



IRS audits to focus on executive compensation

Don't be surprised if—in connection with an Internal Revenue Service (IRS) examination of your company—the revenue agent requests the personal income tax returns of your company's key executive(s).

The IRS perceives widespread misuse of executive compensation arrangements to produce questionable tax benefits to either the employer or its executives. In addition, the IRS has discovered some executives are not filing individual tax returns, so it will be focused on executive compensation issues during audits.

New audit technique guides (ATGs) issued by the IRS instruct its agents to re-

quest and examine the individual income tax returns of executives, especially those of Securities and Exchange Commission reporters. Agents are also instructed to obtain other returns and documents, such as related-party returns and employment tax returns.

ATGs have instructed agents to focus on compensation issues, including:

- ◆ Stock option transfers to related persons in return for deferred payments
- ◆ Fringe benefits, like spousal travel, provision of tax services, consulting fees to former executives and loans to executives to purchase homes, etc.
- ◆ Nonqualified deferred compensation

plans, especially where the corporation takes an immediate deduction while the executive defers the recognition of income

- ◆ The \$1 million compensation deduction limitation for SEC company executives
- ◆ Stock options and phantom stock
- ◆ Split-dollar life insurance
- ◆ Golden parachute payments

Refund opportunity for EU customs duty

Before the extraterritorial income exclusion (EIE) was repealed, European Union (EU) countries applied additional import duties to many products from the U.S. in retaliation against export tax breaks given to U.S. companies.

Beginning March 1, 2004, the EU imposed an additional 5% duty that increased 1% every month thereafter.

In response to the U.S. repeal of its EIE legislation, the additional duty was suspended January 1, 2005. Notification of the

New rules combat abusive tax shelters

by Rich Royster, Springfield,
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While we make every effort to avoid unnecessary legalese, you may notice new disclaimer language in our written federal tax advice and e-mails. We are now required by the federal government to include the following paragraph—or one similar—in certain written federal tax advice:

“Tax professionals that practice before the IRS are required to adhere to certain professional standards prescribed by the Department of Treasury and the Internal Revenue Service (IRS). These standards require us to inform you that this advice is not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties that may be imposed.”

We must include this paragraph under new U.S. Treasury Department regulations that govern written federal tax advice issued by tax professionals.

The purpose of the new regulations is to help combat abusive tax shelters. Tax practitioners who fail to comply with these rules are subject to fines, censure or disbarment from practice before the IRS.

Although BKD has not and does not promote abusive tax shelters and does not issue abusive tax shelter opinion letters, we are, nonetheless, subject to the new regulations.

Under the new rules, taxpayers generally may rely on written federal tax advice for penalty protection only if the advice is a “covered opinion,” which is basically a lengthy and comprehensive formal tax opinion that meets strict and rigorous IRS standards.

If the opinion does not meet IRS standards, penalty protection does not apply.

If you have any questions or concerns about how these new requirements will affect you, contact your BKD advisor for assistance. ❖❖❖

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suspension was not made until January 31, 2005. Accordingly, additional duties paid during January 2005 exceeded the normal rate for those goods.

In most instances, EU importers will pay the excess duty and will be eligible to claim the refund; however, if the shipping terms are delivered duty paid, the U.S. exporter is eligible for the refund.

Foreign subsidiaries of U.S. multinationals will want to consider possible refund claims as well.

Evaluate ways to tap corporate cash

Since the passage of the *Jobs and Growth Tax Relief and Reconciliation Act of 2003*, qualified dividend income is worth more after taxes than the same amount of wages and other forms of ordinary income.

In light of beneficial tax rates for quali-

fied dividend income, owners of closely held corporations should reassess the best manner to get cash out of their businesses.

This involves comparing the tax consequences of pulling cash out of the closely held corporation via declared dividends, constructive dividends (which presumably can be qualified dividends), salaries, leases or licenses and redemptions.

Form W-4 reporting requirements relaxed

Effective April 14, 2005, employers no longer have to report questionable Forms W-4 to the IRS for employees who will earn more than \$200 per week.

New employees are required to complete Form W-4 to claim dependents and marriage status for income tax withholding. Before the rule change, employers were required to report certain questionable W-4s to

the IRS. Now, employers will only have to do so if contacted by the IRS.

Carrying over cafeteria plan contributions

The IRS recently announced employees can carry over unused amounts in cafeteria plans. The unused amounts can be carried forward for up to 2½ months past year end as long as their employer elects to modify the company's plan.

Cafeteria plans—also called Section 125 plans or flexible benefit plans—allow employees to use pretax dollars to pay for qualified benefits that include employer-provided accident and health insurance, long-term life insurance, dependent-care assistance and adoption assistance.

Historically, these use-it-or-lose-it plans forfeited any amount not used by the employee at year end. The IRS now permits

IRS increases transfer pricing enforcement

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The IRS plans to increase the number of audits of large and mid-size businesses. A primary audit target in 2005 will be mid-market corporations that may have escaped audits in the past; audits of partnerships are expected to increase as well.

In these audits, the IRS will pay special attention to transfer pricing and intercompany transactions.

Related party transactions

The government is concerned that taxpayers will shift income and expenses to related parties to avoid U.S. taxes, especially where non-U.S. companies or locations are involved.

Therefore, U.S. tax laws require taxpayers to treat related party transactions as if they are between two unrelated parties.

Further, taxpayers with related party transactions are required to compile reasonable and full documentation of arm's-length pricing before filing annual returns.

Failure to produce this documentation within 30 days of notice of audit places taxpayers at risk for additional tax, interest and penalties. Penalties can be as high as 40% of the portion of underpaid tax.

Taxpayers must document transfer pricing

A recent IRS internal memorandum re-emphasized a 2003 IRS directive that agents routinely request transfer pricing documentation from taxpayers.

Before the directive, IRS agents requested documentation in only 35% of audits of large and mid-sized businesses.

Since the directive was issued, agents have requested documentation 55% of the time, and IRS officials further stress the need for agents to request documentation regardless of materiality.

IRS requests for transfer pricing documentation don't necessarily result in an IRS challenge, but taxpayers who don't have documentation are at higher risk of both an active transfer pricing audit and ultimately a penalty.

The sole method of avoiding a transfer pricing penalty where the IRS adjustment exceeds certain thresholds is to have a study that meets the standards in the regulations.

Take action

In light of this IRS directive, taxpayers with related party transactions should be aware the IRS is planning to request transfer pricing documentation in every audit and will strictly enforce the rules in this area.

Therefore, be prepared to maintain the required contemporaneous documentation.

For further information, please contact your BKD advisor. ♦♦♦

(but does not require) a 2½-month grace period following year end. Expenses for qualified benefits incurred during this time can be paid or reimbursed from unused funds at the end of the immediately preceding plan year.

During the grace period, any unused benefits from a prior year cannot be cashed out or converted to any other benefit. When the 2½ months expire, employers may continue a normal run-out period for employees to submit requests for payment or reimbursement of expenses incurred during the grace period.

Employers are required to amend their plans if they want to provide this benefit, which is available the year the plan is amended.

For example, if an employer's plan is on a calendar year, amending it before December 31, 2005, will allow participants to take advantage of the benefit for 2005 and seek reimbursement through March 15, 2006, for 2005 plan contributions.

Employers also offering health-savings accounts (HSAs) should note: Amending a plan to take advantage of the 2½-month carryover could adversely affect HSA plan qualification.

New Medicare drug benefit & subsidy

Employers with retiree drug plans take note: Deadlines approach for Medicare's prescription drug benefit, including the government subsidy for qualifying plans.

The *Medicare Modernization Act of 2003* added Part D, a new prescription drug benefit that covers medication and gives plan sponsors several options:

- ◆ Employers sponsoring qualifying plans can receive a subsidy of 28% of costs between \$250 and \$5,000. Medicare-eligible retirees would stay in the plan and not enroll in Part D.
- ◆ Employers can coordinate their retiree drug plan to wrap around Medicare's Part D, similar to what is already done with Medicare Parts A and B.
- ◆ Employers can contract with a Medicare-approved prescription drug

plan or Medicare Advantage plan to offer benefits to eligible retirees. They can choose to pay the Part D premiums.

- ◆ To determine the best option, employers need to meet with their actuaries and pharmacy benefit managers to analyze plan expenditures.

Many employers are opting to receive the subsidy. The plan basically does not change, but the government

would pay a tax-free subsidy of around 28% of the benefits.

To qualify for the subsidy, plan benefits must be of equal or greater value than the Part D benefit, so a plan that caps benefits or passes significant costs on to retirees probably won't qualify. Applications for the subsidy option are due September 30, 2005.

Employers who do not qualify can try a "wrap-around plan" to supplement Part D coverage similar to the kind of coverage many employers already provide to supplement Medicare Parts A and B.

Retirees would enroll in both the company plan and Medicare, with the employer choosing whether to pay the Part D premiums.

In addition, employers can provide a fully insured Medicare-approved drug plan or Medicare Advantage plan to offer benefits to Part D-eligible retirees, in a manner similar to Medicare+Choice. However, many health management companies left the Medicare+Choice market because they felt inadequately compensated.

After electing a plan option, employers are required to notify retirees by November 15, 2005. Opting for one of these plan designs is not a permanent choice; employers can go with a different option for 2007.

Deduct up to \$5,000 in start-up expenses

Starting a new business usually involves a lot of time and expense, but you can't claim a tax deduction for the hours spent analyzing potential markets and traveling to line



up prospective suppliers and customers.

However, the associated out-of-pocket costs, as well as expenses incurred in setting up your company, may be deductible.

Under a recent tax law change, you can elect to deduct up to \$5,000 in start-up expenses (advertising costs, pre-operational salaries, etc.) in the year you begin active business operations. The \$5,000 limit is reduced dollar for dollar once total start-up expenses exceed \$50,000. Remaining start-up costs may be deducted ratably over 180 months.

If you elect not to deduct start-up expenses, all of them are capitalized and may be amortized over 15 years. A similar election is available for organizational expenses incurred in setting up a corporation or partnership, including fees for legal and accounting services and state incorporation fees.

Finally, don't forget to keep records. If you're launching a new trade or business, keep good records of the amounts you spend before things are up and running. That way, if it's to your advantage, you'll be able to deduct them.

Telecommuter guidelines

If you work from home and your employer is just across town, it's still considered a long-distance relationship, and things may not always be harmonious. If you can work through the challenges and establish a good telecommuting arrangement, it can be rewarding for both employer *and* employee.

If you're considering a work-from-home arrangement with an employee, consider the following before taking the plunge:

Scheduling and oversight - If you allow employees to telecommute, it means you trust them to work a certain number of hours or accomplish a certain amount of work without supervision.

Before you approve the arrangement, be sure your soon-to-be *employee in absentia* is clear about the hours or work expected. Establish a reporting system to verify the work is being done and spell out other details, such as vacation and sick time.

Liability and other insurance matters -

Make sure you have liability insurance to cover the employee's home office, insurance on any business equipment you provide and adequate workers' compensation insurance.

Office visits - Don't let off-site turn into out of sight. Even a long-distance telecommuter should be expected to come to the office routinely—for quarterly meetings or certain company events, for instance.

Bankruptcy reform bill has tax implications

The *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, signed into law April 20, targets repeat bankruptcy filers and also introduces other reforms, including some notable tax implications.

Discuss the new law with your attorney if you or your business is considering bankruptcy or are a creditor in a bankruptcy. Provisions that may affect you or your business include:

- ◆ Repeat bankruptcy filers will have more

difficulty in getting relief for unpaid taxes.

- ◆ Generally, retirement funds, including individual retirement accounts (IRAs), up to \$1 million are protected from creditors. The amount will be adjusted each year for inflation.
- ◆ Section 529 college savings plans and educational IRAs are generally protected from creditors.
- ◆ In Chapter 13 and 11 bankruptcies, the advantages under previous law concerning unpaid taxes have been eliminated.

Damages for faulty home construction

An IRS ruling makes it clear you generally won't be taxed on any damages you receive from a builder, architect or other responsible party for faulty construction of your residence.

Rather, you can reduce your basis (your cost for tax purposes) for measuring gain or loss if and when you sell the home; however, you are currently taxed to the

extent the damages you receive exceed your basis.

These rules apply whether the damages are awarded in a lawsuit or paid in settlement of a suit.

Exclusion rules for some home sales

With the dramatic increases in home prices, particularly in some locales, significant gain may accrue in a short time. Homeowners can generally exclude \$500,000 of gain (\$250,000 for single taxpayers).

The home-sale exclusion generally applies to taxpayers who have owned and lived in their residences for at least two years. Taxpayers making more frequent sales or exchanges don't usually qualify.

However, if the quick sale is due to certain reasons explained in recently issued final regulations, *e.g.*, change of employment, health or unforeseen circumstances, an exclusion is available.

The maximum exclusion in these situations is less than the limit that generally ap-

Reporting rental income & expenses

Surf, turf & taxes

Are you buying a vacation home with the idea of renting it out when you're not using it? While renting out your second home can give you

extra cash to pay homeowner expenses, you'll face some complicated tax rules.

The tax treatment of your second home depends on the number of days each year you and your family use the home compared to the number of days you rent it out.

For your home to be considered a second residence, your personal-use days must exceed the greater of 10% of rental-use days or 14 days. Otherwise, your home will be considered rental property.



Your personal getaway

When your home qualifies as a second residence, you can report the rental income on your tax return (see exception below). You can deduct against that income the

following expenses in full:

- ◆ Mortgage interest and property taxes attributed to the period of rental use
- ◆ Expenses associated with the rental, such as the cost of advertising the property

Other rental expenses, including maintenance, utilities and depreciation, are deductible up to the limit of any remaining income. (You may be able to deduct any excess rental expenses in future tax years, so keep good records.)

Mortgage interest and property taxes attributed to the period of personal use qualify as itemized tax deductions.

Your investment

When your home is considered rental property, you report the rental income on your tax return just as you did for a personal residence.

All rental expenses are potentially deductible. However, you won't be able to take an itemized deduction for property taxes or mortgage interest.

The good news

Rent your home for 14 days or less, and you won't have to report the rental income at all. You can still claim itemized deductions for property taxes and qualifying mortgage interest, but rental costs won't be deductible.◆◆◆

plies, but, with less than two years for the property to appreciate, even a reduced maximum exclusion should be sufficient to shelter the gain for most home sales that qualify under the final regulations.

Moving expense deduction possible

If you pulled up stakes this year and moved to a new home, you may be able to write off some of your unreimbursed expenses.

The move must be work related—for a first job, a new job or the same job in a new workplace—and you must pass two tests:

- ◆ The distance between your new job location and your former home must be at least 50 miles more than your old commute. If you didn't work full time before the move, the new job site must be at least 50 miles from your old residence.
- ◆ You must be employed full time in the general area of your new job location for at least 39 weeks during the 12 months following your move.

Self-employed individuals also have to work full time for at least 78 weeks during the 24 months following the move. At least 39 of those weeks must be during the first 12 months.

If you pass the tests, you can deduct the cost of:

- ◆ Packing and shipping your belongings
- ◆ Storing your possessions for up to 30 days while they're in transit
- ◆ Traveling to your new home, including lodging but not meals
- ◆ Connecting utilities at your new home

New rules for auto donations

Charitable contributions of autos, boats and planes made after 2004 are subject to new restrictions. The deduction for these donations generally depends on how the charity uses the donated property.

If it sells the vehicle without (1) making major repairs or improvements—or (2)

actually uses it in its regular activities—the donor's deduction is limited to the sales proceeds.

However, this restriction does not apply if the charity gives or sells the auto to a needy individual at a price significantly below its value; this *only* applies if supplying a vehicle to a needy individual directly furthers the donee's charitable purpose of relieving a poor and distressed or underprivileged individual in need of transportation. Noncompliant charities are subject to penalties.

The donor's deduction depends on a host of new charity requirements:

- ◆ Within 30 days of the donation, the charity must acknowledge the donation in writing, including the vehicle identification number.
- ◆ If the charity plans to use or improve the vehicle as part of its regular activities, including the sale or gift to a needy person, the written acknowledgement must state the intended use and that it will not be sold before its use or improvement.
- ◆ If the charity sells the vehicle without qualified use or improvement, it must give the donor written information about the sale, including the price and that the donor's deduction is limited to the sales price.
- ◆ The charity must report this information to the IRS, which is slated to roll out a new informational form for this purpose.

Rental car insurance dilemma

You're at the booth ready to sign for your rental car when the agent asks if you want to buy the insurance offered by the rental company.

Before you accept or decline, here are a few things to consider:

Are you already covered? - Check with your auto insurance provider. Chances are, if collision and comprehensive coverage are

included in your policy, you'll be covered for damages to a rental car and other property.

If you have to file a claim, it could result in higher premiums.



Did you charge it? - Charging the rental to a major credit card may mean you're protected by a loss/damage waiver. Check with the card issuer to find out what protection—if any—is available.

If your rental car won't be covered through these channels, consider saying "yes" when the rental agent asks about insurance.

Are investment expenses deductible?

The short answer is maybe; the long answer is probably not—unless you have many itemized deductions and a modest income.

Costs falling into the category of investment expenses may include fees for professional advice, subscriptions to investment publications and accounting and legal fees related to investment activities, among others.

To be deductible, investment expenses—along with other miscellaneous itemized deductions—must exceed 2% of your adjusted gross income (AGI).

In 2005, the amount you can deduct decreases when your AGI exceeds \$145,950 (\$72,975 for married filing separately). Miscellaneous itemized deductions are completely disallowed for individuals subject to alternative minimum tax.

What's *not* deductible:

- ◆ Trading commissions added to your investment cost basis
- ◆ Travel costs and attendance fees for investment seminars, conventions and stockholder meetings
- ◆ Costs related to purchasing tax-exempt securities

Of course, you may still be able to deduct the interest on money you borrow to purchase taxable securities. ♦♦♦



Hedge funds primer: know what they are before you invest

by J.R. Humphreys, BKD Wealth Advisors, LLC, ehumphreys@bkd.com

Over the past decade, the hedge fund industry has exploded, continuing to swell to more than 8,000 funds from as few as 300 in 1990. Much of the growth can be attributed to investors looking for absolute returns after the technology bubble burst in 2000.

Another growth factor surfaced during the equity bear market period from 2000 to 2002, when the S&P 500's performance over several quarters was significantly negative, while hedge funds posted positive returns and positive press.



What is a hedge fund?

Simply put, a hedge fund is a securities' transaction that reduces the risk of an existing investment position.

Like mutual funds, hedge funds are vehicles that use a variety of strategies to invest in various asset classes; however, unlike mutual funds, hedge funds are typically organized as limited partnerships and—depending on the strategy—often use leverage to enhance returns.

Therefore, the risk and return characteristics of a certain hedge fund will be determined by its particular investment strategy.

Hedge fund styles can be broken into two groups: nondirectional and directional. Nondirectional styles tend to be less risky and include market-neutral, event-driven and arbitrage styles. Directional styles tend to be higher risk and include long/short and macro.

Investing in hedge funds

The best argument for investing in hedge funds is their low correlation with the traditional asset classes of stocks and bonds, which can result in improved diversification and a more efficient portfolio.

But don't think of hedge funds solely as a means of achieving extra return. Take a look at the Hedge Fund Research Performance Index Fund of Funds (HFRI FOF) Composite Index, which is fast becoming the benchmark for hedge funds.

For 10 years ending July 2003, the average annual return for the S&P 500 large cap equity index was 10.28%; the return for the HFRI FOF Composite Index was 7.93%.

However, the three-year and five-year returns for the HFRI FOF Composite Index were positive, while the S&P 500 returns were negative.

Remember, as a "fund-of-funds" index, the HFRI FOF Composite Index tracks every hedge fund style. During the 10 years ending July 2003, returns for individual hedge fund styles within the index ranged from 1.25% to 13.65%.

There are risks

Hedge funds offer little or no transparency. When it comes to investments made to generate returns, little information is typically available, which limits what an investor can learn.

In addition, it's difficult for investors to monitor this type of investment because hedge fund managers protect the details of the market inefficiencies they plan to exploit. Their future profit potential hinges on keeping this information quiet.

Compared to other types of investment vehicles, most hedge funds are very illiquid, and many require a multiyear investment

and offer only short windows of opportunity to redeem holdings within a year. Their fee structure is generally higher, too, typically 1% to 2% of assets per year, plus 20% of the profit generated.

Depending on a hedge fund's particular strategy, leverage is often used to enhance returns, but the downside is it can also amplify *negative* returns. Leverage adds volatility, which increases risk.

The hedge fund industry is not yet heavily regulated, despite the \$3.5 billion bailout of Long-term Capital Management in the late 1990s and concerns about the industry's rapid growth and the need for greater oversight.

This may be because hedge fund investments are typically offered only to "accredited investors"—sophisticated, high net-worth individuals, who are considered knowledgeable about the risks involved.

Hedge funds today & what's ahead

Hedge funds may have a place in the portfolios of some investors, but in the current environment of modest stock and bond returns, many investors are looking for opportunities to increase their returns.

The proliferation of these funds over the past few years has made it more difficult for hedge fund managers to find and exploit pricing inefficiencies. It's also brought to market many less-experienced, less-proven managers, which has contributed to large variances in manager performance within each investment style.

Opportunities still exist to improve diversification and reduce risk by adding hedge funds to an investment portfolio, but, going forward, the potential likelihood of more moderate hedge fund return should be weighed against the added cost. ♦♦♦



Market commentary: second-quarter gains counteract first-quarter losses

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

In the first three months of the year, factors influencing market activity spilled over into the second quarter: Oil prices reached a new high of more than \$60 per barrel, and the Federal Reserve (Fed) continued to raise short-term interest rates.

Despite ongoing headwinds, U.S. stock market averages produced gains that partially offset first-quarter losses. Bonds also posted gains in the quarter, pulling year-to-date returns into positive territory.

Economy growing at above-trend pace

Despite persistently high oil prices, the economy continues to grow at an above-trend pace. The revised figure for first-quarter growth came in at 3.50%, resulting in a growth rate of 3.60% for the trailing four quarters.

The Fed raised short-term rates during each of its two meetings in the quarter, bringing the Fed funds rate to 3.25%. This key short-term rate is now at a level just above the rate of inflation, resulting in a positive “real” Fed funds rate.

This, combined with the slowing impact of high oil prices, causes many analysts to believe that the end of Fed tightening is in sight.

The yield curve continued to flatten in the period, with the two-year Treasury note offering a 3.70% yield, while the 10-year note declined to a 4.05% yield.

With bond yields still hovering just above 40-year lows, shorter durations and more modest return expectations are appropriate for the bond portion of portfolios.

Although the overall U.S. economy is doing quite well, there are pockets of weakness and concern. In May, the bonds of both General Motors and Ford were downgraded to “junk” status by Standard and Poor’s.

This action highlights the unrelenting pressure large U.S. manufacturers face from global competition, rapidly rising health care costs and large defined benefit pension obligations.

The International Statistical Institute (ISI) estimates the average hourly costs of wages and benefits in the U.S. auto sector is \$36.55, while it’s \$1.96 in China and \$5.87 in Brazil. Such a disparity in cost structure creates a difficult environment for profitability in the global economy that exists today.

GDP hits all-time high

Consensus estimates leading into the reporting period were for 8% growth over the first quarter of 2004. Actual reported earnings growth was 13%, reflecting the impact of a strong economic backdrop, technology-driven gains in worker productivity, muted growth in average hourly earnings and abnormally high earnings from companies in the energy sector.

Profits as a share of gross domestic product (GDP) hit an all-time high in the quarter, surpassing

the preceding peak in 1997. Expectations for second-quarter earnings growth stand at a cautious 7%.

International stocks were the only equity asset class to post negative results in the second quarter, largely because of the strengthening dollar, which hit a nine-month high against the euro in June.

The currency effect boosted international equity returns to U.S. owners in 2003 and 2004 as the dollar weakened, but has had the opposite influence so far in 2005.

Gains in productivity, lower tax rates and an accommodative Fed have resulted in significantly better growth in both GDP and corporate profits over the past two years.

Stock prices have not reflected this strength over the past 18 months, resulting in a contraction in the market’s valuation even as earnings have grown rapidly.

The longer this situation persists, the more attractive stocks become. Therefore, we remain optimistic about the return potential for stocks in the second half of 2005. ♦♦♦

| | 2Q 2005 | 2005 YTD |
|-----------------------|---------|----------|
| S&P 500 | 1.37% | (.81)% |
| NASDAQ Composite | 2.89% | (5.45)% |
| Russell 2000 | 4.32% | (1.25)% |
| MSCI EAFE | (1.46)% | (2.70)% |
| Lehman Aggregate Bond | 3.01% | 2.51% |
| Lehman Municipal Bond | 2.93% | 2.89% |

Rebounding M&A activity gains momentum

by Jason Corson, BKD Corporate Finance, LLC, jcorson@bkd.com

BKD Corporate Finance continues to see a strong rebound in the number and value of mid-sized companies coming to market.

Timing critical when selling your company

Selling your company at the right time can add significant value, while selling at the wrong time can result in a significantly *lower* value.

To help you determine the right time to sell, study a variety of uncontrollable value-driving forces, including:

- ◆ General economic conditions
- ◆ General financial markets
- ◆ Interest rates
- ◆ Availability of transaction capital
- ◆ Tax and regulatory environment
- ◆ Industry trends
- ◆ Valuation multiples

The more you know about these variables, the better educated your decision will be when determining if the time is right for you. ♦♦♦

After reaching record levels in 2000, merger and acquisition (M&A) activity declined dramatically in 2001 and 2002.

It began to increase in the first quarter of 2003 and continues to gain momentum as we head into the second half of 2005.

The improving economy, large amounts of private equity, low interest rates and rising corporate earnings have driven M&A volume in 2004 and the first half of 2005.

Favorable trends

U.S. M&A activity was strong in the first half of 2005.

Compared to the same period in 2004, total **value** of announced transactions increased significantly, and announced deal **volume** declined slightly, though experts expect the second half of 2005 to be as good or better.

With buyer demand increasing, 2005 and 2006 should shape up to be good years for sellers.

Private equity firms, fueled by a large overhang of uninvested capital and an active fundraising environment, continue to aggressively pursue opportunities.

This, coupled with the return of strategic buyers, has created an extremely competitive environment. This is certainly good news for sellers as increased competition

for deals typically translates into higher valuation multiples.

In addition to these favorable trends, the overall economy is at its healthiest since 9/11, debt markets are robust and interest rates remain at historical lows. As a result, overall valuation multiples are at their highest levels since the boom era of the late 1990s.

It's important to be flexible in the timing of your exit strategy. If you are within three to five years of exiting your company, contact BKD Corporate Finance for more information about exit strategies. ♦♦♦



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