



Information to Help You Make Smart Business & Financial Decisions

## New GAAP accounting rules for income taxes

If your enterprise issues its shareholders, lenders or others financial statements based on generally accepted accounting principals (GAAP), plan now to implement new accounting rules for uncertain tax positions, **especially if your enterprise is taxed as a C corporation**. Pass-through and not-for-profit enterprises also are subject to the new rules and could be affected in some circumstances.

Financial Accounting Standards Board (FASB) interpretation number 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, is effective for financial statement periods beginning after December 15, 2006. Enterprises registered with the Securities and Exchange Commission (SEC) were required to implement these rules in 2007 first-quarter filings.

FIN 48 imposes new standards for recognizing, classifying and disclosing tax positions, penalties and interest in GAAP financial statements. The term "tax position" refers to a position taken in a previously filed tax return—or one expected to be taken in a future tax return—that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods.

A tax position can result in (1) a permanent reduction of income taxes payable, (2) a deferral of income taxes otherwise currently payable to future years or (3) a change in the expected realizability of deferred tax assets. They also encompass but are not limited to:

- ◆ A decision not to file a tax return
- ◆ An allocation or a shift of income between jurisdictions

- ◆ The characterization of income or a decision to exclude reporting taxable income in a tax return
- ◆ A decision to classify a transaction, entity or other tax return position as tax exempt

The evaluation of a tax position is a two-step process: First, an enterprise must determine whether each tax position, based on its technical merits, is more likely than not to be sustained on examination.

Enterprises must presume an appropriate taxing authority—one with full knowledge of all relevant information—will examine each position. Tax benefits may not be recognized if they are generated by positions that do not meet the more-likely-than-not standard.

Second, measure tax positions that meet the more-likely-than-not threshold to determine the amount of benefit that may be recognized in the financial statements.

Enterprises must also accrue additional expense where a tax position would result in penalties and/or interest. Summary disclosure of uncertain tax positions is also required, possibly resulting in increased scrutiny on examination by taxing authorities.

If your enterprise is affected by FIN 48, plan now to identify and assess potentially uncertain tax positions to avoid surprises during your next financial statement audit or review.

## BKD announces new director of tax services

**B**KD, LLP announces Partner **Lisa Workman** as its new firmwide director of tax services, effective April 18. Before moving to her new post, Workman was a member of BKD's WealthPlan services team in the Joplin office.



As firmwide director of tax services, she will oversee the management, quality control and strategic growth of the firm's tax practice and will direct specialized services, including estate and retirement planning, real estate cost segregation, state and local taxes, international tax services, research and development credits, business structuring and compliance.

Workman brings a solid skill set to her new role, with more than 18 years of experience providing tax consulting services for businesses and individuals. She also previously served as the firm's associate director of tax services for two and a half years.

Newly appointed Managing Partner **Neal Spencer** (see related story, page 4) says he is pleased to have her on the administrative team: "I look forward to working with Lisa to continue to build BKD's tax advisory practice into one of the best in the country in providing quality solutions to our clients."

The third director of tax services in 21 years, Workman's goal is to assist BKD's tax professionals to develop opportunities for expanding the depth and breadth of the firm's tax services. ❖❖❖

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Your enterprise may be able to avoid the impact of FIN 48 by issuing income tax basis financial statements or financial statements with a departure from GAAP for FIN 48. Before adopting either measure, obtain approval from your lender(s) and other users of your financial statements and contact your auditor.

## IRS loses taxpayer data

A government agency says the Internal Revenue Service (IRS) is not adequately protecting taxpayer data stored on laptop computers.

An inspection by the Treasury Inspector General for Tax Administration (TIGTA) reveals 490 IRS laptop computers were either lost or stolen over a 42-month period. The laptops contained confidential personal information, such as Social Security numbers, belonging to at least 2,359 individuals.

TIGTA also found IRS employees failed to correctly report the theft or loss in 85% of the incidents. According to a related inspection, encryption software is often not installed on IRS computers, increasing the likelihood information on these lost or stolen computers could be easily accessed and read by crooks.

One TIGTA recommendation is for the IRS to educate its employees about their responsibilities for protecting computers, with periodic tests to verify encryption software is used.

TIGTA reported similar findings in 2003, but the IRS has not yet taken corrective action; however, it recently promised to take steps by April 2008 to better protect taxpayer information, including a commitment to encrypt backup data sent to non-IRS facilities.

## Consider tax issues in divorce

Unfortunately, divorce is a common event. In addition to intense personal and financial issues, it also affects family businesses and may have significant tax implications. Where possible, divorcing spouses should split up assets, including the family business, in a tax-efficient manner. Receiving help from your legal counsel and tax advisor in this process is essential.

Property transfers between spouses incident to a divorce are generally not taxable: The spouse who transfers the property is not entitled to a tax deduction, and the spouse who receives it is not taxed.

## Praxity: gateway to the global marketplace

In a business world where borders are increasingly transparent, many companies are looking for business opportunities beyond their national boundaries. While this direction opens unlimited new horizons, it also presents many challenges for global accounting solutions.

That's why we are pleased to announce BKD is part of Praxity, AISBL, a newly launched global alliance of dynamic international, national and regional accounting firms, which is designed to meet those challenges and offer a global reach for companies that operate worldwide.

The creation of Praxity is a joint initiative taken by former Moores Rowland International key members and Mazars to better meet market expectations at a critical time and to enhance their offer of services and overall momentum. Before Praxity, BKD had alliance relationships with both Moores Rowland International and Mazars.

As a member of Praxity, we're now aligned with a host of worldwide firms, assessed and selected on their technical capabilities, commitment to quality, financial strength and leadership positioning within their respective global geographies.

By operating with firms inside the Praxity alliance, we will work with professional accounting firms as committed as we are to providing the best possible service throughout the United States and the world.



BKD's outgoing Managing Partner and Chair of Praxity (see related story, page 4), **William E. Fingland Jr.** explains the new alliance's mission: "In a business environment that is increasingly global, the members of Praxity provide a dynamic and innovative option to better serve businesses on an international level. We want to open up the world market and bring its infinite possibilities to everyone's advantage."

Praxity was launched and formally began operations in April 2007, with coverage in more than 65 countries and a combined 2006 turnover of approximately \$2.4 billion (EURO 2.0 billion).

Organized as a not-for-profit organization under Belgian law (AISBL), Praxity has its administrative center in London, England.

For more information on BKD's international solutions, contact your BKD advisor, and for more information about Praxity, visit [praxity.com](http://praxity.com). ♦♦♦

Following divorce, it is generally not advisable for both ex-spouses to be involved in the family business. The direct purchase of or reimbursement for one spouse's stock by the other, incident to a divorce decree, is generally not taxable. However, the purchasing spouse may have to sell other assets in taxable transactions, receive a dividend or borrow funds to raise the necessary cash.

Using corporate funds is possible but may result in decreased cash flow, decreased working and investment capital and/or debt. Redemption will generally result in tax, though the parties can usually choose which spouse will pay the tax through structuring techniques. Additional options may be available depending on the circumstances:

♦ Structure the property settlement or

buy-out as a loan to spread out installment payments and interest. The interest paid may be deductible.

♦ Where one spouse is active in the business and the other is not, the nonactive spouse can be given nonvoting stock with various rights or stipulations, including call rights.

This could allow the active spouse to control the business and buy stock back over time, while allowing the nonactive spouse to share in risk and appreciation of the business.

♦ Where both spouses are active in the business, a corporation may be separated in a tax-free reorganization transaction known as a "split-up," which could allow both spouses to operate separate businesses.

- ◆ If one spouse has not received adequate compensation for prior services to the business, it may be possible to allocate a portion of the property settlement or buy-out to compensation in arrears. Such compensation could be deductible by the business.

Discuss these issues with your legal counsel and BKD advisor before taking action.

## Final 409A regulations issued

Past issues of the **BKD Advisor** have covered new requirements for nonqualified deferred-compensation plans (NQDC plans) established by the *American Jobs Creation Act of 2004*. Internal Revenue Code (IRC) Section 409A (409A) basically imposes limitations on the design of NQDC plans, which must meet distribution, election, funding and documentation requirements.

If a plan fails to comply, all cumulative earned and deferred compensation not subject to a substantial risk of forfeiture is immediately included in a participant's taxable income, and a 20% penalty and interest will be imposed.

The IRS has now issued long-awaited final regulations under 409A that clarify (1) arrangements subject to 409A, (2) exceptions, (3) definitions and (4) other guidance. Most arrangements that provide for compensation deferral are NQDC plans, including but not limited to:

- ◆ Most traditional elective top-hat plans
- ◆ Deferred compensation arrangements under employment or severance agreements
- ◆ Supplemental executive retirement plans (SERPs)
- ◆ Discounted nonqualified stock options, phantom stock or stock appreciation rights
- ◆ Split-dollar life insurance agreements

An NQDC plan generally *does not* include a qualified employer plan, *e.g.*, 401(k) plan or a vacation, sick leave, compensatory time, disability pay or death benefit plan. As with most other tax laws and regulations, there are special exceptions and exceptions to the exceptions. Contact your tax advisor or employee benefits counsel for help determining if a plan is subject to 409A.

**If your business provides any NQDC plan, seek immediate qualified employee benefits counsel because it will likely need to be amended or updated to qualify under 409A. Failure to comply may result in significant tax and penalties on plan participants.**

## Structure S corporation loans to increase basis

If you are an S corporation shareholder, you generally may deduct your share of the S corporation's losses up to the adjusted basis of your stock and debt of the S corporation.

Your adjusted basis in S corporation stock is generally equal to the amount you paid for it (or value upon death if inherited), plus additional paid-in capital and your cumulative share of the S corporation's income and less your share of the S corporation's losses and shareholder distributions. Your adjusted basis in S corporation debt is equal to the amounts you directly loan it.

If your share of S corporation losses exceeds your adjusted basis, the excess is not currently deductible but is carried forward to future tax years. Many S corporation shareholders make loans to increase adjusted basis to deduct current losses.

When doing this, it's very important to properly structure the loans:

- ◆ Where circumstances warrant, it's easier to simply make an additional contribution to capital, especially if you own 100% of the corporation. When the S corporation becomes profitable, the contributions can be repaid in the form of shareholder distributions.
- ◆ Loan funds directly to the corporation; you cannot merely guarantee a debt of the S corporation.
- ◆ Deposit funds in the S corporation's account; you cannot merely make a promise to loan the funds.
- ◆ Use a formal note with arms-length terms, including interest, and follow the note's formalities.
- ◆ Generally, you may restructure the S corporation's existing bank debt as a "back-to-back" loan, so you borrow funds directly from the bank and loan the same amount to the S corporation.



Be very careful when borrowing funds from another company you own to loan to the S corporation. Avoid circular loans: The courts generally have ruled there is no economic substance when a taxpayer borrows funds from Company A to loan to Company B, then Company B loans the funds back to Company A.

Such transactions are essentially disregarded for tax purposes. If you need to acquire funds from another company you own, take a shareholder distribution where possible instead of a loan.

## Basic strategies for reducing estate tax

As the chance of estate tax repeal fades in the short-term, individuals with assets of \$2 million or more should focus on strategies to reduce this tax. The chance for estate tax repeal or reform has caused many individuals with assets between \$2 and \$10 million to avoid estate tax planning. This is unwise, especially when basic estate planning is less complicated than many people expect.

There are many ways to reduce the estate tax. Some widely used basic strategies include:

- ◆ Use the annual exclusion (currently \$12,000 per person) to shelter gifts to heirs. A joint couple can annually give \$24,000 worth of assets to an individual.
- ◆ When gifting to heirs, give appreciated investments, such as stock instead of cash.
- ◆ The first \$2 million of assets per spouse are generally exempt from the estate tax. (This number may be reduced or eliminated if you have given large gifts to heirs.) Make sure your strategy doesn't waste your exemption amounts.
- ◆ Consider the possibility of using a family limited partnership to transfer assets to heirs in a tax-efficient manner while retaining an acceptable level of control over the assets.
- ◆ Life insurance policies should be owned by your heirs, not you. If you own them, the proceeds will generally be subject to the estate tax. This is not so if you hold no incidents of ownership in the policies. One



common strategy is to use an irrevocable trust (ILIT) to purchase life insurance.

- ◆ Consider the possibility of using a qualified personal residence trust to efficiently transfer the value of your home to heirs.
- ◆ If charitably minded, consider using a charitable remainder trust to leave assets to charity, retain rights to income or principal of the trust and generate a current charitable contribution deduction.

These strategies are very basic, but there are many other ways to reduce your future estate tax and increase the amount you leave your heirs.

## Tax consequences of repossessing real estate

The repossession of real estate can be a tricky issue for tax purposes. Generally, you can't deduct any loss from the repossession, and, in certain circumstances, you may have to report some gain.

Let's say you sold real estate and extended credit to the buyer in the form of a loan secured by the property. Now, you have to repossess the property in full or in partial satisfaction of the debt.

Generally, the seller reports all interim installment payments, *i.e.*, the principal payments received before repossession, as gain to the extent they exceed the amount of gain reported as income before the repossession.

However, if the amount you received is less than your previously reported gain, you cannot report a loss. The gain reported on the repossession of real property can never exceed the original sale price minus (1) your original basis in the property, (2) the gain you recognized and (3) your repossession expenses.

The basis of the repossessed property will be your basis in the debt, plus any gain you reported on the repossession, plus any expenses you incurred in connection with the repossession.

So, while you may have to pay tax on the repossession, you will get a stepped-up basis, which should reduce your gain when you resell the property. ♦♦♦

## BKD makes seamless top leadership transition

For only the fourth time in BKD's history, the stage is set for a leadership change: Following an early 2007 transition period, Managing Partner **William "Bill" E. Fingland Jr.** handed over the reins June 1 to **Neal D. Spencer**, partner in charge of the firm's Kentucky and Southern Indiana offices.

Fingland has led the firm for the past 10 years and will move into the newly created role of "chair" at the firm's Springfield, Missouri, headquarters. As part of the succession plan, Fingland will be available to provide ongoing counsel to the new managing partner.

"The transition period that began in early 2007 will pave the way for a seamless top leadership change midyear," says Fingland. "This has been a work in progress. Implementing the specifics of our succession plan actually began in 2005. We believe wholeheartedly Neal will lead the firm effectively in its next stages of evolution and strategic plans."

Spencer has been with the firm 21 years and is an active client service partner and member of the BKD Health Care Group. To begin the leadership transition process in earnest, he relocated from Louisville, Kentucky, to Springfield in February.

"The top leadership role presents so many opportunities and challenges. I'm

excited by the prospect of taking our firm from where we are now, harnessing our potential and driving us forward," he says.

"Bill has done a tremendous job providing visionary leadership. It's a great privilege to be able to step into the role, especially given the positive values and culture Bill has done so much to enhance during his tenure."

An alum of the University of Arkansas, Fayetteville, Spencer is also a fellow in the Healthcare Financial Management Association and a member of the American Institute of Certified Public Accountants and the University of Louisville Accounting Advisory Council. In 2003, he was recognized as Accountant of the Year in Public Accounting by the Sam M. Walton College of Business at the University of Arkansas.

As managing partner, Spencer is responsible for the firm's overall management and leadership. He will oversee strategic planning and also will serve as firm spokesperson.

Spencer assumes leadership as national and international business environments grow increasingly complex and competitive and face higher regulatory compliance demands—issues that pose new and continuing challenges and opportunities. ♦♦♦



## Fingland's guidance critical to BKD's strength

**B**ill Fingland began his public accounting career with BKD in 1976. He was partner in charge of the firm's Tulsa, Oklahoma, office for nine years and served as BKD's first national director of health care services.

Fingland spearheaded BKD's management and growth since being elected the firm's third managing partner in 1997, succeeding **James O. Glauser**.

Through his experience, influence and guidance, BKD has positioned itself as a leading regional accounting firm, highly regarded in the industry.

In his new role as chair, he will devote much of his time to issues within the accounting profession, strengthening international affiliations via Praxity (see related story, page 2) and furthering BKD's growth and development. ♦♦♦

# Tax breaks to help disabled

**D**isabled individuals are entitled to certain tax breaks via income exclusions, deductions and credits. (*The following information for fully or partially disabled individuals is only a summary. Contact your BKD advisor for specific details.*)

## Income exclusions

- ◆ Legal settlements and court awards for personal injury or sickness are generally not taxable.
- ◆ Disability insurance benefits received in the form of Social Security or Tier 1 Railroad Retirement payments are tax free for lower-income individuals. Taxation of these benefits normally starts when modified adjusted gross income (AGI) exceeds \$32,000 for married couples who file a joint return and \$25,000 for single individuals.
- ◆ Supplemental Security Income (SSI) benefits generally are not taxable.
- ◆ Disability benefits received from the Department of Veterans Affairs (VA) are not taxable.
- ◆ Other disability insurance payments for personal injury or sickness are generally taxable if the insurance premiums were paid by your employer (unless the premiums were treated as taxable compensation).
- ◆ Payments for the cash-surrender value of a life insurance policy received before death (accelerated death benefits) are generally taxable if they exceed the premiums paid. However, accelerated death benefits are generally not taxable if the insured individual is terminally or chronically ill.
- ◆ Proceeds from the sale of a life insurance policy on a terminally or chronically ill taxpayer to a qualified viatical settlement provider are generally tax free.
- ◆ Qualifying military and government disability pensions are not taxable if received from a pension, annuity or

other allowance for personal injury or sickness resulting from active service.

- ◆ Workers' compensation payments are generally not taxable.
- ◆ Welfare, and public-assistance payments for a disability are generally tax free.
- ◆ Generally, qualified long-term care insurance benefits are not taxable.

## Deductions

Partially or totally blind taxpayers get an additional standard deduction. For 2007, the amount is \$1,300 for single and \$1,050 for married couples.

Among others, the following may be deducted as itemized medical expenses:

- ◆ Prosthetics, eye-glasses and hearing aids
- ◆ Additional cost of Braille books and magazines over the price of regular printed editions



- ◆ Special communications devices for hearing- and vision-impaired persons
- ◆ Wheelchairs
- ◆ Guide dogs
- ◆ Therapy
- ◆ Certain home improvements, such as ramps

## Tax credits

The child- and dependent-care tax credit may be available for taxpayers who incur employment-related expenses to care for a child under age 13 or a spouse or other dependent who is physically or mentally unable to care for him/herself.

Disabled individuals with earned income may also qualify for the Earned Income Credit. ♦♦♦

## Tuition for learning disabilities may be deductible

**T**he IRS has ruled tuition paid to a special school for a child diagnosed with multiple learning disabilities is a deductible medical expense. Deductible medical care includes the cost of special schooling to help with a physical handicap, including a school for Braille or lip reading.

If the handicap is the principal reason for attending, the cost of tuition for ordinary education and room and board at the school also qualifies as a medical expense. A special school is one in which the substantive content of its cur-

riculum is enabling students to compensate for or overcome a handicap.

For example, Jane has a child diagnosed with a developmental disorder. At her doctor's recommendation, she enrolls her child in a school that employs special-education teachers and mental health specialists.

It also uses special teaching techniques to assist students in overcoming their disabilities. Therefore, Jane can deduct the tuition as a medical expense. ♦♦♦



# Market commentary: 2007 profit growth

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

## Economic environment

After upward revisions to earlier estimates, final fourth-quarter 2006 real economic growth came in at 2.50%, a pace consistent with last year's second and third quarters and representing continued, slightly below-trend growth.

The economy continues to expand at a pace that meets or slightly exceeds economists' expectations at this point in the cycle. The consumer has driven the growth, while business spending has been somewhat disappointing despite record levels of corporate profitability in recent years.

Given the significant role the consumer has played in supporting economic growth over the past five years, recent difficulties in the sub-prime lending area and the decline in housing activity have raised concerns about the future.

The default rate on sub-prime loans has risen significantly this year, and, although these lower-quality loans represent a relatively small portion of the overall mortgage market, the prospect of the credit risk spreading upstream has caused some trepidation. A downturn in the housing market is likely in the middle innings and will still need to run its course.

According to Merrill Lynch, the real estate boom accounted for nearly half of all economic growth since 2001, which explains the concern over the current contraction and the end of "easy money" conditions that have existed in the mortgage market for the last few years. This will be a key area to monitor as we progress through 2007.

So far this year, the Federal Reserve (the



Fed) has maintained a neutral stance regarding interest rate changes, as inflation indicators have moderated. However, the recent resurgence in oil and gas prices may start to pressure inflation readings once again, potentially causing a drag on growth.

We continue to believe employment indicators will be the key data the Fed considers when making future interest rate decisions. The housing slowdown has created a substantial rise in the number of unsold homes across the country, which will undoubtedly reduce construction activity this spring.

The net result will most likely be fewer construction jobs. To the extent these workers are not absorbed into other jobs or industries, the unemployment rate will rise. This scenario causes us to believe the next Fed move will be a decrease in interest rates, and this will likely occur in the second half of the year to rejuvenate a slowing economy.

## Equity markets

Continuing the upward surge that began in the second half of 2006, global stock markets advanced steadily for the better part of the first two months of 2007. Through February 26, the S&P 500 index rose more than 3% for the year.

Investors were caught by surprise the next day, as major market indices declined 3.50%, the largest one-day decline in almost four years. Catalysts for this sudden descent:

- ◆ A precipitous decline in Chinese local shares the night before
- ◆ Former Fed chairman Alan Greenspan's comment a recession was possible in the U.S. later this year
- ◆ Sub-prime loan concerns

Although this late-February downward movement pushed the indices into negative territory, the market pulled back into the positive in March. Here are the index returns for the first quarter of 2007:

Equity Index Returns	1Q 2007
S&P 500	.64%
S&P Mid-Cap 400	5.80%
Russell 2000	1.95%
MSCI EAFE	4.08%

In our view, the significant one-day decline in February does not necessarily portend additional large downside events, but after three consecutive years of very tame trading patterns, more normal levels of volatility may return.

*Research suggests large-cap growth companies also tend to do well in the late phases of an economic cycle, which is where we are currently.*

Historically, a 10% peak-to-trough decline within a year is a fairly normal occurrence. In the past three years, the closest we've come to a decline of this magnitude was in the May-June period of 2006 when stocks dropped 8% from peak levels.

So we are likely to see more volatility, particularly as the economic cycle matures, given that this is a typical characteristic of equity investments over time.

Since the beginning of the decade, various measures suggest growth stocks have traded down to historically low valuation levels vs. value stocks. Also, after several years of underperformance, the shares of large companies now appear attractive when compared to those of small companies.

Research suggests large-cap growth companies also tend to do well in the late phases of an economic cycle, which is where we are currently. As growth in the economy slows, investors normally shift focus to



## may be in single digits

larger companies with consistent growth characteristics.

Finally, the trading activity of the past two months suggests investors may be becoming more risk averse. All these factors point toward relative outperformance of large established companies with above-average earnings growth rates, resulting in a possible change in market leadership as we progress through 2007.

### Fixed income market

Bond yields were relatively stable during the first quarter. The yield curve is slightly inverted, as short-term rates are just above 5% while the 30-year bond currently trades to yield 4.80%. The 10-year note finished the quarter at 4.70%, about where it started.

Fed action (or inaction) will continue to drive the shorter end of the curve. That said, short rates likely will be stable based on current information, at least until the second half of the year.

Meanwhile, the long end continues to be well supported by demand, as dollars sent abroad for oil and the goods the U.S. imports find their way back to the dollar-denominated investment of choice for many foreign countries: U.S. Treasury securities.

In addition, the deflationary forces of globalization have kept concerns about inflation at bay, making longer-term bond investments more palatable at current-yield levels.

This is evidenced by the fact long-term U.S. Treasury yields are at levels similar to the established economies of other countries around the world. So, although yield levels seem fairly low relative to the levels of the past 20 years, they are not that low in the context of the current global environment.

Certain parts of the corporate bond market were a bit more interesting during the first quarter because February's large, one-day decline in stocks caused a risk aversion or "flight-to-quality" response,

resulting in wider interest rate spreads between corporate bonds and government bonds.

Bonds of companies associated with the sub-prime loan market also declined in price. Given the narrow spreads that have existed

*The stable yield backdrop resulted in returns that were driven by the "coupon" once again in the first quarter.*

between high-quality and low-quality bonds in recent years, this is a warranted and healthy response by bond investors.

The stable yield backdrop resulted in returns that were driven by the "coupon" once again in the first quarter. This means bond prices did not change significantly, so returns were in the neighborhood of one quarter of the annual coupon rate.

The Lehman Municipal index gained .81% during the period, while the Lehman Aggregate bond index gained 1.50%. We expect bond returns to be largely coupon-driven until the Fed offers an indication of the timing and direction of its next interest rate move.

### Investment outlook

With the Fed's tightening cycle ending in June 2006, we've entered the period when the last of these interest rate increases will begin to affect the economy, given the nine- to 12-month lag that historically occurs.

The contraction in the housing market is one sign of the higher cost of money's impact. When combined with recent oil and gas price increases, it's likely economic growth will slow to 2% or slightly below for the first quarter of this year.

Growth will probably continue at the current pace for the next couple of quarters, assuming the decline in housing activity has

further to go and energy prices remain at current levels.

Environments of decelerating economic growth limit opportunities for companies to grow profits. Consensus estimates are for single-digit profit growth in 2007, following a string of 18 consecutive quarters of double-digit gains that ended in the third quarter of last year.

Some of the more pessimistic forecasts call for virtually no growth in earnings this year, as profit margins decline from peak levels and the economy slows. Optimistic projections call for upper single-digit growth, betting (1) the economy will continue to provide modest upside surprises, (2) the sub-prime loan problems stay contained and (3) cash-rich companies continue to buy back stock, which underpins earnings growth.

We currently favor the "glass is half-full" scenario and believe earnings growth will be in the upper single-digits this year. It's our view the market multiple of 16 times 2007 earnings estimates is very reasonable in an environment of 3% inflation.

Should the Fed become concerned about the sustainability of economic growth as the year progresses, causing it to ease, the potential for multiple expansion exists. However, without Fed easing, returns above the pace of earnings growth will be difficult to achieve in 2007. ♦♦♦

## WealthPlan News Digest

For links to BKD Wealth Advisors' recent media exposure, visit:

[bkd.com/mediacenter/  
WealthPlan\\_NewsDigest/](http://bkd.com/mediacenter/WealthPlan_NewsDigest/)



# People factor adds up

by **Troy Prewitt, BKD Corporate Finance, LLC**, [tprewitt@bkd.com](mailto:tprewitt@bkd.com)

In the business world, the mere mention of success floods the brain with images of innovative products and bulging balance sheets. Successful entrepreneurs make it look easy, while those with more modest results toil in vain wondering when their ship will come in.

Over the years, I've asked countless entrepreneurs their secret to success. By far, the most common response is to credit their employees, their *people* as the key to success.

The first couple of hundred times I heard this, I discounted it as simply the modest reply of those who might be a little embarrassed by their own success. Surely, their uncanny business acumen and keen decision-making ability were the driving forces.

Somewhere along the line, I realized I had mistaken a genuine, heartfelt conviction for an "aw-shucks" answer. Successful entrepreneurs really *do* attribute their success

to their people, and, if true, it must be a measurable response.

## Research supports case

Without too much effort, my simple Internet search revealed multiple studies, citing empirical evidence to support the case that business owners value the people they employ and consider them a critical factor in the business's success.

For example, Leigh Branham of Keeping the People, Inc., pits the composite financial results of **Fortune Magazine's** (**Fortune**) "100 Best Companies To Work For" against the S&P 500.

Branham's calculations indicate **Fortune's** composite group consistently outperforms the S&P 500 composite. Depending on the period measured, **Fortune's** group grows at three to five times the rate of the S&P 500.

By contrast, we don't need sophisticated studies to know the impact of poor employee relations.

The cost of employee turnover is fairly intuitive and measurable in the period in which it happens. But there are downstream impacts, too.

The unknown ripple effect in employee morale and customer relations notwithstanding, the ability to recruit new employees will grow increasingly difficult as the boomer generation enters retirement. It's impossible to calculate the cost of key vacan-

cies during an anticipated shortage of executive talent, but it's not a trivial amount.

Savvy buyers understand the value of people, as well. Strategic and financial buyers alike typically list a strong management team as one of their top three investment criteria. Buyers want businesses where revenue is tied to people, products and processes instead of to a single rainmaker, typically the owner.

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Your people *are* critical to your business's success. As you contemplate your succession plan in a changing world, be sure to invest in your people. ♦♦♦

**Strategic and financial buyers alike typically list a strong management team as one of their top three investment criteria.**

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