

SPRING 2002

Quill

QUARTERLY NEWSLETTER

TABLE OF CONTENTS

Introducing RKO Business Valuation Services	1,2
IRS To Examine 50,000 Returns in Depth	2
Compensating for Fraud Risk in Government	2,3
Ratio Analysis	3
Welcome New Employees	3,4
Other Articles	4
RKO in the Community	4
Congratulations	4

Editor: Danielle Martin

Runyon
Kersteen
Ouellette

Certified Public Accountants
and Business Consultants

INTRODUCING RKO BUSINESS VALUATION SERVICES

By Heidi Walker, Senior Valuation Consultant

Let me start by saying that I am extremely happy to have joined the RKO team and I am excited about the opportunity to offer our clients in-house business valuation services. I believe that having business valuation expertise within the firm will allow us to better serve our clients as they make various financial and strategic decisions.



A question I am often asked goes something like this, "what is a business valuation, who might need one, and why?" A business valuation is simply an opinion or an estimate of the value of an interest in a business entity. The opinion or estimate is most often provided either in the form of a letter report, typically used for internal purposes such as to assist management with strategic decisions, or a more in-depth report, primarily used to support estate and gift tax returns. The in-depth report contains all of the information and analysis required by the Internal Revenue Service in order to start the three-year statute of limitations on estate and gift tax returns.

Business valuation services provide opportunities for both corporate and individual clients. Perhaps the most common tax purpose for a business valuation is to determine the value of a business interest for estate and/or gift tax purposes. Valuation for estate tax purposes is critical because the estate tax value determines the liability for federal and state estate taxes. In addition, the value of the business as determined for the estate also determines the tax basis of the business interest for the beneficiaries of the estate, since the beneficiaries, under current law, receive a stepped-up basis equal to the business fair market value on the date of valuation. Through the use of various discounts within the valuation, estate tax can often be diminished or avoided. Further, accuracy in determining the tax basis of the business interest passed to beneficiaries may help to avoid unnecessary capital gains tax when that interest is sold or disposed of in the future. Perhaps the most advantageous use of valuations in the estate tax scenario is in conjunction with estate and/or retirement planning. Knowledge of the value of a business interest that is likely to become part of an estate, or that is a significant portion of the interest owners' retirement assets, is critical to proper planning.



Another area where valuation services can be very beneficial is in the use of Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs) as estate planning vehicles. For example, in the case of an individual who owns commercial real estate, a transfer tax would typically be incurred on the fair market value of the real estate transferred to his or her successors. An alternative to transferring the entire property outright would be to contribute the property to an FLP and then transfer successive, annual, non-controlling interests in the Partnership to the successors. In this way, the value that is transferred is not the value of the commercial real estate, but the value of a non-controlling interest in a partnership that owns commercial real estate. By its nature, this non-controlling interest is worth much less than its pro-rated portion of the fair market value of the underlying property, thus lessening the amount of transfer tax incurred.

Companies considering a conversion to S corporation status should also obtain a valuation in order to identify the amount of unrealized built-in gains. Built-in gains are the difference between the tax basis and the fair market value of the assets of the S corporation as of the beginning of the first tax year the S election is in effect. For this purpose, built-in gains include

tangible as well as intangible assets, such as goodwill or going-concern value. Built-in gains are subject to a corporate-level tax upon the disposition of the assets, or the entire business, within ten years after the date of the S election. A proper valuation will ensure that only the gain on the date of the election, and not future appreciation in value, is subject to this tax.

Valuations are also an important consideration when drafting a buy-sell agreement. One of the key ingredients in the agreement will be providing a definition and means to arrive at a value for the business. This value will be used in the event of death, disability, retirement, or dispute, so it is important that all of the parties agree up front. RKO professionals are happy to work with a client's attorney to ensure the agreement contains the appropriate value for the business, including important provisions for how discounts are to be handled.



Thinking about selling your business? To ensure your business will be a desirable target for acquisition at the time you wish to sell, you should begin preparing well in advance. Having a solid plan ensures that you can move forward strategically to create maximum value. An initial valuation by a trained professional can prove worthwhile and should be updated to show progress to your ultimate goal.

Other areas in which a valuation can be critical are discounting undivided interests in real property, divorce, dissenting stockholder actions, corporate or partnership dissolution, breach of contract, antitrust, and other damage cases, bankruptcy reorganizations, employee stock ownership plans, incentive stock options, and ad valorem (property) tax issues.

If you identify an area in which you may need valuation assistance, please contact your RKO advisor.

IRS TO EXAMINE 50,000 RETURNS IN DEPTH

After watching its audit rate drop steadily in recent years, the IRS has decided to change its approach. Using a new sampling technique, the IRS will begin a new project for targeted taxpayers. Involving 50,000 individual taxpayers, this will be a semi-random check of the 130 million returns filed annually. The name the IRS assigned to this project is an interesting choice - the National Research Program! Of the returns selected, about 2,000 will be targeted for line-by-line audits under which every exemption, deduction and income item is scrutinized. Other audits will purportedly be less intrusive.

It is no wonder the IRS needs to perform such audits. A recent survey revealed that the number



of Americans who find cheating on their returns unacceptable has declined from 87% in 1999 to 76% in 2001.

Another tidbit-of the 618,000 audits of individuals in 2000, 25% resulted in no changes.

If you are ever selected for an IRS audit make sure you contact us before responding to, or meeting with the IRS.

COMPENSATING FOR FRAUD RISK IN GOVERNMENT

By Kathy Tyson,
Principal



In a prior "Quill", we looked at some of the causes for and types of fraud. When fraud is uncovered in a local

government, it is not only the financial losses that are cause for concern. The bad publicity and mistrust that results can affect the government for years to come.

Local governments in Maine primarily have a small finance and accounting staff with sometimes one person handling all functions. Governments experience frequent cash collections, the employees handling this cash may be paid low wages, and collection of cash is sometimes made from a variety of locations. Also, since unlike a business enterprise there is no "profit motive" in a governmental environment, follow up on unexpected shortfalls may go unnoticed for periods of time. Pressure during the budget process to limit the cost of added personnel can result in overburdened personnel, employees who are inadequately trained, and improper segregation of duties. With all these risks facing the local



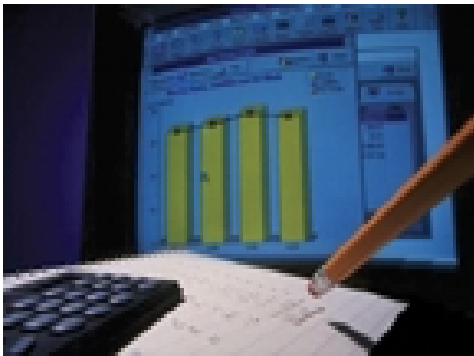
government, what can be done to reduce the risk of fraud from occurring?

For the smaller government, where proper segregation of duties is next to impossible, the importance of effective oversight and review is critical. Your outside auditor visits only once during the course of the year, and does not design her audit to detect all instances of fraud. Oversight and review must occur on an ongoing basis, within the government. In the small government with no professional administration, the burden for oversight and review falls clearly on the elected officials. Since elected officials often come from non-financial backgrounds and need to spend a great deal of time on other governing matters, it is important to have a process in place that is simple to follow and perform.

We recommend that in addition to the development of policies and procedures, a checklist be developed that can be used on a regular, periodic basis. The items on the

checklist will vary from community to community depending on exactly where weaknesses have been identified that increase the risk of fraud. We would be happy to assist you in the process of risk assessment.

One item common to any checklist however, would be a periodic, in-depth review of bank statements and related reconciliations. Perhaps once or twice each year on a surprise basis an oversight official could request the bank statement be sent directly to him or her from the bank. The statement should be reviewed for any unusual checks clearing, checks with stale dates and any checks which were prepared manually rather than using the normal computer system process. A sample of checks can be selected and tied back to the warrant to ensure the vendor, dates and amounts are in agreement. Substantiation of non-payroll checks made out to Town employees can be



reviewed. Deposits on the bank statement should be reviewed for timeliness (it is good practice to make deposits daily, or at least on some regular agreed upon basis). Substantiation of a sample of deposits can be obtained and reviewed. Any other transactions on the statement could be questioned for reasonableness (for example, transfers to other accounts). This process should not take more than 2-3 hours and is a very effective compensating control for lack of segregation of duties in the areas of cash receipts and disbursements.

Finally, the statement should be returned to the accounting staff for reconciliation, after which, a review of the reconciliation can be made. When reviewing bank reconciliations, the focus should be on the reconciling items listed as well as whether the balance actually ties to the Town's general ledger cash balance as of the reconciliation date.

At first these procedures may seem

overwhelming to an elected official, however, the benefits of these compensating controls truly makes the effort worthwhile.

RATIO ANALYSIS:

What is it? Why Should you Care?

By Joanne Dionne, In-charge Accountant

Simply put - ratio analysis is used to quantify relationships between account balances. It is a powerful tool, which allows managers to track trends within an organization. Comparing an organization's financial ratios to industry benchmarks can provide managers with valuable insight into their own financial health. Lenders, investors, and other third parties also use financial ratios to determine if an organization is financially sound. Their assessment can directly impact things such as an organization's ability to acquire credit.



Some basic financial ratios include Liquidity Ratios, Activity Ratios, Debt Ratios, Profitability Ratios, and Investor Ratios. A detailed treatment of financial ratios and their many variations is beyond the scope of this short article. However, the standard formulas can be easily found in accounting texts or on the Internet. To find resources on the Internet, simply go to a search engine such as Google.com and search on keywords "financial ratio analysis".

Following are some of the more common ratios: Liquidity Ratios show an organization's ability to meet its short-term obligations with its current assets.

Activity Ratios take several forms. The more common ones include:

- Accounts receivable turnover - provides an indication of the success of an organization in collecting its receivables and the number of days required collecting them.
- Inventory turnover - provides an indication of how quickly inventory is sold and the number of days required selling it.
- Operating cycles - indicates the number of

days between acquiring inventory and the realization of cash from the sale of that inventory.



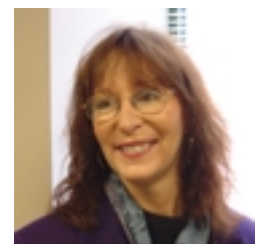
- Debt Ratios - indicate the percentage of assets financed by debt and the ability of an organization to cover its total debt with its operating cash flow.

There are many variations of these ratios and applications of them. The intent of this article is to raise awareness of some of the simple tools that are available to managers that will provide valuable insight into their businesses from various important perspectives. The insight provided by financial ratio analysis will provide valuable input into an organization's management processes. If you are interested in learning more about financial ratio analysis and how it can benefit your organization, a representative from RKO would be happy to assist you. Ask if our Business Performance Review is right for you!

WELCOME NEW EMPLOYEES

As previously publicized, RKO has acquired the tax, consulting, and business valuation services of Cloudhawk. In addition, we are please to announce that the following employees have joined our firm:

Almalee Foote, CPA - Almalee Foote joins RKO as a Supervisor in the Non-Profit Division specializing in auditing, accounting, and management consulting. Ms. Foote is a member of the AICPA, the Maine Society of CPAs, and member/former Executive Board member of the Augusta Business and Professional Women's Organization. Ms. Foote holds an Associates degree from Thomas College and a Bachelors degree in Accounting from the University of



Maine - Augusta. Ms. Foote has counseled associations, labor unions, and non-profit organizations that receive federal and/or state funding which require audits. Ms. Foote has extensive experience with non-profit, tax, and government clients. Ms. Foote is also currently Vice President of Public Relations of the Kennebec Valley Toastmasters and also serves on the Kennebec Valley Chamber Business to Business Committee. Ms. Foote is a former member of the Board of Governors of the Maine Society of Certified Public Accountants and the Board of Directors of the Kennebec Valley Humane Society.

Robert Neal, Jr. - Robert Neal, Jr. joins RKO as a Senior Accountant in the Commercial Department specializing in small and large business audits and consulting. Previously serving as Controller of Criterium Engineers, Mr. Neal's experience includes manufacturing and service related industries. Previously employed with a local accounting firm, Alternative Energy Inc. and the Charleston Correctional Facility, Mr. Neal has an extremely well-rounded career. A graduate of Husson College with degree in public accounting, he

previously obtained an Associate in Science degree from the University of Maine.

OTHER ARTICLES

Don't forget to view other articles located in the EQUILL section of our Web Site at www.rko-cpas.com. Articles are updated regularly. March 2002 articles included:
Tax and Financial News [Highlights of 2002 Tax Law Changes.](#)
General Business News [Whose Fault is it Anyway?](#)
Stock Market News [Explaining the Indexes.](#)
Financial Planning [Identity Theft-Is It really That Bad?](#)
What's New in Technology [Test your IQ.](#)
Year End Tax Planning [2002 Income Tax Planning after Tax Reform.](#)

RKO IN THE COMMUNITY

Richard Morin - Dick is active in many different community organizations. Since 1983 Dick has been a Director of the KV Federal

Credit Union. He has served as both the Chairman and the Vice Chairman of the Board and while serving as the Chairman he was instrumental in overseeing the construction of their new building. Last year Dick was also appointed by the Mayor of Augusta to serve on the Cony High School Building Committee. Cony High School is one of the 103 applicants for public funding of a new facility and if chosen next April this committee will be in charge of the construction and planning. Besides all of this, Dick finds time to act as the Treasurer of the Calumet Education Foundation, providing post secondary scholarships and grants to local students. He also serve as a lecturer for St. Augustine Church and as a member of LeClub Calumet and the Augusta Elks Club.



CONGRATULATIONS to Mary and Kent Cyr, proud parents of Franklin Patrick Cyr, born on January 17, 2002.

Runyon
Kersteen
Ouellette

Certified Public Accountants and Business Consultants

SOUTH PORTLAND
20 Long Creek Drive
South Portland, Maine 04106
(207) 773-2986
(800) 486-1784

AUGUSTA
189 Water Street
Augusta, Maine 04330
(207) 623-8401
(800) 639-2150

WATERVILLE
30 Elm Street
Waterville, Maine 04901
(207) 877-9397
(800) 639-2160

Bulk Rate
U.S. Postage
PAID
Permit No. 449
Portland, ME
04101