

Strategies to Build Your Business & Personal Net Worth

Deadline for accelerated deductions

A December 2003 rule change provides an opportunity to accelerate business deductions for certain intangible assets acquired or created after January 24, 2002.

This lets accrual-basis businesses deduct costs, including insurance, taxes and licenses, warranty and service contracts and certain others when paid, instead of over the life of the contract.

For many businesses, this can result in a deferral of income tax until such time as the business is disposed.

The IRS did not release final procedural guidance on this issue until March 2004—after many calendar-year businesses had filed their 2003 tax returns—so some businesses have not yet taken advantage of this opportunity.

Therefore, the IRS has set a September 15 deadline to amend 2003 tax returns. Unless the IRS makes another rule change, those businesses that want to change accounting methods after the deadline must go through a complicated application process and pay IRS user fees.

New IRS schedule for C corps

For taxable years ending on or

after December 31, 2004, C corporations with ending total assets of \$10 million or more must complete a new Internal Revenue Service (IRS) schedule.

The new Schedule M-3 is part of the federal C corporation income tax return (Form 1120) and serves as a detailed reconciliation of financial statement net income and taxable income. C corporations are currently required to complete a less-detailed reconciliation.

The new schedule's purpose is to increase transparency between financial net income and taxable income, helping the government identify corporations that have engaged in aggressive transactions. The IRS will use the schedule to target prospects for examination.

The new schedule will require affected taxpayers and their tax preparers to compile and report additional information on tax returns. The IRS also announced plans to develop a similar schedule for S corporations and partnerships but has yet to release details or a target date.

State & local tax incentives

State and local tax burdens continue to increase as states look for additional funds. Income, franchise, capital, sales and use, property, employment and other business taxes are sometimes over-

looked by businesses but can add up to significant amounts.

Careful planning can result in reduced state and local tax liabilities, including:

- ✓ State nexus studies to help determine exposure to state and local taxes
- ✓ Reverse sales tax studies to help identify sales tax overpayments
- ✓ Consulting to help identify and obtain financial incentives from state and local governments
- ✓ Property tax studies to help identify overpayments and challenge assessed values

States use new technology to hunt tax evaders

State and local tax jurisdictions across the nation are hunting for tax evaders with high-technology tools.

For example, Massachusetts can scan a U.S. Customs and Border Protection database of people who paid duties on big-ticket items as they entered the country. Anyone failing to pay the state the required 5% use tax is identified.

The state also has begun comparing motor vehicle registration data with tax returns, specifically looking for people who might be driving expensive vehicles but declaring only small-income levels.

The new technology tools are able to mine increasingly large amounts of information from various sources. Activities that would previously have taken years of work can now be done in seconds.

Such tools have reaped hundreds of millions of dollars in increased tax collections. Massachusetts, Texas, California, Washington, Virginia, Iowa and Florida are known to be leaders in this

inside

- ✓ **Alternative minimum tax catches more people every year**
- ✓ **Real estate owners take note**
- ✓ **Vacation home tax issues may apply to you**
- ✓ **How to keep your best customers**
- ✓ **Doing it right...a BKD standard**
- ✓ **Mathematics of market returns**
- ✓ **WealthPlan short takes**
- ✓ **Market commentary**

trend. The IRS also is exploring utilization of these techniques.

These new tax agency “data warehouses” can stockpile information from state and federal agencies and, in some cases, private sources, and the dollars at stake are substantial.

For example, Texas notes its data-mining technology has harvested more than \$362 million since the late 1990s. Many states implement a pattern-recognition technology similar to what credit

card companies use to flag unusual charges.

Such a system can examine cigarette, alcohol and sales taxes collected and compare the amounts to what should be expected of a similar business.

Use of other databases, such as the Federal Aviation Administration’s records, can conceivably highlight individuals who have purchased planes, yet failed to pay sales or use taxes on such items.

If the trend continues, other

states where BKD clients live and operate businesses will likely acquire similar capabilities.

Federal law denies joint filing for legally married same-sex couples

A recent Massachusetts Supreme Judicial Court case recognizes the right of same-sex couples to marry in Massachusetts, effective May 16, 2004.

According to a draft technical information release from the Massachusetts Department of Revenue, same-sex couples who marry in Massachusetts are treated the same as other married couples.

Therefore, they must file their state income tax returns as a married couple, either jointly or separately; however, the IRS, makes it clear that legally married same-sex couples may not file joint returns for federal income tax purposes.

Not being recognized as married for federal tax purposes also prevents legally married same-sex couples from claiming numerous other income and estate tax breaks allowed to other married couples.

The IRS noted the *Defense of Marriage Act* defines marriage—for purposes of administering federal law—as the “legal union between one man and one woman as husband and wife.” It further defines “spouse” as “a person of the opposite sex who is a husband or wife.”

The IRS also noted that its publications reflect the above rules. In particular, IRS Publication 17, “Your Federal Income Tax,” states that a taxpayer’s filing status depends on marriage and that “marriage means only a legal union between a man and a woman as husband and wife.”

IRS issues guidance on shareholder loans

A common way for a shareholder to withdraw cash from a closely held corporation is to borrow money from it.

This is because loan proceeds are not taxable, whereas dividends from a C corporation are taxable, and distributions from an S corporation might be taxable.

For such a tax strategy to pass muster with the Internal Revenue Service (IRS), the loan must be businesslike.

Alternative minimum tax catches more people every year

About 3.3 million taxpayers will owe additional taxes in 2004 because of the alternative minimum tax (AMT), up 27% from 2003.

By 2010, more than 31 million taxpayers—nearly 30% of all individual taxpayers with an income tax liability—will be hit with AMT.

How did it start?

The AMT’s original purpose was to prevent a small number of high-income taxpayers from completely avoiding federal income taxes through the use of sophisticated loopholes.

The idea was to subject those taxpayers to a secondary tax computation, then pay the higher of their “regular tax” or the tax determined under the AMT computation; however, the calculation has never been indexed for inflation, so an increasing number of middle-income taxpayers are now caught in the AMT trap.

Why it’s a growing problem

Recent tax cuts have made the problem worse because ordinary tax rates have been reduced while the AMT rates remain at 26% or 28%, depending on income level.

Even if the AMT rates are lower than a taxpayer’s standard income tax rate, the loss of certain deductions and exemptions in the AMT computation could result in a higher tax bill.

Who it will affect

Among the middle-income taxpayers most likely to be affected by AMT are those who live in areas with high taxes, have several dependents or exercise company stock options.

Itemized deductions for state income taxes and property taxes are not allowed in the AMT computation. Deductions for personal and dependency exemptions also are disallowed.

And, while no regular taxes are due when an incentive stock option is exercised, the difference between the stock’s value and the price paid for the stock on exercise typically must be reported as income for AMT purposes.

Ways to lower AMT exposure

While there is growing support in Congress for overhauling the AMT, there is currently no provision on the table for an immediate fix. To reduce AMT in the meantime:

- ✓ Defer the payment of certain deductible expenses, such as state income taxes, to a future year to reduce your AMT adjustments and potentially avoid AMT, but be sure you have paid enough tax to avoid underpayment penalties.
- ✓ Consider municipal bonds or mutual fund that specifically generate income exempt from AMT.

The key is to be sure decisions are not based on a single tax issue or made without regard for the effect on your overall financial strategies. □

The IRS considers the following factors in determining whether withdrawals are loans or taxable dividends. “Yes” answers to the following questions can help support loan treatment:

- ✓ Did the shareholder provide security for the loan?
- ✓ Is the shareholder in a position, *e.g.*, salary, other income and net worth, to repay the loan?
- ✓ Did the shareholder sign a note with the corporation?
- ✓ Is there a repayment schedule or an attempt to repay?
- ✓ Is there a set maturity date?
- ✓ Is interest paid on a regular basis?
- ✓ Does the corporation make systematic efforts to obtain repayment?
- ✓ Is there a ceiling on the amount the corporation can advance?

“Yes” answers to the following questions indicate distributions to a shareholder may be constructive dividends rather than loans:

- ✓ Does the shareholder control the corporation’s affairs?
- ✓ Were large advances made to a controlling shareholder whose ability to repay is contingent on future events?
- ✓ Does the corporation have adequate earnings and profits with respect to the advances made, coupled with no history of paying dividends?

The IRS weighs all of these factors, so the arrangement must be carefully planned.

What are your chances of being audited by IRS?

According to a recent Treasury report, of the approximately 130 million total income tax returns filed in 2002, about 850,000 indi-

Real estate owners take note

Quicker depreciation for building owners

Under the current depreciation system, businesses can write off the cost of machinery and equipment over relatively short periods, *e.g.*, five or seven years, using accelerated methods; however, for commercial buildings and their structural components, the depreciation period is a long 39 years and only the straight-line method is available.



In an important case, the Tax Court said a taxpayer was correct in depreciating a portion of an electrical system as if it were a piece of machinery or equipment.

In the same case, the more rapid depreciation of many other building components, such as carpeting, also was held to be appropriate.

While most building owners view a building’s electrical system as an integral part of the building as a whole, the taxpayer in the above case took a different view.

The taxpayer argued that part of the electrical system installed in the building, was specifically being used to power equipment.

The taxpayer further pointed out that, because the percentage of the electrical system used to power the equipment wasn’t needed to power the building as a whole, it was a nonbuilding component and, therefore, eligible for more rapid depreciation.

Implications for building owners - Building owners should have a cost segregation study to

determine what portion of a building’s cost serve purposes other than the operation and maintenance of the building itself.

That way, a portion of these costs that would otherwise be depreciated over 39 years may qualify for a much shorter recovery period.

The difference in early-year depreciation expense can be significant, and it is not uncommon to see a present-value cash-flow savings of up to 10% of the cost of the building.

Cost segregation can help

Perform an engineering study of building plans to identify building components that can be depreciated over a shorter period of time, thus speeding up tax deductions for depreciation and cash flow.

The cost of a nonresidential building is typically expensed over 39 years for tax purposes, but a cost segregation study can identify building components that may be expensed over 5, 7 or 15 years.

It also is possible to perform studies on buildings purchased in years before the current year.

Deferred exchanges

Income tax deferral can be achieved through the use of deferred exchanges of property. For example, instead of selling a property and separately purchasing another, a qualified intermediary can be used to swap the properties, resulting in the deferral of tax.

Deferred exchanges require careful planning and execution. Tax deferral also can be obtained where casualties, such as storm, fire, theft or condemnation, occur and replacement property is purchased. □

vidual returns have been audited. This represents just over one half of one percent of the total returns filed.

The report also indicated about 54.5% of the individual returns audited had a positive total income of under \$25,000, which seems to indicate the IRS is focusing on earned income credit issues.

These numbers do not include notices generated by the IRS’s matching program in which the IRS matches items of income reported on Forms 1099 and K-1 to the recipient’s income tax

returns.

Other interesting facts stated in the report include:

- ✓ The highest percentage of individual income tax returns audited continues to be those with Schedule C that report gross receipts of less than \$25,000 (3% of these returns are audited)
- ✓ One percent of individual income tax returns with total income of \$100,000 or more were audited
- ✓ The number of corporations audited dropped by more than

10% and only 0.58% of corporations with assets under \$10 million were audited; for corporations with assets of \$10 million or more, the rate was 12.08%, and the audit rate was 0.30% for S corporations

- ✓ The number of partnership returns audited increased from the prior year; 0.35% of the partnership returns were audited

The IRS has pledged to increase compliance through increased audits and is in the process of reallocating resources to this end.

Employee stock ownership plans

When business owners use an employee stock ownership plan (ESOP), they can sell their stock to company employees and, in certain circumstances, pay no individual income tax and retain control of the company, as well as render the company essentially nontaxable. ESOPs are well established but require proper planning and execution.

Impact of accounting methods

An accounting method study can help determine the optimal methods for your business, resulting in significant tax savings.

Accounting methods dictate in which taxable year income and expenses are included in net taxable income. Current tax rules allow for alternative accounting methods; choosing the right methods for your business can help reduce income taxes.

Alternative accounting methods may be available for:

- ✓ Depreciation and amortization
- ✓ Compensation
- ✓ Cost of goods sold
- ✓ Prepaid expenses
- ✓ Advanced payments for services
- ✓ Accounts payable/receivable
- ✓ Other income and expense items

Tax-favored savings plans

Qualified retirement and education plans can defer taxes on savings. Individual retirement accounts, 401(k)s and other tax-favored retirement plans can help participants save for the future

Vacation home tax issues may apply to you

by Jerry Isaacs, Tulsa, jisaac@bkd.com

A vacation home can provide a nice getaway now and then, but don't forget to consider the tax aspects of how many days you spend there or rent the home:

Tax-free income - A taxpayer who rents a home for fewer than 15 days during the year doesn't report rental income and can't claim rental deductions.

This tax break can be a windfall for those who own properties in other sought-after areas—such as a city with a prime sporting event like the U.S. Open—where even a few rental days can bring in substantial dollars.

Vacation home used as a residence - A vacation home is treated as a personal residence during a tax year if personal use exceeds the greater of 14 days or 10% of the days the property is rented to others.

Although the property is considered to be a personal residence, the owner still must treat the rental portion of the vacation home separately from the personal portion.

and provide employers with current tax deductions and satisfied employees.

With careful planning and administration, business owners and key employees can defer taxes on substantial amounts of compensation at a relatively low after-tax cost.

Similar concepts apply to education savings.

Research credit

Companies that engage in product development or process improvement, such as warehouse, distribution, manufacturing process innovation or software creation, may be eligible for research and experimentation (R&E) tax credits.

R&E credits can help offset expenditures for research that is technological in nature, consti-

tutes a process of experimentation and is performed with the intent to result in a new or improved business component.

A research credit study can help identify eligible activities and costs and leading to valuable tax credits.

This credit expired on June 30, 2004, but costs incurred on or before that date are still eligible. There is a legislative effort to extend the credit.

Entity planning

One of the most important decisions a business owner makes is the choice of legal entity through which to carry on the business.

One size does not fit all, so business objectives, capitalization, industry, ownership, location and other factors must be considered when making this important deci-

Vacation home used as rental property - A vacation home is treated as rental property for a tax year in which personal use of the unit doesn't exceed the greater of 14 days or 10% of the days the property is rented during the year at a fair rental.

Deductions for rental losses are subject to complex restrictions.

Rental portion - Rentals of vacation homes are included in taxable income but may be offset with deductions for the rent-related portions of expenses such as utilities, maintenance, upkeep, mortgage interest, real estate taxes and insurance.

The owner also may claim a depreciation deduction related to the rental use; however, deductions generally can't exceed rental income.

Excess expenses are carried forward and may be used in a future year when there is additional rental income.

Personal portion - The owner may be able to deduct the real estate taxes and mortgage interest allocable to personal use of the home as itemized deductions. □



Penalty refund for EFTPS use

The IRS has implemented a program that allows a refund for employers who were assessed a payroll tax deposit penalty. To qualify, the employer must:

- ✓ Pay the penalty in full
- ✓ Enroll in and use the electronic federal tax payment system (EFTPS) for four consecutive quarters
- ✓ Make all Form 941 payments on time through EFTPS

Beginning in 2005, the IRS will automatically determine which employers have met the

four quarters of EFTPS compliance and refund the most recent penalty. No other action by the employer will be necessary.

The IRS will refund a penalty paid within the four quarters immediately preceding the four-quarter compliance period.

Accordingly, if an employer enrolls in and uses EFTPS for all four quarters in 2004, the IRS will refund a penalty paid as far back as the quarter beginning January 1, 2003.

Penalties paid earlier than one year before the four-quarter compliance period are not eligible for the automatic offer.

Disability benefits: tax now or later?

Employers often provide employees with disability coverage on a pretax basis; however, disability benefits are taxable to the employee if the benefits they receive are attributable to employer contributions and not included in the employee's gross income.

The result is a disabled employee with a tax bill on his/her disability benefits. To avoid this situation, employers can amend their disability plan to allow employees to elect to pay tax on the premiums. This way, any disability benefits received will not be taxable.

The election can be made annually, so employees can change each year. This option can be beneficial to older employees, employees with deteriorating health or employees who would rather pay premium taxes now instead of paying taxes on disability benefits should they become disabled. □

How to keep your best customers

What makes customers keep coming back? Factors beyond product and price are important in creating long-term satisfaction.

Here are some simple ways to build your repeat business:

Accessibility - Customers expect to be able to contact your business when necessary. That makes it important to prevent communication obstacles.

For example, a complex answering system may be counterproductive if it prevents incoming callers from easily and quickly reaching a live representative.



Give existing customers priority - Identifying prospects and working to develop new customers are essential and exciting tasks, but don't lose sight of the continuing sales potential of your existing customer base.

Making sure existing customers are not neglected can be as important as building new relationships.

Your web site should be easy to navigate

- If you sell over the Internet, strive to conserve your customers' time and avoid unnecessary keystrokes.

An ordering process that requires compli-

cated entries and repetitive steps does not invite repeat business; users should be able to correct entries easily without having to reenter data or start over.

Supervision and training - Your cashiers and other front-line service personnel need to be chosen, trained and supervised to provide customers with *consistently* positive experiences. Satisfying *both* old and new customers should always be a high priority.

Pay attention to staff quality - A telephone operator, receptionist or other employee with a bad attitude or poor people skills can weaken customer bonds.

Because employees represent your business in all of their contacts with customers, it's important to choose, recognize and reward quality performers at all levels of your organization.

Fix mistakes quickly - A sincere apology combined with a prompt correction can blunt the impact of a mistake; however, to a customer, once is a mistake and twice is indifference.

When mistakes occur, first learn the cause. Then, act to prevent them from recurring.

Set and exceed expectations - Establish

clear expectations of your staff: Make sure phone calls are returned promptly, appointments are kept and commitments to provide information, price quotes or deliveries are met.

Don't over promise, and if execution does fall short—for instance, running out of stock on an advertised sale item—be prepared to offer a substitute or “rain check.”

Know the competition - If you and your employees can accurately compare your products and services to those of your competitors, you'll be better prepared to make effective presentations.

Listen to clients - It may sound like “Selling 101,” but listening to and identifying customer needs is as valid with old customers as it is with new.

Attention to your customers' needs—plus strong product knowledge—may lead to new sales opportunities.

Maintaining customer relationships depends on quality products or services, well-chosen prices *and* consistently good service.

For any size business, customer service remains a key factor and these practices can help you deliver. □

Doing it right. . . a BKD standard

Public accounting firms are among the most heavily regulated professions in the country and for good reason.

The general public—that's you—expects CPA firms like BKD to perform their work with integrity and objectivity, to avoid conflicts of interest and to “do what's right.” Constituents of the clients of CPA firms—stakeholders, private owners, employees, customers, strategic partners, vendors, etc.—rely on the integrity of CPAs.

In February, BKD and another regional firm, Moss Adams LLP, based in Seattle, took the unprecedented step of announcing formation of two advisory bodies, one for each firm, to provide additional oversight of their professional and business practices.

BKD and Moss Adams are believed to be the first CPA firms in the country to add this additional layer of oversight to their practices.

Tone starts at top

This commitment to a new level of internal due diligence sends a clear signal that we take our public responsibilities as a CPA firm very seriously.

“We recognize, as does the Congress, the Securities and Exchange Commission and other regulators, that ethics and integrity start with the tone at the top,” says **Bill Fingland**, BKD's managing partner.

“Formation of independent advisory boards charged with oversight of BKD's quality controls affecting our public responsibilities sends a clear message that we walk the talk.”

BKD forms Council

Accordingly, BKD has formed

a Public Interest Council of three individuals, knowledgeable about accounting, business, law and ethics.

The Council will help BKD fulfill its mission to maintain sound professional, business and financial standards by independently monitoring BKD's peer review, independence standards and procedures and internal quality controls aimed at ensuring the firm meets its responsibilities to the public.

The Council is developing its own work plan, but the specific tasks under consideration include:

- ✓ Availability to any BKD partner or employee wishing to discuss specific Council observations or recommendations
- ✓ Meeting with partners and employees to assess knowledge of the firm's values and tone from the top
- ✓ Continuing education conferences to monitor presentations and interview staff
- ✓ Reviewing the firm's peer review process, internal inspection program and independence standards

Council appointees named



Raymond Dockweiler

Council appointees are **Raymond C. Dockweiler**, director emeritus of the University of Missouri,

Columbia, School of Accountancy; **Stephen L. Hayford**, professor of business law, ethics and dispute resolution in the Kelley School of Business, Indiana University, Bloomington; and **Thomas S. Stewart**, the



Stephen Hayford

Mission statement - The Council's mission is to help ensure that BKD, acting of its own accord, meets its obligations and high duty to the public and its clients. The Council will fulfill that charge by autonomously monitoring and evaluating the firm's independence standards and other internal policies and procedures designed to establish and maintain the quality, objectivity and competency of BKD's people and services and by examining any other matters deemed appropriate. The goal of these efforts is to assist BKD in achieving its ongoing commitment to the highest ethical, professional and business standards.

managing partner of and a practicing attorney for Lathrop & Gage L.C., a regional law firm based in Kansas City, Missouri.



Thomas Stewart

“Our Council members have impressive credentials and careers that clearly qualify them for their responsibilities as BKD's ‘public watchdogs.’ They will have unlimited access to the people and areas of our practice that affect our public responsibilities,” says Fingland.

What it means for you

Clients, prospective clients

and friends of BKD should find the establishment of the Public Interest Council another clear indicator of BKD's commitment to do what's right.

Our outstanding record of strong fiscal management, regulatory compliance and unqualified peer reviews should provide reassurance that BKD is a firm you can rely on as a trusted advisor.

As the accounting firm of choice for growing companies and high net-worth individuals, BKD helps clients make smart business and financial decisions through our technical expertise, client-first focus and disciplined delivery of solutions.

If you have questions about our Public Interest Council, we encourage you to talk with your BKD advisor or call Bill Fingland, BKD managing partner, at 417 831-7283. □

NASBA & JOA commends BKD & Moss Adams

In the **Journal of Accountancy's** July issue, Rick Telberg's article, “Two Firms Launch New Ethics Programs,” says: “Their approaches differ...But the aim is the same: to ensure the high ethical tone at the top of the firms is filtering through the organizations to clients and the public.”

A letter of commendation from the prestigious National Association of State Boards of Accountancy (NASBA) echoed the same praise: “These new programs, although different in approach, clearly establish your firms as leaders in the profession as you strive to strengthen the public's trust.” □

Mathematics of market returns

by Jeff Layman, BKD Wealth Advisors, LLC, jlayman@bkd.com

Despite the strong rebound in stock prices last year, the bear market of 2000 to 2002 is still fresh on most investors' minds.

Ranked as the most severe in 70 years, the recent bear market dropped a cumulative 45% from its peak in March 2000 to its trough in October 2002.

After enduring a decline of this magnitude, investors often greet even small market fluctuations—normal for this asset class—with concern that stocks are about to experience another big decline.

WealthPlan. Professional investors have felt the severity of the bear market decline, too. Many market strategists and prognosticators call for returns from stocks to be significantly below historical averages over the next several years. Some predict market returns of 5% to 7% vs. the long-run average of 10% to 12%.

Clearly, return expectations for stocks have moderated a great deal over the past few years, which may prove positive for future market returns.

Consider this analysis by Tom McKissick of TCW during the bear market's final days in October 2002: "Since the inception of the S&P 500, the worst 10-year period of returns was 1929 to 1938, with a -4.90% average annual return.

"Using 2000 as the base year, the S&P 500 would have to return **8.95%** annually from present (October 2002) levels in order to *equal* that dismal decade."

In addition, our own computations indicate stocks will need to

average nearly 10% per year from 2003 through 2009 to avoid a loss for the full 10-year period (2000-2009).

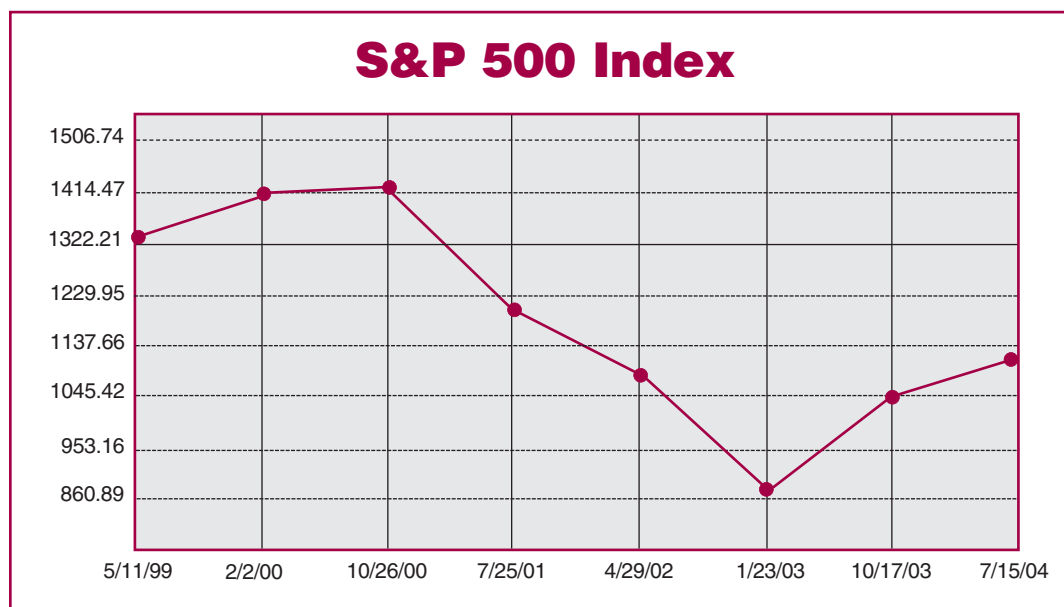
Although not unprecedented, losing money in stocks over a 10-year span has been a rare occurrence.

With our economy improving significantly over the last several quarters, corporate earnings have risen sharply.

That—combined with the fact that market valuation levels are approximately half what they were in early 2000—offers reason to be

optimistic the current decade will not assume the title for the S&P 500's worst-ever 10-year period.

Mathematically speaking, results much better than that imply average annual returns in the range of 10% or higher, which is similar to historical norms. □



WealthPlan. short takes

Wealth planning with trusts

There are only three potential beneficiaries of an estate: family, charity and the IRS.

Transfer taxes can eat up half of an estate and leave heirs with no choice but to sell the business or other inherited assets to pay the tax bill.

Proper planning and use of trusts can result in reduced taxes and probate costs, wealth preservation, protection from

creditors, privacy, reduced family disputes and smoother business succession, while allowing senior family members to control assets.

Trusts also can be used to help achieve philanthropic goals and current tax reduction while providing an income stream.

FLPs & estate planning

A recent high-profile court case affirmed the use of properly struc-

tured family limited partnerships (FLPs) in estate planning.

With careful planning and execution, FLPs can gradually transfer assets from older generations to younger members of a family.

FLPs make such transfers in a tax-efficient manner, while allowing the older generation effective control of assets. □

Market commentary

by Jeff Layman, BKD Wealth Advisors, LLC, jlayman@bkd.com

Three consecutive quarters of robust economic growth have resulted in a significant increase in corporate earnings.

More than half of the companies in the S&P 500 reported earnings that exceeded analyst expectations in the first quarter of 2004 and overall earnings for these companies were more than 20% higher than in the first quarter of 2003.

As companies begin to report second-quarter profits, similar growth is expected. Despite these strong results, equity markets moved only slightly higher this year, as investors focus their concerns on rising interest rates, higher oil prices and geopolitical issues.

U.S. and international equity markets posted only small gains during the second quarter and for the year-to-date.

June 30, the Federal Reserve (Fed) raised rates for the first time in four years, moving the Fed

Funds rate from 1.00% to 1.25%. The Fed indicated the inflation threat is still relatively low, which should allow further rate increases to come at a "measured" pace.

The Fed's action coincided with the release of data indicating 1.3 million new jobs were created in the first six months of the year, the most in four years.

In anticipation of the Fed's move, interest rates in the bond market started to rise late March. Since then, the yield on the benchmark 10-year Treasury note has risen as much as 1% from the year's lows.

Consequently, the total return offered by bonds has begun to moderate, as the interest income they produce is offset by the decline in the market prices of existing bond positions.

In 2004, both the Lehman Aggregate Bond and the Lehman Municipal Bond indexes have experienced declines, both down fewer than one percent for the year. Current Fed policy is still very accommodating.

Oil prices continued to move higher in the quarter. In addition to being inflationary in the short run, higher energy prices also can pose a risk to future economic growth; however, on an inflation-adjusted basis, the price of oil is still well below the levels of the 1970s.

Therefore, many economists believe the risk to the economy is limited at current oil price levels.

The final revision to first-quarter Gross Domestic Product growth came in at 3.9%, slightly below earlier estimates.

Preliminary estimates of second-quarter growth are in the 3% to 4% range, despite some signs of slowing late in the quarter. The economy continues to grow above the long-term trend rate of 3.5%.

A significant decrease in volatility has become the hallmark of the stock market in 2004. The price level of the S&P 500 has ranged from 1157 to 1084 this year, or only 73 points (or 7%) from the high to the low.

Another measure of volatility is the Chicago Board Options Exchange's® Volatility Index, which is currently under 15. This represents its lowest level since late 1996. Both of these statistics indicate extremely low stock market volatility.

Short-term "headline" risk will increase as the election draws near and rhetoric grows. The debate on drug re-importation, energy policy and taxation will continue to influence market activity according to the results of the latest poll.


Earnings for the second quarter are expected to show growth similar to that of the first three months of the year. When earnings rise and stock prices remain essentially flat, the result is a cheaper stock market valuation.

The S&P 500 currently trades at a multiple of 17 times expected earnings for 2004 and about 15 times expected earnings for 2005. Given the current level of interest rates and inflation, the market is reasonably valued. □

Investment strategies from BKD Wealth Advisors, LLC



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