Shannon & Associates LLP
Certified Public Accountants
Management Consultants

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COMMITTED TO YOUR SUCCESS

Summer 2012

ARE YOUR SYSTEMS AND PROCEDURES PROTECTING YOU FROM FRAUD?

According to the 2012 Association of Certified Fraud Examiners Report to the Nations on Occupational Fraud and Abuse a typical organization loses 5% of its revenues to fraud each year. This number continues to blow my mind as I put it in perspective and consider the impact this can have on each individual business. The research also continues to show that small businesses with fewer than 100 employees are particularly vulnerable to fraud. Smaller organizations typically have fewer resources than their larger counterparts, which often translates

to fewer and less effective anti-fraud controls. In addition, because they have fewer resources, the losses experienced by small businesses tend to have a greater impact than they would in larger organizations. The 2012 Fraud Report to the Nation also states that over 50% of the frauds observed in their study were committed as a result of lack of internal controls or an override of existing internal controls.

What is internal control?

What are we talking about when we say "internal control" or "control"? The definition of internal control is: Systematic measures (such as reviews, checks and balances, methods and procedures) instituted by an organization to

- conduct its business in an orderly and efficient manner,
- safeguard its assets and resources,
- deter and detect errors, fraud, and theft,
- ensure accuracy and completeness of its accounting data,
- produce reliable and timely financial and management information, and
- ensure adherence to its policies and plans.

So let's face it, we don't all have the resources of Microsoft or Boeing to implement textbook level internal controls where there is immaculate segregation of duties in every department that helps to prevent and detect fraudulent transactions. Small businesses tend to place a lot of trust and responsibility with one or two key people, and this does not have to be a negative thing. In fact, it is very critical in the operation of your business to achieve maximum efficiency. However, designing adequate oversight and controls over key areas is important and can help prevent but also detect fraud and can actually help improve efficiency.

We can help

Shannon & Associates, LLP has been involved in the review and design of internal controls for many businesses. Business owners are prompted to take a look at these controls for various reasons; sometimes that reason is a fraud has taken place and management wants to implement controls that can help prevent it from happening again, other times management is being diligent and proactive and want to help protect their business from the "not if but when" scenario that faces most small business. Improving the efficiency of various departments is also another reason businesses may want to participate in a process review or internal control review. The result is not only increased efficiency by employees, but also a stronger system of internal controls.

Having an internal control review of your business is a cost effective, painless and sometimes even fun process. These reviews can be highly customized to fit your businesses wants and needs; this includes the scope, timing and delivery of our observations. Typically an assessment which consists of asking questions and walking through the daily operations of your business is

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Let us help with your ERP software and IT needs!

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Reviewing your internal processes and controls for efficiency as well as fraud prevention practices

Shannon & Associates is proud to be an independent member of Nexia International, a worldwide network of independent auditors, business advisers and consultants. Nexia International is the 10th largest network of accounting firms in the world, with member firms in over 100 countries. This global representation with Nexia enables us to offer our expertise in international taxes and accounting around the world and provide top quality service to our clients with foreign and domestic financial needs.

MIDDLE CLASS TAX RELIEF AND JOB CREATION ACT OF 2012

The Middle Class Tax Relief and Job Creation Act of 2012 (the “Act”) was signed into law on February 22, 2012. The legislation extends, through the end of 2012, the two percentage point payroll tax cut for employees and self-employed individuals that had been in place for 2011 and the first two months of 2012.

Background

As part of an economic stimulus law, the Social Security payroll tax for 2011 was reduced by two percentage points, from 6.2% to 4.2%. A similar reduction was applied to the self-employment tax for self-employed individuals. At the end of last year, those payroll and self-employment tax cuts were extended for two months, through February 2012.

Payroll tax cut extended through 2012

For the balance of 2012 only, employees will continue to pay a 4.2% Social Security tax rate on wages up to $110,100 (the 2012 Social Security Wage Base). Similarly, the Act reduces the tax rate for the Social Security portion of self-employment tax on self-employment net earnings up to $110,100.

Therefore, the maximum savings for employees and self-employed individuals in 2012 will be $2,202 (i.e., 2% of $110,100). For spouses who both earn at least as much as the Social Security Wage Base in 2012, the maximum savings will be $4,404.

Note that employers continue to pay the full employer portion of Social Security taxes for their employees.

Call us

We can help you determine how the extension affects you or your business. Contact us today.

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completed in order to obtain a detailed understanding of the current environment. Secondly, observations and recommendations are gathered which are communicated and discussed during our initial assessment as well as formally to management. One of the primary concerns I hear from business owners prior to the engagement is that they don't have the resources to hire more employees to create ideal internal controls or they can't implement controls because it affects efficiencies. However, most of the time recommendations can be implemented that work with the resources currently in your business to make slight changes that do not have a negative impact on any one person's role or responsibility but at the same time add a very strong level of control to the operations of the business.

A recent testimonial given by a client in response to their internal control and process review highlights the steps taken as well as the results they experienced as a result of engaging in this review:

Recently, we asked Shannon & Associates to perform a review of our Bookkeeping procedures at Protective Coatings, Inc. Jessica Kinney was assigned to lead the review. From start to finish she was professional and provided us exactly what we were looking for. Jessica spent time with several departments while on site and took a tour of our facility. She was genuinely interested in learning not only our financial process, but our production process as well. All during the visit Jessica let me know her suggestions in areas that needed attention as she came upon them. She explained things in a manner that was easily understood, and gave simple suggestions as to how to implement her ideas. After her visit to our facility, she drafted a letter to explain what she had observed. She included both ideas for change and positive feedback. She asked if we had any ideas to add and if we felt comfortable with the results. She then came to meet with myself and the President of our company to close the review. We have put her suggestions into place, and can already see the difference they have made. The experience was educational, beneficial, and enjoyable. – Becki Holberg – Protective Coatings, Inc

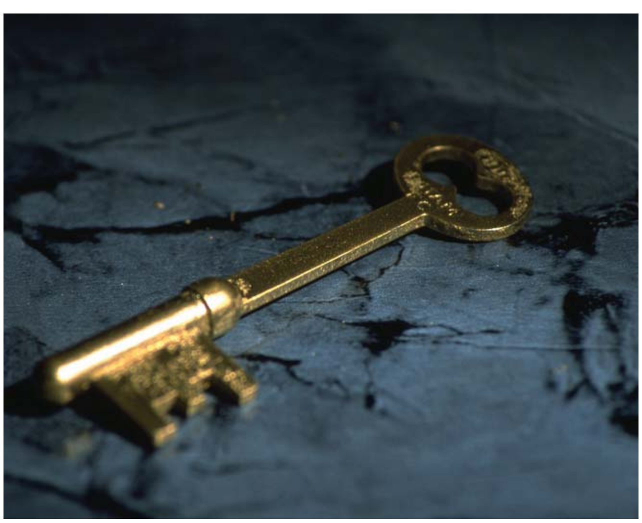
If you are interested in further information or exploring the benefits of obtaining an internal control review please contact Jessica Kinney at jkinney@shannon-cpas.com .

FINANCIAL ANALYSIS IS IMPORTANT TO YOUR BUSINESS

Many business owners and company managers have found that insight gained from their examination of company financial statements can be invaluable. Such insight can help businesses improve their profitability, cash flow, and value.

Ratio analysis is a key metric

One important tool that can help sort out the data you need is "ratio analysis." Ratio analysis looks at the relationships between key numbers on a company's financial statements. After the ratios are calculated, they can be compared to industry standards — and the company's past results, projections, and goals — to highlight trends and identify strengths and weaknesses. The bottom line is that ratio analysis can give you valuable feedback which, in turn, may yield profitable results for your business.



Higher sales may equal higher profits

Recent increases in a company's sales figures may be impressive when viewed in isolation. However, business owners must take measures to ensure that the additional revenues are being translated into greater profits. Net profit margin measures the proportion of each sales dollar that represents a profit, after taking into account all expenses. So, if a company's margins aren't keeping pace during sales growth periods, a thorough review of overhead and other expenses may be in order.

Focus on accounts receivable

Commonly, companies extend credit to their customers. As a result, a firm needs to keep a close watch on outstanding accounts so that slow payers can be contacted about past due amounts. From a broader view, knowing the company's average collection period would be insightful. In general, the faster a company can collect money from its customers, the better its cash flow will be. However, management should also be aware that, if credit and collection policies are too restrictive, potential customers may decide to take their business elsewhere.

Efficiently manage inventory

Inventory turnover measures the speed at which inventories are sold. A slow turnover ratio relative to industry standards may indicate that stock levels are excessive. The excess money tied up in inventories could be used for other purposes. Or it could be that inventories simply aren't moving, and that could also lead to cash flow issues. In contrast, a high turnover ratio is usually a good sign unless inventory levels aren't sufficient to fulfill customer orders in a timely manner.

Look to us

We can help you calculate and review the financial analysis ratios that are meaningful to your business. Contact our firm today for more details.

BUSINESS OWNERS MAY DEFER TAX ON AN EMPLOYEE STOCK OWNERSHIP PLAN SALE

Many owners of small companies plan to sell at some point, perhaps to finance their retirement. If you are in that situation, you may have a very low cost basis in the company's shares. On a sale, you could owe a substantial amount of income tax, especially if tax rates on long-term capital gains have increased by the time you sell.

You can prepare now for a huge future tax break. To do so, plan on selling your shares to an employee stock ownership plan (ESOP). An ESOP is a qualified retirement plan with the tax advantages you'd expect, such as tax deductions for contributions. ESOPs also provide employee motivation and a market for the shares you own.

Happy ending

Yet another ESOP advantage can be found in Section 1042 of the tax code. Under this section, you may defer the tax on the capital gain you report from selling your company's stock to an ESOP. To qualify, you must meet several criteria, such as the following:

• The ESOP must own at least 30% of the total value of your company's outstanding stock (other than certain preferred stock) or at least 30% of each class of your company's outstanding stock (other than certain preferred stock). This must be true immediately after you sell your shares.

• You must have owned your company shares for at least three years before the sale.

• Your company must be a C corporation.

• If the company's stock is not readily tradable on an established securities market, you must have a qualified appraisal that supports the selling price.

• You must reinvest the sales price in qualified replacement property (QRP) during a replacement period that begins three months before the sale of company stocks and ends 12 months after the sale.

Generally, QRP includes securities issued by domestic corporations. Such corporations must be active businesses, which, for these purposes, means that no more than 25% of the corporations' gross receipts were passive investment income for the year preceding the year the securities were purchased.

Example 1: Bart Rogers, age 65, is the sole owner of his small business, which he started 30 years ago. Bart sells his company to an ESOP and nets a $2 million long-term capital gain. Assuming a 15% tax rate, Bart would owe $300,000 to the IRS.

However, Bart reinvests all of the sales proceeds in a portfolio of domestic stocks and bonds that are QRP. He owes no immediate income tax from the sale, thanks to the Section 1042 tax deferral. Bart receives the income from, and participates in any appreciation of, the $2 million worth of securities.

Noteworthy

In the previous scenario, the tax deferral will go on as long as Bart holds onto his QRP. But what happens if Bart invests in a bank stock for its high dividend and then decides to sell after the bank reports a loss? What happens if Bart invests in a corporate bond that's redeemed in a few years?

In such cases, Bart no longer owns the QRP. Under Section 1042, if Bart relinquishes the QRP, in whole or in part, he'll recognize the gain that he deferred due to his purchase of the QRP and owe tax on it. Suppose Bart invests 25% of the sales proceeds in Big Bank Co. stock. He'll owe tax on 25% of the deferred gain if he sells his Big Bank Co. shares.

If you want to extend the tax deferral as long as possible, you can put the sales proceeds into so-called "ESOP notes." These are floating-rate notes issued by highly-rated corporations. The terms on these notes vary, but for example, they might have a 40-year maturity, with 30 years until first call. (A call gives the issuer the right to redeem the note prematurely.)

ESOP notes usually pay interest equivalent to the yields on short-term securities. Thus, yields are scant now. However, the banks and brokerage firms selling these notes may offer to let you borrow 80% or 90% of the face value of your ESOP notes, so you can reinvest elsewhere.

Example 2: Bart Rogers clears $2 million from the sale of his company and defers the tax on the gain by investing $2 million in an ESOP note. He then borrows $1.8 million, using the ESOP note to secure the loan. Bart invests that $1.8 million in a diversified portfolio of stocks and bonds.

In this example, Bart still owns the ESOP note, which is the QRP. Consequently, he maintains his tax deferral. Meanwhile, Bart can trade or redeem the stocks and bonds he has purchased with the borrowed funds without triggering the deferred income tax. If Bart wishes, he can use some of the borrowed money for personal expenses. The net cost of the ESOP note may be modest, compared with the value of the tax deferral.

If Bart dies while still holding the long-term ESOP note, his heirs will inherit it. Assuming that current tax law still applies at that time, the heirs will get a basis step-up; therefore, no one will ever owe capital gains tax on the sale of Bart's company. Our office can help you decide if an ESOP can fit into your succession plan for your business.

KEEP TRACK OF NONCASH CONTRIBUTIONS

Throughout the year, you probably make multiple donations of items other than cash. You might give used furniture to Goodwill, for example, or donate a pre-flat screen TV to a homeless shelter. Such contributions may cut your tax bill if you itemize deductions on your tax return, but you need to proceed carefully.

Most important, you should get a receipt for all noncash contributions. The receipt will show that you actually gave books, clothing, furniture, or any other item to a specific charity on a given date.

Valuing your deduction can be tricky. The tax law says that you are entitled to a deduction for the fair market value of each item. But what is the fair market value of a used computer or an old lamp?

Setting the price

In some cases, the fair market value is simple to determine.

Example 1: Jill Warner buys flowers every week and has them delivered to her church for display. Jill receives no reimbursement and does not take the flowers home after the services. Jill can deduct the amounts she spends on the flowers, which is the fair market value.

At Christmas, Jill spends $200 on toys and donates them, still in their boxes, to a charity that distributes the toys to needy children. Again, the price that Jill paid for the toys is the fair market value because they were unused and donated immediately. She can deduct the $200 she spent.

Donations of used goods, though, generally are more difficult to value. One approach is to check websites, such as the Salvation Army's, which provides a valuation guide at www.satruck.org/donation-value-guide.

For example, a working color TV might be valued anywhere from $75 to $225, according to the Salvation Army's guide. The value of a man's raincoat on this list might be between $5 and $20. (A Salvation Army receipt will have a more extensive valuation guide on the back, listing items ranging from adding machines to wigs.)

You also might value used items by going to online sites such as eBay and Craigslist to see what used items sell for. Alternatively, you can price goods at a thrift shop. In any case, you should record your efforts to find the fair market value of the items you donate, in case your deductions are questioned.

Under the tax code, you generally can't deduct donations of used household goods or clothing unless the items are in "good used condition or better." The IRS doesn't define that term precisely, but it probably means that an item can be used as-is by a recipient; junk or trash won't qualify. You might want to take photos of items you donate to show their condition.

Going private

In recent years, many charities have solicited auto donations. Often, they implied that any car would be accepted and that donors would enjoy better financial results, after tax, than they'd realize from a sale or trade-in.

The IRS responded to such practices by issuing reminders and warnings about vehicle donations. IRS Publication 561, "Determining the Value of Donated Property," includes a section specifically devoted to donations of cars, boats, and aircraft. It says that the fair market value of a donated vehicle is the price listed in a used vehicle pricing guide for a private party sale, not the dealer's retail price. What's more, that price is valid only if the guide lists a private sales price for a vehicle that is the same make, model, and year and sold in the same area - in the same condition - and with similar options, accessories, and warranties as the donated vehicle.

Example 2: Luke Barnes donates a car in poor condition to charity. A used car guide lists the dealer retail value for a similar car in poor condition at $1,500. However, the guide also shows the price for a private party sale of the car at $700. Luke can take a $700 tax deduction for donating the car.

THANK YOU FOR YOUR REFERRALS!!

We appreciate the confidence you have in our services to refer to us other individuals and businesses.

THE GIFT TAX STILL MATTERS

The Internal Revenue Code includes a gift tax. One of the reasons for having a gift tax is to prevent people from avoiding the estate tax by making gifts during their lifetime to reduce the size of their taxable estate. There is a unified lifetime exclusion amount for the gift and estate taxes ($5.12 million in 2012). Because the exclusion is unified, the amount of the exclusion used to prevent taxation on lifetime gifts reduces the amount of the exclusion that can be used to reduce the estate tax.

Additionally, there is an annual gift tax exclusion, which is currently $13,000 per recipient. If an individual makes gifts equal to or less than the annual exclusion amount to a recipient, the individual's lifetime exclusion is not reduced.

Example: Bonnie Dawson, an elderly widow with a net worth of over $8 million, gives $4 million to Richard Dawson, her only child, in 2012. Say that Bonnie dies in 2016 with a $4 million estate. If the federal estate tax exclusion in 2016 is $5.12 million, as it is in 2012, Bonnie's estate will be under the threshold and, thus, owe no federal estate tax.

That is, Bonnie's estate would owe no estate tax if not for the federal gift tax. After the annual $13,000 exclusion, Bonnie's $4 million gift to Richard results in a taxable gift of $3,987,000. In 2012, the lifetime gift tax exclusion is also $5.12 million. Assuming Bonnie had not made any taxable gifts in the past, she will not have to pay gift tax, but her $3,987,000 taxable gift in 2012 will reduce her gift and federal estate tax exclusion by that amount. Consequently, Bonnie has only a $1,133,000 estate tax exclusion remaining. If Bonnie dies with a $4 million estate when she has a $1,133,000 exclusion remaining (this assumes no increase in the exclusion amount before her death), her estate will be nearly $3 million over the limit. The federal estate tax bill could top $1 million.

Uncertain future

As mentioned, the federal estate tax exclusion is now $5.12 million. Under current law, married couples effectively have a $10.24 million estate tax exclusion, no matter which spouse dies first. Therefore, many people believe they will not owe any estate tax. If estate tax isn't a threat, why pay attention to the gift tax?

There may still be reasons to plan around the gift tax. For one, there is no guarantee that the current federal estate tax exclusion amount will remain in place. If no legislation is passed between now and year-end 2012, the gift and estate tax exclusion will drop from $5.12 million in 2012 to $1 million in 2013. Even if that drop is averted by legislation this year, the exclusion amount could be reset below $5.12 million, perhaps to $3 million or $3.5 million. (President Obama has proposed setting the estate tax exclusion amount at $3.5 million in 2013.) The lower the estate tax exclusion, the more estates will be subject to estate tax, and the more families that could benefit from gift tax planning.

Another reason to plan for the gift tax is that the numbers mentioned previously relate to federal estate tax. Many states have their own estate tax, with exclusions much lower than $5.12 million. If you leave an estate worth, say, $2 million or $3 million, your heirs might owe hundreds of thousands of dollars in state estate tax. Depending on where you live, knowing how the gift tax works can lead to strategies that will reduce state estate tax.

Yet, one more reason to keep the gift tax in mind is the requirement to file a gift tax return. In general, an individual must file a gift tax return if he or she gives gifts in excess of the exclusion amount to a donee. Although the lifetime gift tax exemption is ample, at $5.12 million, the 2012 annual gift tax exclusion is modest, at $13,000. If you make a gift contribution of $15,000 to your child's 529 college savings plan in 2012, you'll be over the filing threshold. In that case, you'll have to file a gift tax return.

To avoid adding hassle and paperwork to your life, try to stay within the $13,000 limit this year. That amount will rise in the future, to track inflation.

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