402-2). However, facts necessary to detail the claim may be unavailable to the taxpayer before the expiration of the limitation

period, such as the exact amount, or the effect of pending litigation. A claim for refund may be filed as a protective measure, however, even without complete detail. A general counsel memorandum acknowledges that the claim will be valid if it apprises the IRS of the essential nature of the claim (GCM 38786).

11. RULINGS, DETERMINATIONS, TECHNICAL ADVICE

11.1 Private Letter Rulings

A private letter ruling or, simply, a letter ruling is a written statement from the national office of the IRS specifying the tax treatment to be accorded a transaction or proposed transaction prior to its inclusion in a tax return. To the practitioner, a letter ruling is a planning tool, enabling taxpayers to obtain definitive guidance in structuring transactions. This guidance is particularly important if substantial amounts are involved and the transaction can be structured in different ways, depending on the IRS view as expressed in the letter ruling. The ruling may also motivate the taxpayer to avoid an as-yet-uncompleted transaction.

Rulings may not be cited as authority for another taxpayer's situation nor, technically, are they binding on the IRS. Only in rare instances, however, do examining agents attempt not to follow the ruling, in which case the ruling should be called to their attention. Rulings, with identifying characteristics removed, are available for public scrutiny and appear in tax publications. A ruling has no value, even to the taxpayer who received it, if the facts of the transaction are not in agreement with those supplied when the ruling was requested.

A conference at the national office may be requested to sound out the government's position, particularly if the transaction is complex or unique, without fully exposing the taxpayer's proposed situation. Taxpayers or authorized representatives should go to a conference with a draft of their request. Nothing said at the pre-submission conference is binding on either party.

The taxpayer must sign a statement attesting to the accuracy of the facts submitted in the filing. A thirty-day period will be allowed for submission of missing information. A request may be withdrawn by a taxpayer prior to the time the ruling is signed by the IRS. Rulings normally require several months for the IRS to process.

Although it is normal procedure to file the request and then to receive one conference as a matter of right, a phone call to the deputy

associate chief counsel for technical matters in the national office may prove useful in sounding out, before filing, whether the IRS is likely to issue a favorable ruling. No ruling will be made orally. The telephone call can also be used to straighten out procedural questions regarding the form of the submission. The telephone conference will proceed on a "time available" basis at the discretion of the deputy counsel.

If a formal ruling is sought, the request must be in writing and should be accompanied by copies of financial statements, minutes of

(Text continued on page 51)

meetings, and other pertinent documents. These will not be returned if the ruling is denied, but will become part of the taxpayer's file at the district level. Tax returns reflecting transactions carried out despite a prior unfavorable ruling are likely to be audited. Each year guidelines for securing letter rulings are detailed in a Revenue Procedure, for instance Rev. Proc. 91-1, including such matters as the following:

— Submit in duplicate if more than one issue is requested, or if a closing agreement is requested.

— Do not submit alternative plans as backup in case your ruling is denied.

— Include complete facts, names, addresses, and identification numbers of all interested parties; copies of all pertinent documents should have an attestation that they are the same as the originals.

— Include a balance sheet nearest the date of the transaction.

— Include analyses that tie together the business reasons for the transaction.

— Give appropriate grounds and authority for the ruling.

— State the outcome of any previous request for rulings on similar issues for the taxpayer.

— State whether the same issue is in the taxpayer's return that (1) is under examination or appeal and without a closing agreement, or (2) is in litigation.

For recent guidelines, also see Rev. Proc. 2000-1.

The areas in which the IRS will not issue letter rulings are set forth in Rev. Proc. 2000-3.

11.2 Determination Letters

A determination letter, issued by a district director at the taxpayer's request, is a written response to a set of facts regarding a completed transaction. The determination is made only if it can be based on precedents and policies previously expressed by the national office. Procedures for requesting determinations are the same as for a letter ruling, but the request should be directed to the district director. Forms are available for determining the tax qualified status of tax-exempt organizations (Form 1023), or pension, profit-sharing, or retirement plans and the trust or custodial arrangements associated with them (forms in the 5300 series). The procedures for requesting determination letters are set forth in Rev. Proc. 95.4 and, more recently, in Rev. Procs. 2000-4, 5, 6, and 8.

11.3 Technical Advice Memoranda (TAM)

These memos are statements written by the national office to provide instruction to a district or appeals office regarding the national office view of the treatment of a technical matter on a return under examination. These memos have other uses; for example, a district director might request technical advice concerning a taxpayer's request for a determination letter. Although the formal request to the national office must come from the district office, a taxpayer may request that this be done. Practitioners usually encounter TAMs when they are requested by a revenue agent. Taxpayers may submit their arguments either in writing or orally before the national office writes its memo.

A TAM may be particularly useful for the taxpayer who believes that lack of uniformity exists in treatment of an issue or that the issue is unusual enough to justify national office attention, while at the same time believing the national office will endorse the taxpayer's point of view, even if the examining agent does not.

An agent who has received a TAM is bound to follow its guidance. The legal issue involved may not be negotiated at the examination nor at the conference level, although a factual or monetary compromise may still be possible. The taxpayer's only other recourse is to go to court.

If the taxpayer asks for a TAM but the agent declines to request it from the national office, the taxpayer, within ten calendar days, should appeal in writing to the Chief, Examinations Office, or the Chief, Appeals Office. If another denial is received, the taxpayer has ten days in which to request that all data regarding the request be submitted to the national office. Details may be found in Statement of Procedural Rules 601.105(b)(5). Procedures for obtaining TAMs are set forth in Rev. Proc. 91-2, updated by Rev. Proc. 2000-2.

11.4 Freedom of Information Act

The Freedom of Information Act (5 USC 552) requires the IRS to make available a variety of information if it has not already been published in the Federal Register, including

— Final opinions and other orders made in the adjudication of cases.

— Statements of policy and interpretations adopted by the IRS.

— Administrative staff manuals and instructions to staff that affect a member of the public.

Public reading rooms where these and other materials are available for inspection are maintained in the national office and in each regional office. Subject to exceptions set out in Statement of Procedural Rules

601.701(b)(1), a taxpayer may request that the IRS make available its "reasonably described records" concerning the taxpayer. (Exceptions relate primarily to IRS personnel rules and to enforcement tactics, including criteria for selection of returns for audit.) A request for records and files must be made in writing, stating it is made pursuant to the Freedom of Information Act and sent to the IRS official responsible for the records. Addresses for the responsible district officers, as well as details for making the requests, may be found in Statement of Procedural Rules 601.702. IRS Publication 876 gives information about the nature and possible use of IRS data banks.

11.5 User Fees for IRS Services

The IRS is required by statute to collect fees for certain services, such as processing a request for change in accounting period or in accounting method. The fee must be paid in advance and varies in amount depending on the time required or the complexity of the response to the taxpayer's request. Fee amounts are set in a revenue procedure issued early each year and vary, depending upon the service, between $100 and $1,000.

11.6 Closing Agreements

IRC Section 7121 authorizes the IRS to enter into agreements in writing that "shall be final and conclusive" regarding a person's tax liability. Shareholders desiring to sell a closely held corporation might seek a closing agreement to definitely establish the amount of the corporation's tax liability. An individual might seek a closing agreement to present to other creditors to help prove his or her financial position. Closing agreements might be used to

— Determine the amount of deficiency dividend to be paid to avoid personal holding company tax.

— Release the executor of an estate from tax liability.

— Determine the amount of a final distribution from a trust or estate.

According to Statement of Procedural Rules 601.202 (26 CFR 601.202), a taxpayer request for a closing agreement should be submitted to one of the following:

— District director with whom the return was filed

— Appeals division, if the matter is under appeal

— Commissioner of Internal Revenue, if the matter relates only to a subsequent period

Form 866, "Agreement of Final Determination of Tax Liability," is used to close out the total tax liability of the taxpayer—for example, by a fiduciary seeking to close an estate or by a corporation being liquidated. Form 906 is for a closing agreement covering specific issues. It might be used for matters having a continuing relevance to future tax years, such as to settle the basis of property or method of depreciation.

11.7 Correspondence

The IRS has provided an explanation of the notice routine and time frames for accounts with outstanding balances and accounts where no tax return has been filed. The first notice a taxpayer receives indicating a balance due is called an *adjustment/error notice.* There are several different adjustment/error "CP" notices that are used to alert the taxpayer of an outstanding balance.

Time Frames for IRS Notices

Balance Due Accounts
Individual Tax Accounts: Adjustment/Error Notice:
–5 weeks - 1st Notice, CP501
–5 weeks - 2nd Notice, CP502
–5 weeks - 3rd Notice, CP503
–5 weeks - 4th Notice, CP504
Business Tax Accounts: Adjustment/Error Notice:
–5 weeks - 1st Notice, CP503
–4 weeks - Final Notice, CP504

Return Delinquency
Individual Tax Accounts: 1st Notice, CP515
–8 weeks - 2nd Notice, CP516
–6 weeks - 3rd Notice, CP517
–6 weeks - 4th Notice, CP518
Business Tax Accounts: 1st Notice, CP515
–10 weeks - 2nd Notice, CP517
–6 weeks - 3rd Notice, CP518

12. PROBLEM RESOLUTION: TAXPAYER ADVOCATE

The Office of the Taxpayer Advocate administers the IRS' Problem Resolution Program (PRP) and is responsible for representing the taxpayer's point of view within the Service. Taxpayers feeling that their

problems are not resolved through normal IRS channels may request an Advocate's help by filing Form 911, Application for Taxpayer Assistance Order (TAO). The form is available by phone (800-829-1040) or at a local IRS office.

The Advocate must be satisfied that the taxpayer has been unable to get relief through usual IRS channels. If, as determined by the Advocate, the taxpayer is suffering or about to suffer a significant hardship as a result of IRS administration of laws, a TAO will be issued. A TAO may require the IRS to take one of these actions immediately:

— Release property of the taxpayer levied upon, or

— Cease any action, or refrain from taking any action, with respect to the taxpayer under

Chapter 64 (relating to collections),

Subchapter B of Chapter 70 (relating to bankruptcy and receiverships),

Chapter 78 (relating to discovery of liability and enforcement of title), or

Any other provision of law that is specifically described by the ombudsman in the order.

The TAO suspends the statute of limitations related to the subject of the order (for example, under IRC Section 6501 relating to the assessment or collection of tax) and immediately stops an IRS action or proposed action (such as a levy on the taxpayer's property). The period of suspension begins on the date of the taxpayer's application for a TAO and ends on the date of the Advocate's decision. Additionally, the Advocate can specify in the TAO any further suspension period.

The IRS has told its employees that it is never wrong to stop collection activities once a TAO has been requested. Advocates are expected to refer a case to the IRS district director if other IRS officials ignore a TAO.

Once a TAO has been issued, it is binding on the IRS unless modified by the Advocate, a district director, a service center director, a compliance center director, a regional director of appeals, or any superior of these officers.

Suggested steps for dealing with the PRO:

1. Phone the Taxpayer's Advocate at the district office to learn what steps must be taken before a TAO will be issued.
2. Tell the officer you are sending the application for a TAO, and record his or her name for follow-up.
3. Send the application and, later, check back with the PRO to confirm that it has been received and learn whether more information is needed.

Form 911 is used to request the TAO, but the IRS says that a written statement will serve as well if the form is not available. The "significant hardship" described in the statute is defined as "more than an inconvenience to the taxpayer or a financial hardship, as such, but rather as a hardship from which the resultant disruption caused or to be caused to the taxpayer by the Internal Revenue Service's action or proposed action is such that it would offend the sense of fairness of taxpayers in general were they aware of all the surrounding facts and circumstances."

The Taxpayer Advocate must consider, among other things, the following four specific factors when determining whether there is a "significant hardship" and whether a TAO should be issued:

1. Whether there is an immediate threat of adverse action
2. Whether there has been a delay of more than thirty days in resolving the taxpayer's account problems
3. Whether the taxpayer will have to pay significant costs (including fees for professional representation) if relief is not granted
4. Whether the taxpayer will suffer irreparable injury, or a long-term adverse impact, if relief is not granted (IRC Sec. 7811(a)(2), as amended by the 1998 Act)

Significant hardships sometimes occur during IRS action to collect tax. Specific examples of hardships are

— Threat of a poor credit rating caused by erroneous enforcement action.

— Possible loss of employment.

— Pending eviction.

— Refusal of the IRS to rescind an erroneous statutory notice (ninety-day letter).

— Significant personal emergency, such as payment for medical treatment.

— Imminent bankruptcy.

— Inability to meet payroll.

The national Office of Taxpayer Advocate submits two reports to Congress annually. One lists goals for the coming year, and the second report lists the twenty most serious problems encountered by taxpayers and suggests ways for solving these problems.

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Saltzman, Michael I. *IRS Practice and Procedure,* 2d ed. Boston: Warren, Gorham & Lamont, 1991.

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Tax Management Inc. Staff. *Tax Practice Series.* 10 vols. Washington, D.C.: BNA Books, 1989. Loose-leaf.

APPENDIX 1: Where to Obtain Out-of-State Tax Forms

ALABAMA
Dept. of Revenue, Income Tax Forms
P.O. Box 327460
Montgomery, AL 36132-7460
(334) 242-1000

ALASKA
Dept. of Revenue
State Office Bldg.
P.O. Box 110420
Juneau, AK 99811-0420
(907) 465-2320

ARIZONA
Dept. of Revenue
1600 West Monroe
Phoenix, AZ 85007-2650
(602) 542-4260

ARKANSAS
Department of Finance and Administration
Revenue Division
P.O. Box 8054
Little Rock, AR 72203
(501) 682-7255

CALIFORNIA
Franchise Tax Board/Forms Request
P.O. Box 942840
Sacramento, CA 94240-0040
(800) 852-5711

COLORADO
Dept. of Revenue
State Capitol Annex
1375 Sherman St.
Denver, CO 80261
(303) 534-1208

CONNECTICUT
Dept. of Revenue Services
State Tax Dept.
25 Sigourney Street
Hartford, CT 06106
(203) 297-4753

DELAWARE
Division of Revenue, Att: Forms Dept.
State Office Bldg.
820 N. French Street
Wilmington, DE 19801
(302) 571-3300

DISTRICT OF COLUMBIA
Government of District of Columbia
Dept. of Finance & Revenue
300 Indiana Ave., NW, Rm. 1046
Washington, DC 20001
(202) 727-6170

FLORIDA
Dept. of Revenue
5050 West Tennessee St., Rm. 104
Tallahassee, FL 32399-0100
(904) 922-9645

GEORGIA
Income Tax Unit, Dept. of Revenue
Trinity-Washington Bldg
Atlanta, GA 30334
(404) 656-4293 or 4071

HAWAII
Taxpayer Service Branch
State of Hawaii, Dept. of Taxation
P.O. Box 259
Honolulu, HI 96809
(800) 222-3229

IDAHO
State Tax Commission
P.O. Box 36
Boise, ID 83722
(208) 334-7789

ILLINOIS
Dept. of Revenue
101 W. Jefferson
Springfield, IL 62794-9010
(217) 782-3336
in IL (800) 732-8866

INDIANA
Dept. of Revenue
State Office Bldg , Room 104
100 N. Senate Ave.
Indianapolis, IN 46204-2253
(317) 484-5103

IOWA
Iowa Dept. of Revenue
Hoover State Office Bldg.
Services Section
P.O. Box 10457
Tax Form Ordering Center
Des Moines, IA 50306
(515) 281-3114

KANSAS
Kansas Dept. of Revenue
Taxpayer Bureau
Box 12001
Topeka, KS 66612-2001
(913) 296-4937

KENTUCKY
Revenue Cabinet
Property-Mail Services
200 Fair Oaks Lane, Bldg. 2
Frankfort, KY 40602
(502) 564-3658

LOUISIANA
State Dept. of Revenue & Taxation
P O. Box 201
Baton Rouge, LA 70821
(504) 925-7532

MAINE
Bureau of Taxation
Income Tax Section
State Office Bldg., Station 24
Augusta, ME 04332
(207) 624-7894

MARYLAND
Comptroller of the Treasury
Revenue Administration
110 Carroll St.
Annapolis, MD 21411
(301) 974-3951

MASSACHUSETTS
Dept. of Revenue
100 Cambridge St.
Boston, MA 02204
(617) 727-4545

MICHIGAN
Revenue Admin. Services Division
Treasury Building
Walnut & Allegan St.
Lansing, MI 48922
(517) 367-6263

MINNESOTA
Dept. of Revenue
Forms Distribution Center
Mail Station 4450
St. Paul, MN 55146-4450
(612) 296-3781

MISSISSIPPI
State Tax Commission
750 South Galatin
Jackson, MS 39204
(601) 359-6247

MISSOURI
Dept. of Revenue
Income Taxes Bureau
P.O. Box 3022
Jefferson City, MO 65105-3022
(314) 751-5337 or (800) 877-6881

MONTANA
Dept. of Revenue, Income Tax Div.
Attn: Form Dept.
P.O. Box 5805
Helena, MT 59604
(406) 444-2837

NEBRASKA
Nebraska Dept. of Revenue
Office Services
P.O. Box 94818
Lincoln, NE 68509-4818
(402) 471-2971

NEVADA
Nevada Dept. of Taxation
Capitol Complex
Carson City, NV 89710-0003
(702) 885-4892

NEW HAMPSHIRE
Dept. of Revenue
Administration
61 South Spring St.
Concord, NH 03301
(603) 271-2192

NEW JERSEY
Div. of Taxation
Taxpayer Information Services
CN269
50 Barrack St.
Trenton, NJ 08646
(609) 292-7613

NEW MEXICO
Taxation & Revenue Dept.
Manuel Lujan Sr. Bldg.
P.O. Box 630
Santa Fe, NM 87509-0630
(505) 827-0700

NEW YORK STATE
Dept. of Taxation & Finance
Forms & Control Unit
Bldg. 12, W.A. Harriman
Campus
Albany, NY 12227
(518) 438-1073

NEW YORK CITY
Finance Administration
Dept. of Tax Collection
P.O. Box 446, Canal St. Station
New York, NY 10013
For Businesses:
25 Elm Place
Brooklyn, NY 11201
(718) 935-6739
(718) 935-6000

NORTH CAROLINA
Dept. of Revenue
P.O. Box 25000
Raleigh, NC 27640
(919) 715-0397

NORTH DAKOTA
Tax Commissioner
State Capitol
600 E. Blvd. Ave.
Bismarck, ND 58505
(701) 328-3017

OHIO
Ohio Dept. of Taxation
P.O. Box 2476
Columbus, OH 43266-0176
(614) 433-7750

OKLAHOMA
Tax Commission
2501 Lincoln Blvd.
Oklahoma City, OK 73194
(405) 521-3108

OREGON
Oregon Dept. of Revenue
955 Center St. N.E.
Salem, OR 97310
(503) 378-4988

PENNSYLVANIA
Dept. of Revenue
Tax Forms Services Unit
Strawberry Square
Harrisburg, PA 17128
(717) 787-8201

RHODE ISLAND
Dept. of Administration
Div. of Taxation
1 Capitol Hill
Providence, RI 02908-5800
(401) 277-3934

SOUTH CAROLINA
South Carolina Tax
Commission
P.O. Box 125
Columbia, SC 29214
(803) 737-5000

SOUTH DAKOTA
Dept. of Revenue
700 Governor's Dr.
Pierre, SD 57501-2276
(605) 773-3311

TENNESSEE
Tennessee Dept. of Revenue
Andrew Jackson State Office
Bldg.
500 Deadereck St., 4th Fl.
Nashville, TN 37242
(615) 741-4465

TEXAS
Comptroller of Public Accounts
State of Texas
111 West 6th, Starr Bldg.
Austin, TX 78701
(512) 463-4600

UTAH
State Tax Commission
Heber M. Wells Bldg.
160 East 300 South
Salt Lake City, UT 84134
(801) 297-2200

VERMONT
Vermont Dept. of Taxes
109 State St.
Montpelier, VT 05609
(802) 828-2515

VIRGINIA
Dept. of Taxation
Taxpayers Assistance
P.O. Box 1880
Richmond, VA 23282
(804) 367-8031

WASHINGTON
Dept. of Revenue
General Administration Bldg.
P.O. Box 47478
Olympia, WA 98504
(206) 786-6100

WEST VIRGINIA
State Tax Dept., Taxpayer
Service
P.O. Drawer 3784
Charleston, WV 25337
(304) 344-3333

WISCONSIN
Wisconsin Dept. of Revenue
Attn: Shipping & Mailing
Section
P.O. Box 8903
Madison, WI 53708
(608) 266-1961

WYOMING
Revenue Dept.
Herschler Bldg.
Cheyenne, WY 82002
(307) 777-5200

APPENDIX 2: Record Retention

Record retention is a must, whether for personal, business, or tax reasons. However, record retention is necessary only to the extent it serves a useful purpose or satisfies legal requirements. For example, generally the IRS must assess additional tax within three years after the later of filing of a return or its due date. The period is six years if the taxpayer omits items of gross income that in total exceed 25 percent of gross income reported on the return. If a fraudulent return is filed or if no return is filed there is no limit to the period the tax can be assessed. In practice, however, most individuals and businesses retain records based on available space.

Many accounting firms maintain permanent files for their clients. In a permanent file, such legal documents as wills, leases, employment agreements, and debt instruments are kept. In addition, other pertinent tax documents such as Subchapter S Election Approval or Keogh plans may be kept in this file. Non-tax records that establish the due professional care with which an accountant has performed an accounting or auditing service should be retained as long as a legal action could be filed by an injured party. This time period varies from state to state and according to whether the action alleges contract or tort damages. Seven years, in most states, would be a satisfactory period for retention. Permanent files are not unique to accounting firms alone. Other businesses can also benefit from the establishment of permanent files to retain the documents listed on the following chart.

Advanced technology has somewhat eliminated the inconvenience of retaining records—the use of microfilm can condense reams of paper to the size of a single sheet. Microfilm is not without disadvantages: It is relatively expensive, nonbillable to clients, and, once the system is adopted, it generally becomes permanent.

Individuals, businesses, and accounting firms facing record retention must answer two questions: "What must I keep?" and "How long do I have to keep it?" Following are charts devised for individuals, businesses, and accounting firms. These charts may be used as a guideline for most records; however, always be sure to check local and state record retention requirements.

Detail on many aspects of record retention, including tax records, can be found in *Guide to Record Retention Requirements in the Code of Federal Regulations,* a publication available from the Superintendent of Documents or from Commerce Clearing House.

NOTE: Because statutes of limitation and state and governmental agency requirements vary from state to state, each firm should carefully consider its requirements and consult with legal counsel before adopting a retention policy.

RETENTION SCHEDULE: CLIENT RECORDS

	*Retention period in years**			*Disposition after retention period*
	In office	*In storage*	*Total*	
Correspondence files	3	7	10	Destroy
Annual financial statements	3	Permanent	—	—
Typed reports				
Auditors' reports, opinion and disclaimer	3	Permanent	—	—
Compiled or reviewed monthly and quarterly financial statements	3	7	10	Destroy
Reports filed with government agencies	3	Permanent	—	—
Special reports (fire losses, special investigations, etc.)	3	Permanent	—	—
Systems reports	3	Permanent	—	—
Pencil drafts of reports	—	—	—	Destroy
Tax files				
Tax returns:				
Present clients	3	Permanent	—	—
Former clients	3	7	10	Destroy
Tax surveys, research reports, agents' examinations, and other special tax reports:				
Present clients	3	Permanent	—	—
Former clients	3	7	10	Destroy
Working paper files				
Audited financial statements:				
Present clients	3	Permanent	—	—
Former clients	3	7	10	Destroy
Compiled or reviewed monthly and quarterly financial statements	3	7	10	Destroy
Systems assignments	3	7	10	Destroy
Special reports	3	7	10	Destroy
Securities registrations and other SEC work:				
Present clients	3	Permanent	—	—
Former clients	3	7	10	Destroy
Special tax assignments (includes IRS examination documents, etc.):				
Present clients	3	Permanent	—	—
Former clients	3	7	10	Destroy
Permanent files				
Present clients	Permanent	—	—	—
Former clients	3	7	10	Destroy

*Whenever records are relevant to a pending lawsuit or charge of discrimination, they must be retained until final disposition of the lawsuit or charge.

Source: *AICPA Management of an Accounting Practice Handbook.* New York: American Institute of Certified Public Accountants, Inc., 1995.

RETENTION SCHEDULE: FIRM RECORDS

Description	*Retention period in years**
Accounting Records	
General ledger	Permanent
Accounts receivable	10 (3 in office; 7 in storage)
Accounts payable	10 (3 in office; 7 in storage)
Clients' invoices	7
Payroll records (journals, ledgers, W-2s, 940s, 941s, etc.)	Permanent
Data transmittal (in central processing system)	7
Expense reports	7
Time reports	7
Other charges to clients' voucher	7
Bill draft	7
Voucher check copies	7
Canceled checks, bank statements, and deposit slips	10 (3 in office, 7 in storage)
Journal voucher	Permanent
Interoffice client charges	7
Client coding form—masters	1 + current
Payroll data and authorization	7
Correspondence	1 + current
Cash receipts and disbursements journals	Permanent
Billed accounts receivable aged trial balance	7
Client unbilled receivables ledger	7
Unbilled accounts receivable status	7
Employee time analysis	7
Analysis of billing adjustments	7
Client charges and billing report	7
Analysis of gross and net fees by service classification	7
Depreciation schedules	Permanent
Administrative Records	
Accident reports and claims	6 (after accident or settlement)
Partnership or corporate records, including local, state and federal licenses, annual reports, capital stock and bond ledger, canceled stock and bond certificates, articles of incorporation, bylaws, and minutes from partner meetings or stockholder and director meetings	Permanent
Legal correspondence, including those pertaining to copyrights, permits, and bills of sale	Permanent
Equipment records	5 (after disposition)
Warranties and service agreements	1 (after expiration)
User's manuals	(until disposition)
Insurance documents, including policies, reports, claims, and coverage information	3–10 (after expiration or settlement)
Leases and contracts	10 (after termination)
Property records, including blueprints, appraisals, and permits	Permanent

*Ordinarily, canceled checks and paid vendors' invoices are destroyed after seven years. However, checks and invoices for purchase of assets, where the determination of basis might be important in the future, are retained indefinitely.

Description	*Retention period in years**
Annual Financial Reports	
Firm tax returns, annual statements, and working papers—operating offices and consolidated	Permanent
Monthly or Periodic Financial Reports	
Monthly statements—operating offices	7
Interim statements—consolidated	7
Other periodic financial reports	3
Supplemental Accounting Data	
Daily cash reports, remittance advices, and bank deposit slips	1
Vendors' invoices and petty cash slips	7
Current Legal Documents	
Partnership agreements or corporate documents	Permanent
Special contracts	Permanent
Noncurrent Legal Documents	
Partnership agreements or corporate documents-superseded	Permanent
Personnel: Post-Employment	
Counseling records	7 (after termination)
Disability benefits	6 (after expiration/settlement)
Discrimination charges	3–4 (after settlement)
Education, training, and CPE records	7 (after termination)
Employee contracts	7 (after termination)
Employee medical history	6 (after termination)
INS 1-9 forms. Complies with Immigration Reform & Control Act	3 from date of filing or 1 year after termination, whichever is longer.
Performance reviews	7 (after termination)
Personnel data, applications, and contracts—present employees	Permanent
Personnel data, applications, and contracts—former employees	7 (after termination)
Salary rates and changes	3 (after termination)
Personnel: Pre-Employment	
Position applications, resumes, tests, or other job advertisements and replies relating to employees	7 (after termination)
Position applications, resumes or other job advertisements and replies relating to non-employees	1 (after completion)
Promotion, demotion, layoff, or discharge of an employee	7 (after completion)
Miscellaneous	
Firm meetings files (annual and special meetings)	7
Attendance records	7 (after termination)
New business reports	7
Interoffice correspondence	7
Bulletins to clients, firm executives, and staff	7
Firm publications, including promotional and recruiting brochures, personnel guide, and client newsletter	7

APPENDIX 3: Recognition and Authorization Requirements for Persons Appearing Before the IRS

Capacity of Person Appearing (Each category includes all categories listed below it)	Attorneys and CPAs	Enrolled Agents	Unenrolled Persons who are not Attorneys or CPAs		Others
			Qualified for Limited Practice Under Sec. 10.7 of Cir. No. 230		
			Return Preparers	Other	
1. As an advocate who is to perform certain acts for taxpayer as prescribed in 26 CFR 601.502(c)(1) (Constitutes "Practice" as defined in Cir. No. 230)	P/A and D Exception (2) may apply	P/A and E	Ineligible	P/A Exception (2) may apply	Ineligible
2. As an advocate (Constitutes "Practice" as defined in Cir. No. 230) who may receive tax information of a confidential nature but is not to perform other acts for taxpayer as prescribed in 26 CFR 601.502(c)(1)	TIA and D Exception (1), (2) or (3) may apply	TIA and E Exception (3) may apply	TIA Exception (4) applies	TIA Exception (2) or (3) may apply	Ineligible
3. As a witness who may receive or inspect tax information of a confidential nature (Does not include "Practice" as defined in Cir. No. 230)	TIA Exception (1) or (2) may apply	TIA	TIA	TIA Exception (2) may apply	TIA
4. As a witness for taxpayer to present his books, records or returns to the examining officer (Does not include "Practice" as defined in Cir No. 230)	No requirements	No requirements	No requirements	No requirements	No requirements

CODE FOR REQUIREMENTS

P/A—Must present or have Power of Attorney on file

TIA—Must present or have a Tax Information Authorization (or Power of Attorney) on file if taxpayer is not also present.

D—Must present or have a Declaration on file. Declaration may be in combination with a TIA or Power of Attorney.

E—Must present evidence of current enrolled status or temporary recognition status.

EXCEPTIONS

(1) An attorney who prepared the estate tax return and is the attorney of record for the estate will not be required to have a TIA on file, but a Declaration must be on file. (26 CFR 601.502(c)(3)(ii))

(2) A trustee, receiver, or an attorney (designated to represent a trustee, receiver, or debtor in possession) may substitute a proper court certificate or a copy of a district court order approving bond in lieu of a P/A or TIA. (26 CFR 601.502(c)(3)(iii))

(3) A TIA is not required if the advocacy can be performed without necessitating Service disclosure of tax information of a confidential nature. (26 CFR 601.502(c))

(4) Unenrolled return preparers are limited to representation of persons during the examination process (ineligible for practice at Appeals Conferences). (Sec. 10.7(a)(7) Cir. No. 230)

Source. *Internal Revenue Manual — Audit.*

BUSINESS PERFORMANCE MEASURES

1. PERFORMANCE MEASUREMENT DEFINED

1.1 Definition

Performance measurement is a consistent long-term process used to create wealth and return on investment in a business. It is an organized process of linking desired future performance with current information that is predictive of logical and consequential results. Key to performance measurement is the identification of critical success factors that lead to measures that can be tracked over time. The process includes evaluation of progress made in achieving specific targets linked to a business's strategic goals.

The measures track aspects of the entire business—both financial and nonfinancial (for example, customer satisfaction, product quality, sales calls, and proposals delivered). By focusing on key performance indicators, management will be able to stay on course with the business's strategy and more easily determine its overall performance.

Performance measurement is as pertinent to a small business as it is to a large business. In larger businesses, performance measurement involves leadership, operational managers, department supervisors, and rank and file workers. It communicates the business's goals and strategies to employees at all levels of the organization. The use of performance measures also allows companies to provide a clear link between compensation and performance and can be used as a means to motivate employees.

Performance measures have a direct correlation to company goals and serve as leading (future-oriented) indicators rather than the usual lagging-indicators (for example, last quarter's income or revenues).

1.2 Dynamic Forces Affecting a Business's Value

Particularly in small businesses, the value of the business is often tied more directly to the personal services of the owner than the intrinsic value of the business processes. Engrossed in constantly doing the work of the business, such proprietors rarely succeed in building businesses that can function independent of them in a completely predictable manner. Most lack the systems and performance measures that build a business's value.

The ultimate value of a business typically will be directly proportional to the owner's success in developing a business built on systematized processes. Where systems are in place for all processes, owners

do not have to do each process personally because they can rely on others less skilled. A business where everything is systematized becomes a "franchise prototype" which, if desired, could be duplicated time after time with completely predictable and reliable results. Of course, franchising their business would not fit the mission statement of most business owners. Yet, every small business owner should approach his or her business with the end in mind and approach each decision with the goal of creating wealth through a business of value that can be sold or transitioned to a successor without the continuing involvement of the owner.

Increasing the value of a business can generally occur only when management addresses the four most common ways in which profitability is created: (1) increasing the number of customers, (2) increasing the frequency of sales to those customers, (3) increasing the average value of each sale, and (4) increasing the effectiveness of each business process. Business performance measures assist the owner in managing the effectiveness of each system, and ultimately the total value of the business.

2. EVALUATING THE NEED FOR PERFORMANCE MEASURES

2.1 Critical Success Factors

The success of each business is built upon the strength of those factors that it must do perfectly, time after time. The performance measurement process helps businesses determine those factors and build a process for measuring and evaluating the effectiveness of each business process. Many, if not most, small businesses fail to achieve their potential profitability because they lack a structured process for measuring, testing, and evaluating the aspects of their business that they must get absolutely right.

2.2 Entrenchment in the Status Quo

Businesses generally cannot become successful by predetermining what the marketplace wanted. The statement "Build it and they will come" might apply to baseball diamonds in cornfields but not to entrepreneurship. Every aspect of a successful business must be constantly measured and tested against the marketplace. This applies to all areas of the business, including advertising campaigns, guarantees, product packaging, and pricing.

2.3 Management Self-evaluation

For a business to successfully implement a performance measurement process, the leadership must be fully behind the process. Embarking on this initiative requires a significant level of time, energy, and resources reallocated to the process. Management should evaluate its own commitment to the performance measurement process by considering the following issues:

— What aspects of the business does management worry about?

— Is there pressure to improve cash flow or net income?

— Are owners or creditors discontented with recent results?

— How committed is the leadership to embracing change?

— What type and level of leadership are leading this initiative? Do they work?

— Which level of management has participated in planning similar changes in the past?

— How have past efforts at enacting change succeeded?

— Where will the resistance to change most likely erupt?

— Will upper management show outward and ongoing support for the initiative?

— Who are the identifiable champions?

— Is there evidence of adopting new measurement tools in the past?

— Has previous strategic planning been done?

— What level of support exists among the board of directors?

2.4 Commitment to Change

Getting commitment from the rank and file employees for the business performance measurement process cannot happen without the leadership making a strong statement of purpose. Commitment can crumble as daily workloads direct attention away from the process. Such a statement of purpose should be repeated often to continue motivating team members toward the common goals. A business embarking on a new initiative for performance measurement should appoint a "champion" or "sustainer," one who will ensure managers and employees implement the changes and new systems required by this reengineering. See section 8.4 of this chapter for more information.

2.5 Building on Previous Strategic Plans

A business that has previously invested in developing a strategic plan should review and evaluate where the company stands in relation to the goals and objectives of that plan. The review should occur at least annually. Consistent, steady progress toward those strategic goals should be noted. A new strategic planning session is appropriate either when the company has achieved the majority of those previously set goals or when the efforts have stalemated. Refer to the chapter "Business Plans" for more information on long-range planning.

CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements (New York: AICPA, 2000) is a set of tools to assist an independent consultant in implementing a business performance measurement system for small business clients. Appendix 1 of this chapter contains a questionnaire suitable for businesses or their consultants to assess their readiness to embark on the performance measurement process.

3. HISTORICAL ASSESSMENT

3.1 Establishing a Baseline

Assessment of a company's current truths is an essential element in establishing performance measures. An honest assessment of performance, quality, customer loyalty, competitive market share, inventory turnover, and business valuation is critical for a solid basis for later decisions. Staff with skills in data acquisition, research, analysis, engineering, and human resources should be part of the assessment team. All aspects of the business's past performance should be included in the evaluation, including financial, operations, human resources, customers, and vendors.

Previous planning documents are very helpful in establishing a baseline. These would include long-range strategic plans, cyclical reviews of facilities needs and capital investment, annual budget and operating plans, staffing and human resource plans, and business succession plans. Other documents useful in establishing baseline information include employment history of key employees, past audit findings, system documentation and the employee handbook. Appendix 2, which contains a checklist for planning documents and existing or prior consulting relationships, can assist a business in assembling this information.

3.2 Vision Statements

An organization's vision statement consists of its core values and beliefs, a statement of purpose, and a statement of mission. A well-drafted vision statement does not significantly change over time and should convey what the business will look like several years in the future.

In addition, the vision needs to be realistic and attainable and appeal to the long-term interests of owners, employees, and customers. It should be focused enough to guide decisions, yet be flexible to allow individual interpretation and initiative. It needs to be clear enough that it can be explained and understood by every person in the business, from CEO to custodian. Finally, the vision must make strategic sense and be measurable in its key elements.

In creating a new vision statement, leadership should picture the company five years hence. The business should be described in terms of its potential structure and key people. Describe the customer base in terms of the number, type, and location of customers. Estimate the level of future revenue and profitability desired in five years. What major products or services are envisioned? What type of facilities and technology would be needed to support the organization? What human resources are needed?

3.3 Mission Statements

A mission statement flows from the vision statement by describing in the present tense why a business exists, whom it serves, and how it intends to accomplish its purpose. A mission statement should indicate the major products or services offered and the company's market position. The business philosophy and core values should be clearly and concisely stated. Mission statements should be updated on a regular basis as the company's products and markets evolve.

3.4 Strengths, Weaknesses, Opportunities, and Threats Analysis

A strengths, weaknesses, opportunities, and threats (SWOT) analysis can be used in preparing the company's mission statement, by assisting in developing its underlying support. SWOT looks at a business through its strengths and opportunities, which are helpful in achieving the overall objectives, and weaknesses and threats, which are harmful to achieving those objectives. Strengths and weaknesses are internal attributes of an organization. Management has control over each and every

strength and weakness. Opportunities and threats, however, are external conditions not readily controllable by management.

For example, opportunities include such issues as new markets opening up for the company or access to new products or services. Threats would be competitors or government legislation that can adversely affect industries.

A SWOT analysis may be conducted for individual aspects of the business, such as financial, operations, human resources, customers, and vendors. Information for SWOT analyses can come from many internal and external sources. Consider the sales history, customer surveys, market surveys, feasibility studies, trade associations, government publications, employee surveys, and competition studies.

An issue may appear as both a strength and a weakness, in different points of a company's life cycle. Door-to-door sales may have been a strength in the past because of the customer convenience. However, technological advances could turn this into a weakness as more customers engage in electronic commerce (e-commerce). In this instance, the business is being viewed from the past or the future rather than the present. A SWOT analysis should focus strictly on what it is today.

The following chart contains listings of various strengths, weaknesses, opportunities, and threats that should be considered in a typical SWOT analysis. They are categorized to assist in defining attributes into categories that are within or outside management's control.

3.5 Life Cycle Analysis

Life cycle analysis looks at the company's maturity through the classic bell curve. In every organization, some aspects of the operation, product or market are moving through start-up, growth, maturity or declining stages. Characteristics that are in the declining stages may need to undergo reengineering to revitalize, bringing them back to a start-up stage. Information from a life cycle analysis is helpful in conducting the SWOT analysis.

3.6 External Assessments

Some valuable information is typically available only outside the organization. Convening a customer advisory board can provide objective feedback on how others perceive the organization's effectiveness in delivering customer relations, service support, product guarantees, and the relative value of its products or services in relation to competitors.

Customer advisory boards may consist of focus groups or ad hoc panels, meeting with an independent facilitator to elicit honest feedback.

Strengths and weaknesses

Revenue and sales
- Product and services pricing
- Customer satisfaction
- Excess sales capacity
- Growth prospects
- Competitive market share
- Profitability
- Marketing plan

Personnel
- Experience and expertise
- Continuing education and job training
- Utilization of workforce
- Employee motivation and morale
- Frequency of staff meetings
- Outside management consultants

Facilities
- Efficiency of facilities
- Productivity of equipment

Availability of capital
- Inventory and purchasing management
- Working capital
- Cash flow
- Availability of credit
- Timeliness, reliability and availability of financial information
- Present measurement of key performance indicators
- Accounts receivable collections

Opportunities and threats

National and local economy
- Economic growth forecasts
- Incremental borrowing rate
- Consumer disposable income

Competition
- Quality of products and services
- Pricing policies
- Customer satisfaction
- Market share

Technology
- Obsolescence due to new technology

Population trends
- Demographics of population
- Amount of leisure time available
- Standard of living

Environmental/legal issues
- Environmental preservation
- New legislation
- Legal case law
- Natural disasters

3.7 Employee Reward Structure

Employees will do more of the things for which they are rewarded. A study of the current compensation structure can give insight into the behaviors that are currently being rewarded. For example, management can stress at great length the need for new, creative ideas from employees. But this behavior may not occur to any extent if employees are rewarded for completing low level, routine tasks (and perhaps penalized for diverting attention toward other activities). Employee compensation and benefits should be structured around the performance measures designed to achieve the overall business objectives.

4. CRITICAL SUCCESS FACTORS

4.1 Attributes

Critical success factors (CSFs) are those things that a business must get absolutely right to be successful. They are essential elements for accomplishing what the organization has stated in its vision and mission statements.

4.2 Selecting Appropriate CSFs for the Organization

Critical success factors should come from each of the key performance areas of an organization: Financial, operations, human resources, customers, and vendors. In selecting CSFs, consider the differences between outputs and outcomes. Outcomes are generally closer to the end results that are being measured, such as "increased customer loyalty." Outputs, on the other hand, are components of a value chain that integrate into subsequent activities, such as "100 percent on-time delivery." Appendix 3 contains a flowchart describing the relationship between inputs, processing systems, outputs, outcomes, and goals.

CSFs should consider the performance attributes that the organization's customers monitor. Customers often have clear and explicit requirements of their vendors. A survey or client advisory board can help determine the variables that other companies monitor.

Examples of typical critical success factors include:

— Management succession plan
— High customer satisfaction rating
— Timely accounts receivable collection
— Increased inventory turnover
— Debt to equity ratio under 2:1
— Increased revenue per salesperson

4.3 Developing a "Short List" of CSFs

An organization should work with a manageable number of CSFs (perhaps six to twelve). The CSFs need to be intuitively understood by the rank and file employees to gain acceptance, particularly if a factor is within an employee's sphere of influence.

Critical success factors should address both short- and long-term aspects of the organization. Selecting CSFs with a short-term focus will

enable the company to achieve some early gains in its reengineering process, thus sustaining the momentum and enthusiasm of the team. Restructuring some aspects of the organization will certainly encompass multiple years.

Attention should be focused on those factors that will most positively affect the organization's results. A long list of possible CSFs can be narrowed down by having the planning team members each rate the CSFs in order of their significance. A paired comparison exercise (deciding the most important of any two items) can quickly reduce a large number of CSFs to a manageable short list.

4.4 Relevance to Vision and Mission Statements

The critical success factors chosen by management should relate directly to the vision and mission statements. The CSFs should build on the strengths identified in the SWOT analysis, leveraging those strengths to take advantage of the competitive landscape. Where the SWOT analysis has identified weaknesses that could be exploited by competitors, a CSF should address this.

5. KEY PERFORMANCE INDICATORS

5.1 Quantifying Specific Changes in Performance

Specific changes in performance can be quantified through key performance indicators (KPIs). KPIs may be either financial or nonfinancial. KPIs must be easily understandable to inspire team members to work toward a specific target or attribute. KPIs should have little or no chance of producing an erroneous reading and should give the same reading consistently given the same operating conditions. The selected KPIs should be timely and frequently reported and be easily obtained from the reporting systems currently in place. Last, they should be measurable against a benchmark.

Following are examples of KPIs typically monitored in a professional services business:

- Work-in-process (WIP) aging
- Accounts receivable aging
- Write-offs as a percentage of WIP added

- Average hourly billing rate realized
- Actual versus budgeted charge hours by employee on a monthly basis
- Actual versus budgeted charge hours for the firm as a whole on a monthly basis
- Utilization ratio of hours billed divided by total available hours
- Average fees per client, actual versus budget
- Ratio of fees from top 20 percent of clients to total fees
- Fees from one-time engagements as a percentage of total fees collected
- Fees from each service area as a percentage of total fees and comparison to budget
- Ratio of fees billed to employee salary and benefits (individual and whole firm)
- Average annual fees from new clients
- Average annual fees from clients lost
- Ratio of fees won to fees lost
- Conversion ratio of new clients gained to proposals prepared
- New client referral sources

It is important to measure the activity that produces the result, not simply the result. While increased sales levels may be a result, the activity leading up to sales consists of number of contacts made with customers, rates of conversion of contacts into sales, frequency of sales with a particular customer, and the average dollar amount of each sale. Appendix 4 contains a sample work plan for establishing KPIs in a local public accounting firm.

5.2 Giving Feedback

Different people within an organization require different levels of feedback. The performance measurement reporting system design should give different user groups the information that is useful to their department. From inquiries of these users, an organization can determine if the KPIs will be used in decision making, compliance, work direction, process controls, or resource management.

5.3 Relating Key Performance Indicators to CSFs

Grouping CSFs into performance areas provides a balanced approach to performance measurement. Performance areas might include employee

satisfaction, supplier performance, operational performance, products and services, customer satisfaction, and financial performance.

Not all CSFs require immediate measurement because some will be integrated into meaningful measurements at a step later in the value chain. To simplify the information required, organizations should begin with narrow, company-specific measures to monitor intermediate steps in the value chain. As the organization gains experience in performance measurement, external measures can be added, such as monitoring the level of product endorsements or outside recognition.

5.4 Predictive and Leading Factors

Traditional accounting systems are rooted in historical information on where an organization has been. Nonfinancial factors can lead toward meaningful predictions of where a company's performance is headed in the foreseeable future. Nonfinancial factors that predict future profitability can include:

— Conversion rates of proposals into sales orders

— Market share and strength of market position

— Customer loyalty

— New product development

— Quality of management team

Focusing on leading indicators, rather than historical results, allows an organization to anticipate and correct negative results by observing its early warning signs. Leading indicators tell management what will happen downstream in the value creation process.

5.5 Benchmarking to Industry Measures

Benchmarking is the process of evaluating key performance indicators against an internal or external target. Industry-wide benchmarks give the organization an indication of how its efficiency and results compare to those of its competitors.

In many industries, data warehouses provide a pool of information shared by a group of companies. Within the pool, individual identification is lost, thus preserving confidentiality and anonymity. These targets allow an organization to set high performance targets, such as achieving performance in the top quartile of industry competitors. Industries that have many manufacturers of generic commodities, such as agricultural production, have led the way in establishing data pools for industry-wide benchmarking.

Industry trade associations often provide useful industry benchmarks. The Risk Management Association (RMA) publishes standards of financial performance compiled from statistically reliable samples of companies in the United States. Internet search engines can also be used to locate and access the wealth of information available online.

In certain circumstances, it may be more appropriate to use internal benchmarks because of the unique position of the company within its industry. However, internally set benchmarks might not stretch the company to achieve high standards of excellence. Many times, looking to another industry for relevant benchmarks is preferable to internal benchmarks.

5.6 Data Gathering and Reporting

The process of gathering data for performance measurement includes identifying the individual owners of the measures. Depending on the measurement factor, this could be an individual, team, or department. One should consider the desired frequency of measurement and develop templates for gathering and reporting that integrate with other measures.

Several software packages exist for performance measurement analysis. *CPA Views,* software developed by the American Institute of Certified Public Accountants in partnership with PerformanceSoft™, was designed specifically to help CPAs addresss management needs for establishing new standards, systematically measuring progress, and monitoring an organization's results compared with earlier performance.

It provides templates for planning input and outcomes. The software includes easy-to-understand measurement tools that can be customized precisely to an organization's needs. The software also features wizards and a graphic display package and allows users to drill down through the performance measurement system in progressive levels of detail. The software captures information at varying levels of detail for key functional or performance areas of the organization. More information is available at www.aicpa.org.

6. FINANCIAL RATIOS

Ratio analysis, in particular, may be undertaken to help a client evaluate past, current, and future performance. A ratio is by itself meaningless until it is compared to prior years, projections, and industry averages, as well as to other ratios. The benefit of ratio analysis is that it provides

a benchmark for measuring performance, targeting future goals, and helping identify potential problem areas.

The financial ratios presented in Appendix 5 may be useful in many different types of client engagements. Those ratios selected for presentation in this section represent only those commonly used in credit or comparative analysis. The term *comparative* is used to refer to the financial data of similar entities or to industry data. Such data may be obtained from a variety of sources. See the chapter "Business Valuation" for a comprehensive list of industry sources.

7. PERFORMANCE TARGETS

7.1 Range of Desired Outcomes

Most performance targets are best defined as a range, rather than a specific amount, for the desired outcome. In setting ranges for outcomes, use logical measures. An independently owned franchise should certainly set targets within the franchiser's requirements for continued product licensing. However, companies that have historically operated far below their peer groups should not set performance targets in the top quartile.

Time-sensitive measures will assist in driving improved value and performance where they anticipate and predict future outcomes. Measures should be linked to the organization's annual plan for planning and periodic review. Seasonal variances need to be considered so that ranges of acceptable outcomes are appropriate for that time of year. This is especially important where mid-year reviews are customary. Year-end reviews can be helpful in providing a springboard for the next year's annual planning activities.

Progress points need to be placed early enough to allow time to address substandard performance. For example, if high absenteeism leads to poor workmanship, high levels of rework, and poor billing realization, the time for measures must be early enough to build in response times. Measurements should be placed far enough apart to allow performance improvements to be apparent in the production process.

7.2 Selecting Achievable and Appropriate Targets

Organizations need to see early gains to maintain momentum and across-the-board acceptance of reengineering initiatives. If targets are

set too high, failure to achieve the initial targets can translate into resentment and resistance. On the other hand, targets set too low provide little motivation to improve performance areas. Rank and file employees should have a strong voice in selecting targets so they assume ownership and responsibility for achieving targets.

Moving in gradual steps away from the historical performance of the recent past lessens the likelihood of internal resistance resulting from early failures where targets are set too high.

7.3 Defining Performance Standards

As standards for performance are established, they need to be defined in terms that employees or vendors can easily understand. Each work group or team in the company should establish its own performance standards. Performance standards cover all aspects of a business, not just financial or production control.

For example, in customer relations the performance standards may address such things as:

— How will telephones be answered? Are calls screened? When can a customer expect a return phone call?

— How are customers greeted? What language is acceptable and how formally are customers addressed?

— How will customers be assisted? Will they be escorted to a requested area rather than pointing?

— How will complaints be handled? Do employees who receive complaints "own" them and are they responsible for the customer's satisfaction even if it is outside of their area?

Even such intangible areas as customer relations can establish performance measures to assess the effectiveness in carrying out the team's performance standards.

8. ACTION PLANS

8.1 Setting Accountability

Action plans ensure that priorities are set in every area of your business, from marketing and operations to management, personnel, and finance. They focus management's attention on the long-term objectives of the business rather than just the urgent day-to-day crises. The plan

defines the specific short-term objectives that will lead the business to that long-term future.

For each action, the plan should identify the:

- Activity
- Responsible party
- Key performance indicator
- Timetable
- Resources needed and budget

For an action plan to succeed, ultimate responsibility for each task should rest on just one person. While more than one person may actually complete a task, sharing the responsibility for its completion increases the likelihood of miscommunication and inaction. An effective rule of thumb is that if more than one person is responsible, no one is responsible.

8.2 Team-based Accountability

Team-based accountability is a powerful motivator in shaping behavior to achieve desired outcomes. Teams produce more predictable, consistent performance than individual workers because the team establishes the norms that all members are expected to attain.

8.3 Developing and Integrating Action Plans

Each work unit should be involved in developing its own action plans so members take ownership in achieving the goals of improving business performance. When each team has developed a draft action plan, the planning team should evaluate and compare the plans to ensure they are compatible and address the right performance measures. Systems need to be implemented to allow reporting of new measures and relationships as identified on the action plans.

8.4 Failure to Implement Action Plans

A common occurrence among small businesses is receiving an action plan from a business consultant as the result of an in-depth systems consulting engagement and then failing to implement the recommendations. The early excitement from the potential for change gives way to the day-to-day crises and emergencies. From the top down, employees put off the action plan and become consumed by the urgent yet unimportant matters of the day.

Appoint a champion within the organization whose task it is to ensure implementation of the plan. Accordingly, this needs to be a very disciplined person who is held in high respect by the employees. The champion needs to keep the pressure on the team to prevent people from reverting to their comfort zone of old methods. The champion should report directly to the CEO and should be the primary point person when important decisions need to be made. The champion should be a conduit for the flow of information among the various parties involved in the process.

9. MONITORING AND REPORTING SYSTEMS

9.1 Types of Reporting and Monitoring Systems

Reporting and monitoring systems must provide reliable information on a timely, consistent basis. For performance measurement, all who need it to do their jobs must be able to easily access the information. Without this feedback, the success of action plans cannot be evaluated and modified on a timely basis.

The most common reporting system may be computer spreadsheets or existing management software. Depending on the work group, however, the reporting system might be as simple as handwritten notes on whiteboards on the shop wall, or other signs posted in break rooms or elsewhere in the office. The information might also be communicated through e-mail, private Web pages, or company newsletters.

Information may also be obtained from performance measurement software applications. See section 5.6 for a discussion of the AICPA's *CPA Views* software.

9.2 System Security

As new information users access reports from the company's computer network, password protection is necessary to ensure the accessing rights to enter data, modify data, or read data are set based on each user's needs. Sensitive information should be security-controlled from a single point for the entire network. Some information may be accessible to the entire organization, while other data need high levels of security clearance. Unique login and password controls should be assigned to each user that accesses information within the network. User groups

might include system administrators, measure owners, owner assistants, data-entry users, commentary-entry users, or users with read-only access.

See the chapter "E-Business" for more information on information technology security systems.

9.3 Evaluation

As the performance measurement reporting system is implemented, the planning team will need to evaluate how well performance measures are actually modifying employee behavior and affecting the overall performance of the company. Planning teams should determine how often each measure is updated and reviewed and reassess the desired frequency of each.

The planning team should assess how well measurement-based decisions and action plans are communicated throughout the company. This may be seen in how the company allocates resources of working capital and labor, develops compensation plans, focuses on initiatives, and expands on existing action plans.

10. PERIODIC REALIGNMENT OF TARGETS

10.1 Structured Review Process

It is important to recognize that the planning team is not an ad hoc committee whose task is completed upon deployment of a performance measurement system. It should be a standing committee charged with ongoing evaluation. The planning team should, ideally, consist of individuals who understand the strategic direction of the company, are motivated for change, communicate effectively, and come from multiple disciplines within the company.

10.2 Periodic Evaluation

At least twice annually, the planning team should meet to discuss the success of implementing and sustaining the performance measurement process. More frequent meetings may be required where significant changes or rapid improvements have occurred.

The committee's ongoing purpose is to assess if the right things are being measured and whether the performance being measured is in alignment with the company's vision and mission statements. Basic

changes in the economy and marketplace may change the selected critical success factors. The committee should also evaluate if the targets or ranges are still reasonable or in need of redefinition. Appendix 6 contains a questionnaire to assist in evaluating and realigning targets and measures.

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APPENDIX 1: Client Readiness Questionnaire*

Have your client complete this questionnaire to assess its readiness to engage in a CPA Performance View initiative.

1. Are there organizational issues that keep you awake at night?
   _____Yes _____No
   What are some of these issues? _____
2. Does your organization need to become more competitive in the marketplace? _____Yes _____No
   In what ways are you not competitive? _____
3. Is your organization growing, and does it have a need for improved leadership and management effectiveness? _____Yes _____No
4. Does your organization have clearly stated goals and objectives? _____Yes _____No
5. Are people willing to change when new organizational strategies require it? _____Yes _____No
6. Do you have a regular process for planning on a periodic basis? _____Yes _____No
7. How often do you gauge yourselves against the plans you created? _____Daily _____Weekly _____Monthly
   _____Semi-Annually _____Annually _____Almost never
   _____Other, specify _____
8. Is there pressure on the organization to make more money?
   _____Yes _____No
9. Are shareholders unhappy with recent financial performance?
   _____Yes _____No
10. How serious is leadership about making changes?
    _____Very interested _____Interested
    _____Somewhat Interested _____Not interested
    _____Extremely interested
11. What type and level of leadership is leading this initiative?
    _____Type _____Level
12. Are there leaders within the organization that have participated in planning similar changes in the past? _____Yes _____No
13. Have previous efforts been made to adopt new procedures?
    _____Yes _____No
14. Where are the stress points in the organization? _____
15. Are there visible potential roadblocks for engaging in a change-oriented initiative? _____Yes _____No
    What are they? _____

*See *CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements*, by Stephen H. Coleman and Thomas G. Wagner (New York: AICPA, 2000). All rights reserved.

16. Will top leadership give visible, sustained support for the initiative? _____Yes _____No
17. Are there identifiable champions within the organization that will assist with implementation of CPA Performance View services? _____Yes _____No

APPENDIX 2: Checklist for Planning Documents and Existing or Prior Consulting Relationships*

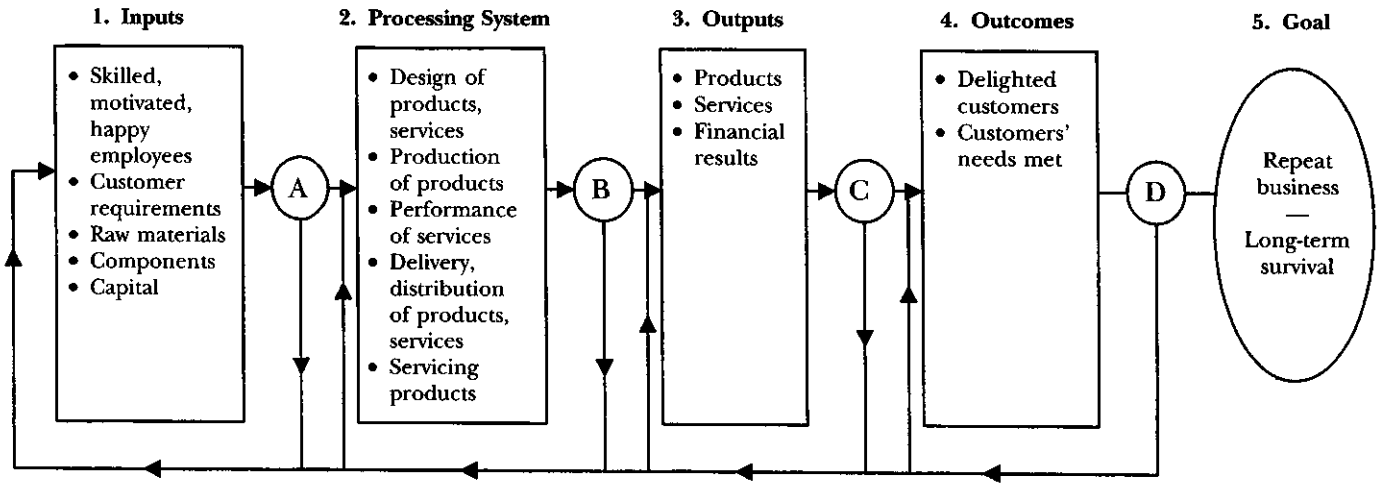
This checklist is not meant to be exhaustive. Use this checklist as a guide to obtaining and reading the pertinent prior performance and planning initiatives the organization has undertaken. This can also be used in engagements in which no prior planning has been done, as a guide for what types of statements and information will be useful to generate throughout the process.

Planning Documents

Mission statement	Yes ☐	No ☐
Vision statement	Yes ☐	No ☐
Written strategic plans	Yes ☐	No ☐
Audited financial statements with footnotes	Yes ☐	No ☐
Divisional financial statements	Yes ☐	No ☐
Ratio analysis or other financial analysis	Yes ☐	No ☐
Budgets or financial forecasts	Yes ☐	No ☐
Benchmarking activities	Yes ☐	No ☐
Organizational goals and objectives	Yes ☐	No ☐
Organizational chart	Yes ☐	No ☐
Business plans	Yes ☐	No ☐
Sales plans	Yes ☐	No ☐
Customer services questionnaires and results	Yes ☐	No ☐
Customer satisfaction surveys	Yes ☐	No ☐
Business growth plans	Yes ☐	No ☐
Facility expansion plans	Yes ☐	No ☐
Employee relations plans	Yes ☐	No ☐
Employee training and development plans	Yes ☐	No ☐
Capital budgeting and investment plans	Yes ☐	No ☐
Process-improvement plans	Yes ☐	No ☐
ISO 9000 plans	Yes ☐	No ☐
SPC reports	Yes ☐	No ☐
Continuous quality improvement reports	Yes ☐	No ☐
Minutes from the board of directors and committees meetings	Yes ☐	No ☐
Other:	Yes ☐	No ☐

*See *CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements*, by Stephen H. Coleman and Thomas G. Wagner (New York: AICPA, 2000). All rights reserved.

APPENDIX 3: Value Chain Illustration*



A Input Measures

1. Employee satisfaction
2. Supplier performance
3. Financial measures

B Process Measures

1. Processes, operational measures
2. Safety, environmental measures
3. Financial measures

C Output Measures

1. Product and service quality measures
2. Financial performance measures

D Output Measures

1. Customer satisfaction

*See *CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements,* by Stephen H. Coleman and Thomas G. Wagner (New York: AICPA, 2000). All rights reserved.

APPENDIX 4: Key Performance Indicator Work Plan

Function/Goal	*Key Performance Indicators*	*By Whom*	*Frequency*	*To Whom*	*Purpose*	*Corrective Action/ Enforcement*
1. The revenue cycle						
a. Creating work-in-process (WIP)	• Charge hours Compare actual hours charged to budget for each accountant (period and YTD)		Monthly	Accountants Managing partner	To ensure revenue projections are met	Performance review Compensation
	• Utilization rate Compare charge hours to available hours on summary basis (period and YTD over prior year)		Quarterly	Exceptions to managing partner	To measure staff productivity	Assess whether shortfall due to unproductive time Discuss with team
b. Turning WIP into AR	• WIP aging by primary and firm (current vs. prior year or target)		Monthly	Exceptions to managing partner	To measure timeliness of billing	Firm administrators meet with accountant
	• WIP over $400 and 90 days by primary accountant		Monthly	Managing partner	To ensure progress billing occurs	Supervisor discusses with accountant Supervisor bills for account

	• Realization % by accountant (YTD vs. target)	Monthly Semiannually	Administrator Managing partner	To evaluate billing rate and efficiency	Supervisor discusses Performance review Compensation
c. Collecting AR	• Average age of AR to prior year or target	Monthly	Administrator	To evaluate collection efforts	
	• AR over 90 days by client	Semiannually	Primary administrator Managing partner	To identify problem clients and develop workout	Suspend future work
2. *Financial statement*	• Review prior year budget to year-end financials	Annually	Managing partner	To target profitability	Explore negative variances
	• Cash, WIP, AR, LOC, receipts	Weekly	Managing partner	Flash report	Step up billing meetings
	• Accrual basis financial statement	Monthly	Board	To monitor profitability	
	• Compare period and YTD total revenue, expenses, and NI to budget	Monthly	Board	To monitor profitability	

Function/Goal	*Key Performance Indicators*	*By Whom*	*Frequency*	*To Whom*	*Purpose*	*Corrective Action/ Enforcement*
3. Client service	• Client fees divided by number of clients to determine amount of service provided to each client		Annually	Managing partner	To measure cross-selling of services	Increase marketing of services to existing clients
	• Clients won/lost CPA Software report of files opened and closed		Annually	Administrator Managing partner	To measure growth	Use in conjunction with average client fees to determine staffing
	• Total revenue and average rate billed for new service areas		Annually	Administrator Managing partner	Assess penetration of new client services	Marketing

Critical Success Factors					
1. Timely service	• % of tax returns completed within one month of interview by primary accountant	Annually	Administrator	To meet client expectations for timeliness	Meeting with accountants who have slowest turnaround
	• % of audits and reviews out within 75 days of year end	Annually	Managing partner	To meet client expectations for timeliness	Discuss exceptions with A&A manager
2. Substantive advice	• Random review of 5 TR memos per client for content	Annually	Feedback to each accountant	To provide added value	Additional training
3. Skilled personnel	• Review of CPE content and hours for each accountant	Annually	Administrator	To ensure staff has proper skill set	Performance evaluation and career counseling

APPENDIX 5: Financial Ratios

LIQUIDITY RATIOS

Ratio		*Formula*	*Interpretation*
Current Ratio	=	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Indicates the extent to which current assets cover current liabilities. Attention should be paid to trends.
Quick Ratio	=	$\frac{\text{Cash + Cash Equivalents + Net Receivables}}{\text{Current Liabilities}}$	A conservative view of creditors' protection, since inventory and prepaid items may not always be liquid. A company is usually in good liquid position when quick assets exceed current liabilities.
Working Capital	=	Current Assets – Current Liabilities	Working capital is a direct indicator of the company's ability to grow.
Inventory to Working Capital	=	$\frac{\text{Inventory}}{\text{Working Capital}}$	Indicates the percentage of working capital supporting inventory. A high percentage indicates operating problems.
Current Assets Turnover	=	$\frac{\text{Cost of Goods Sold + Operating Expenses + Tax – Noncash Expenses}}{\text{Current Assets}}$	Indicates the number of times current assets must turn over to cover expenditures. Measures control of current assets.
Inventory to Current Liabilities	=	$\frac{\text{Inventory}}{\text{Current Liabilities}}$	Shows the degree to which the company relies on inventory to meet its current obligations.

PROFITABILITY RATIOS

Ratio		*Formula*	*Interpretation*
Gross Profit Percentage	=	Gross Profit / Net Revenues	Reflects control over cost of sales and pricing policies. The ratio must be viewed in relation to the client's past performance and the industry average.
Operating Profit Percentages	=	Operating Profit / Net Revenues	Indicates the company's ability to control operating expenses. The ratio should be viewed in relation to increased sales and changes in gross profit.
Net Income Before Taxes Percentage (NIBT)	=	Income Before Taxes + Extraordinary Items / Net Revenues	Provides a more consistent basis for comparisons. It is also used in the calculation of other ratios.
Net Income After Taxes Percentage (NIAT)	=	Net Income After Taxes / Net Revenues	Reflects the tax effect on profitability and represents the profit per dollar of sales.
Return on Equity*	=	NIAT / Stockholders' Equity**	Measures the return to stockholders and represents their measure of profitability. When compared to the return on assets, this ratio indicates degree of financial leverage.
Return on Assets*	=	NIAT / Total Assets** or NIAT Percentage × Assets Turnover	Reflects the earning power and effective use of all the resources of the company.

*Can be calculated by using operating income, NIBT, or earnings before interest and taxes (EBIT).
**When material transactions affecting the balance have occurred, an average balance should be used in the calculations.

EFFICIENCY RATIOS

Ratio		*Formula*	*Interpretation*
Accounts Receivable Turnover	=	Credit Sales / Average Accounts Receivable	Indicates the number of times it takes receivables to turn into cash per year. Attention should be paid to credit terms, billing procedures, trends, and industry average.
Accounts Receivable Collection Period	=	360 or 365 Days / Accounts Receivable Turnover	Reflects average length of time from sale to cash collection.
Inventory Turnover	=	Cost of Goods Sold / Average Inventory	Indicates the number of times the business liquidates its inventory over a period and whether too little or too much inventory is carried.
Inventory—Days in Inventory	=	360 or 365 Days / Inventory Turnover	Reflects the number of days it takes to sell the inventory. Used in conjunction with accounts receivable collection period to determine operating cycle.
Operating Cycle	=	Accounts Receivable Collection Period + Days in Inventory	Indicates the length of time it takes to convert inventory to cash. If the cycle increases, more permanent working capital is needed.
Accounts Payable Turnover	=	(Cost of Goods Sold – Beginning Inventory) + Ending Inventory / Average Accounts Payable	Indicates the number of turns per period of time it takes for the company to pay its trade payable. Should be compared to credit terms.
Accounts Payable—Days Outstanding	=	360 or 365 Days / Accounts Payable Turnover	Same as above but expressed in number of days rather than number of turns.
Assets Turnover	=	Net Revenue / Total Assets*	Indicates the turnover rate of total assets to achieve net revenue. When viewed historically, ratio indicates the effectiveness of generating sales from assets expansion.
Net Revenue to Working Capital Turnover	=	Net Revenue / Working Capital	An indication of the amount of working capital required to support sales. An increasing ratio may, for example, indicate insufficient working capital to support sales growth.
Net Fixed Assets to Stockholders' Equity	=	Net Fixed Assets / Stockholders' Equity*	Indicates the proportion of stockholders' equity that is committed to fixed assets and is not available for operating funds. A low percentage would indicate a favorable liquid position.

EFFICIENCY RATIOS

Altman Z Score = The Altman Z Score, developed by Edward I. Altman, is a composite formula that is widely used to measure the financial "health" of a company. The formula takes financial ratios and multiplies each by a specific constant. The amounts so computed are added together to obtain an overall score. This score is then compared to scores from other companies to rate relative financial health. These scores could be helpful in evaluating a "going concern." The formulae are as follows:

For Corporations: (five variables)

$$\frac{\text{Working Capital}}{\text{Total Assets}} \times 012$$

$$\frac{\text{Retained Earnings}}{\text{Total Assets}} \times .014$$

$$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}} \times .033$$

$$\frac{\text{Market Value Equity}}{\text{Book Value of Total Liabilities}} \times .006$$

$$\frac{\text{Sales}}{\text{Total Assets}} \times .999$$

For Private Companies (five variables)

$$\frac{\text{Working Capital}}{\text{Total Assets}} \times .717$$

$$\frac{\text{Retained Earnings}}{\text{Total Assets}} \times 847$$

$$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}} \times 3\ 107$$

(*continued*)

*When material transactions affecting the balance have occurred, an average balance should be used in the calculations.

EFFICIENCY RATIOS (*continued*)

Ratio	*Formula*		*Interpretation*
	$\frac{\text{Net Worth (Book Value)}}{\text{Total Liabilities}}$	× .420	
	$\frac{\text{Sales}}{\text{Total Assets}}$	× .998	
For Private Companies: (four variables)	$\frac{\text{Working Capital}}{\text{Total Assets}}$	× 6.56	
	$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	× 3.26	
	$\frac{\text{Income Before Interest and Taxes}}{\text{Total Assets}}$	× 6.72	
	$\frac{\text{Net Worth}}{\text{Total Liabilities}}$	× 1.05	

Score	*Probability of Failure*
1.8 or less	Very high
1.81 to 2.7	High
2.8 to 2.9	Possible
3.0 or higher	Very low

CAPITAL STRUCTURE RATIOS

Ratio		*Formula*	*Interpretation*
debt to equity	=	$\frac{\text{total debt}}{\text{stockholders' equity*}}$	Indicates the relation of the owners' and creditors' positions. This ratio should be viewed in the light of industry averages.
current debt to equity	=	$\frac{\text{current liabilities}}{\text{equity}}$	Indicates the proportion of debt to total equity that is current in maturity. A high ratio may indicate the need to restructure debt.
operating fund to current portion of long-term debt	=	$\frac{\text{NIAT + noncash expenses}}{\text{current portion of long-term debt}}$	Shows the ability of the company to meet its current payments.
times interest earned	=	$\frac{\text{NIBT + interest}}{\text{interest}}$	Shows how well the company is able to cover interest from earnings. Measures the level of earnings decline to meet interest payments.
long-term debt to equity	=	$\frac{\text{long-term debt}}{\text{stockholders' equity*}}$	Measures the relationship of long-term debt to equity.

*When material transactions affecting the balance have occurred, an average balance should be used in the calculations.

APPENDIX 6: Realignment Questionnaire*

Before meeting with the client's performance measurement teams, the following questions and other possible questions should be reviewed to make the realignment process as effective as possible.

Questions

Have the strategic objectives and goals of the organization changed?	Yes ☐	No ☐
Are the mission and vision of the organization still relevant?	Yes ☐	No ☐
Are there new market factors that need to be taken into account when realigning measures, critical success factors or targets?	Yes ☐	No ☐
Do we experience new competition in our marketplace that needs to be addressed?	Yes ☐	No ☐
Do we have additional information or data available that was unavailable before?	Yes ☐	No ☐
How long has the performance measurement system been in place?	Yes ☐	No ☐
Has it been in place long enough to evaluate its effectiveness?	Yes ☐	No ☐
Are we measuring the right things?	Yes ☐	No ☐
Does the performance being measured line up with the organization's vision and mission?	Yes ☐	No ☐
Are the selected critical success factors still critical?	Yes ☐	No ☐
Are the targets or ranges reasonable?	Yes ☐	No ☐
Are the targets too easy and not stretch targets?	Yes ☐	No ☐
Do the targets need to be redefined?	Yes ☐	No ☐
Should anything else be changed?	Yes ☐	No ☐

*See *CPA Performance View Services: A Practitioner's Guide to Providing Performance Measurement Engagements*, by Stephen H. Coleman and Thomas G. Wagner (New York: AICPA, 2000). All rights reserved.

INDEX

All references in this index are to the chapter title and chapter section numbers. The following is a key to abbreviated references used in the index.

Chapter	Index Abbreviation
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Business Plans (Volume 2)	BP
Cash Management (Volume 2)	CM
Corporations	CORP
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IMPORTANT FILING NOTES

1. The **"Financial Mathematics"** chapter is deleted with this update. Please delete chapter pages 1 to 59 and the corresponding tab card with this update.

2. Insert NEW chapter tab card **"Business Performance Measures"** and NEW text pages 1 to 36 immediately following the "IRS Practice and Procedure" chapter.

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NOTE: Updated **Human Resources** Appendix material moved to the *Accountant's Business Manual Toolkit CD-ROM* with this supplement has not been revised in book.

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