ClientTell
Blackburn, Childers, and Steagall, PLC
Certified Public Accountants and Consultants

Volume XIX No. 2 Summer 2013 Blackburn, Childers & Steagall, PLC Quarterly Newsletter

Apples, Oranges & Lemons: *Differences Between Net Income, Taxable Income & Cash Flow*

by Travis McMurray

Over the past twenty years, I've encountered the following question many times: "How can I owe tax? I didn't make any money!" This question is typically asked by a business owner who is legitimately confused as to how we managed to take the financial information for his/her company and put it on a tax return which shows tax due. The answer: net income is not the same as taxable income and both are different than cash flow (sometimes significantly so). All three are financial performance indicators just like apples, oranges and lemons are all fruits. However, they each are quite different.

Net income represents the actual financial return on the business for a given time period. However, the IRS does not allow a tax deduction for some business related expenses. For example, country club dues and political donations are non-deductible, and meals & entertainment expenses are generally only 50% deductible. Depending on the type of entity and the nature of the benefits, some life insurance and disability insurance premiums may also be non-deductible. With these "add-backs" to income, a company may appear to have no net income and yet still have taxable income.

In theory, cash flow and net income should be fairly similar in a cash-basis entity (report revenue when payment is received and expenses when payment is made). However, there are two very common differences: fixed asset purchases and loan repayments. Often a company will simply pay cash for equipment purchases or building improvements, and these represent legitimate business expenses from a tax standpoint and a financial standpoint.

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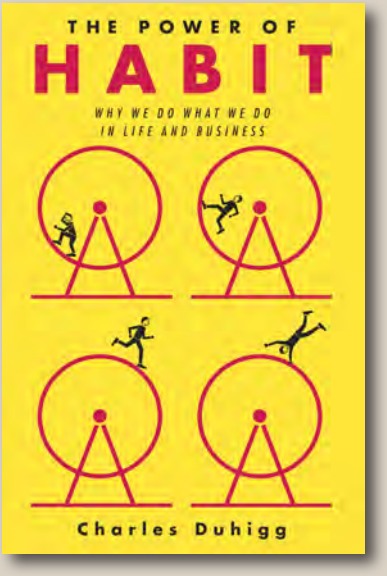
BCS Phone Bank on WJHL for the VITA Program

On February 19th, Kevin Ewers, Melissa Steagall-Jones, Wade Farmer, Sheila Emory and Charles Steagall (left to right) manned the VITA Tax Preparation Phone Bank on WJHL Channel 11. VITA is a program sponsored by Milligan College to provide taxpayer assistance to those who qualify for the program in our area.

The Power of Habit

Viewpoint by Tommy Greer

Habits are powerful…probably more powerful than we'll ever realize. The beauty of our habits is that our brains actually want to operate as efficiently as possible. This is accomplished by turning regular activities into a routine, thus becoming a habit that we don't even have to think about. Basically, we just hit autopilot. However, the challenge of our habits is that our routines are often non-productive or destructive behaviors.



In Charles Duhigg's book *The Power of Habit*, he writes about research conducted on the habit loop. The loop consists of three basic components: a cue, a subsequent routine based upon the cue, and then a resulting reward. Over time the loop becomes more and more automatic. In the early stages, brain activity was relatively high during the entire loop. After the process became familiar, the brain activity was only high around the time the cue was introduced and when the reward was received. The routine portion became automatic and the brain activity decreased dramatically during this period. Eventually, as the habit began to become engrained, the brain activity was only high when the reward was received. Once the habit was entirely an automatic response, the high brain activity shifted to just after the cue was introduced. The brain activity spiked in anticipation of the reward even before the routine was initiated indicating that a strong craving was now driving the habit loop. As Mr. Duhigg writes, "The problem is that your brain can't tell the difference between bad and good habits, and so if you have a bad one, it's always lurking there, waiting for the right cues and rewards."

As psychologists have studied habits, a concept called the "Golden Rule of Habit Change" emerged. The concept states that a bad habit cannot be eliminated; it has to be changed. So how does one change a habit? According to habit reversal training, you use the same cue while providing the same reward, but you change the routine. This concept can be applied to any habit we desire to change (dietary habits, exercise habits, smoking cessation, sleep habits, work habits, etc.).

Researchers also discovered that in order to truly change some habits, another element is necessary: belief. Various studies have demonstrated this power of belief and its effect on change. The placebo effect is one example of the power of belief. Belief in God is another example which studies have shown can improve health, overcome addictions, and eliminate other destructive behaviors. Without this component of belief, habit change couldn't hold up under periods of extreme pressure or stress.

The final component to effectively change a habit is a support group…even if it's just one other person. It's important to have at least one trusted individual with whom you can be completely open and honest, who encourages, challenges, and holds you accountable.

So, in order to change a habit, you must change the routine, believe that change is possible, and maintain a support group to see you through the process.

Financial Spring Cleaning

by James Motte

Although it has not seemed like it recently, Spring is here, and the arrival of Spring brings with it the annual ritual of Spring cleaning. This article does not focus on traditional Spring cleaning (no beating rugs or baseboard dusting), but rather on financial Spring cleaning. Below are a few items to consider.

Review of Portfolio Allocations

- Review your portfolio to see if your target allocations are out of balance with your current allocation. If so, rebalance by selling from the assets that increased in value and buy the assets that have lost value with the proceeds. For example, if your target allocation is 60% equities and 40% bonds and your current allocation is 70% equities and 30% bonds, you would need to sell 10% of you equity allocation and buy 10% more bonds. This would restore you to your target allocation.

Review of Beneficiary Designations on Retirement Accounts and IRAs

- It's always good to review your beneficiary designations on an annual basis. You should take a look at your
  - IRA (Traditional, Roth, SEP or SIMPLE)
  - 401k, 403B, 457 Plan or Thrift Savings Plan (TSP)
  - Pension Plans

Review of Wills and Power of Attorney Designations

- You need to make sure these documents are current and make changes if circumstances have changed in the past year. Items that would likely require updates are:
  - Getting Married
  - Having a Child or Grandchild
  - Death in the family
  - Divorce

Review of Credit Report

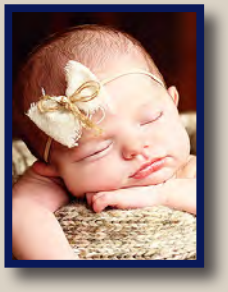
- Review your credit report to make sure it is accurate and up-to-date.
  - Go to annualcreditreport.com to order a free copy of the report (you are allowed one free copy every year). Be sure to obtain and review a copy from all three major reporting agencies: Experian, Transunion and Equifax.

We would be happy to assist you if you have any questions.

Please visit and subscribe to BCS Wealth Management's blog at BCSWealth.com for more articles about investing, retirement, education savings, personal financial planning and info about your BCS Wealth team.

Personal Lines

Jonathan Thomas Jonathan Thomas is the new videography intern. He is a graduate of Milligan College with a degree in Communications with an emphasis in Film. He previously interned with a local ad agency and a special effects company in LA. Jonathan and his wife Nicki attend North Ridge Community Church where he plays in the worship band.



Brittany Cassell Jake and Brittany Cassell welcomed their baby girl, Eliana Marie Cassell, on February 15th. Eliana weighed 6 lbs., 5 oz., and was 19 inches long.

Top 5 Findings from Employee Be

by David Babb

These days, it's hard to find an employer that doesn't include a retirement plan benefit in their list of benefits offered to employees. Today's most common retirement plans, 401(k) plans, offer a relatively inexpensive way to provide a retirement plan benefit to employees without the added complexities (and cost!) of a traditional pension (remember those?). However, these retirement plans do come with strict compliance rules from agencies such as The Department of Labor (DOL) and the Internal Revenue Service (IRS), while at the same time being subject to The Retirement Income Security Act of 1974 (ERISA).

Some of these retirement plans (those generally having 100 or more eligible participants, with certain exceptions) are required to be audited in accordance with DOL regulations. Because of the lengthy compliance matters, those in charge of plan administration can sometimes make mistakes; that's where we come in. We have compiled a list of our most common findings as a result to those audits to assist plan administrators in preventing and detecting future errors:

1. Failure to Remit Employee Contributions Timely

Plan administrators often believe they have until the 15th day of the following month in which contributions were withheld to remit them to the plan. In actuality, they must be remitted on the earliest day in which they can be segregated from the employer's assets. Therefore, plan administrators could be inadvertently remitting contributions untimely and could face DOL repercussions, such as payment of lost earnings to their employees.

This issue can typically be avoided by establishing a reasonable pattern throughout the year of remitting contributions and sticking to it. We would even suggest having a back-up plan in place (e.g. cross training other employees) if the employee charged with this task is gone on vacation or other circumstances arise.

2. Incorrect Calculation of Compensation

Plan administrators coordinate with payroll personnel to determine the amount of contributions to withhold from employees. To do this, payroll personnel determine what forms of compensation are eligible for this calculation. Sometimes, plan personnel are unfamiliar with the terms laid out in the plan document and end up improperly including or excluding certain wages from this calculation.

This issue can be avoided by periodically examining your plan document for the definition of compensation and ensuring your payroll personnel are well versed in its provisions.

3. Lack of Trustee Meetings and/or Minutes of Those Meetings

Plan administrators should schedule at least an annual meeting with the plan's trustees, service providers, and investment advisors. This provides adequate review of investment activity, due diligence that the current investment offerings are optimally benefiting the participants, and reasonableness of fees being paid by the plan.

Fiduciary responsibilities can easily be performed and documented by holding these annual meetings and retaining minutes of those meetings.

nefit Plan Audits

4. Eligibility

Plan administrators can often inadvertently allow an employee to participate that hasn't met the eligibility requirements. They can also fail to allow an employee to participant when they have met the eligibility requirements.

This issue can be avoided by ensuring the plan administrator is well versed on the terms of the plan and performing periodic reviews of newly added participants.

5. Incorrect Vesting on Distributions

Plan administrators sometimes incorrectly calculate the amount of forfeitures that need to be applied to an employee's distribution, resulting in either overpaying or underpaying the employee.

This issue can be avoided by ensuring that the proper years of service goes into the vesting calculation, taking into account any years that the employee may have worked less than the full year but still qualifies as a year of service based on the plan document's definition of service.

Though your employee's retirement plan may not be subject to an annual audit by a CPA, you should still consider these common findings and determine if any of these may be a concern with your plan. If you are unsure if they are or would like to discuss your plan's risks with one of our employee benefit plan team members, call us at 423-282-4511.

Please visit www.irs.gov/Retirement-Plans and www.dol.gov/ebsa for a useful guide to fix common plan errors.

Tennessee Unclaimed Property

by Crystal Mitchell

Do you have payroll checks still outstanding that employees or former employees have never cashed? Have you sent vendors checks that have never cleared the bank? Then you have unclaimed property that needs to be reported to the Tennessee Unclaimed Property Division. This property can be anything intangible that has been abandoned or unclaimed by the rightful owner. Examples include bank accounts, stock certificates, checks, unclaimed wages, refunds, and gift certificates.

When you have property belonging to someone else, send the owner a letter to the last known address telling them about the situation and ask them to either pick up the item or give you a call regarding this matter. If after a reasonable period of time there is no response to the letter, you must send these items to the Unclaimed Property Division of the State of Tennessee. The State of Tennessee will then be the custodian of the property until it is claimed. Reporting requirements have to be met to stay compliant with the state regulations. The website www.tn.gov/treasury/unclaim has more information regarding the requirements and for questions you may have.

Using the above website, you can also search for unclaimed property you might not have collected or determine if someone has claimed property you previously submitted to the state.

For more articles pertaining to small business owners, *subscribe* to our Blog at BCScpa.com! Find more info about charitable contributions, partnership debt, capital gains and much more!

Construction Industry: On the Rise?

by Nick Crowe

The construction industry has been hit hard over the recent years with the downturn in the economy. It appears that may soon change. The value of U.S. private and public building construction is expected to grow 11% in 2013 over 2012, according to the latest industry forecast from "Inter-Industry Forecasting at the University of Maryland" (INFORUM). With concerns about a recession relapse alleviated by Congressional action on "fiscal cliff" legislation of 2013, the industry is anticipating high growth in both new construction and renovation of commercial real estate. The fastest-growing construction sectors include multi-family, retail, and restaurant construction, according to the Association of General Contractors. Single-family housing construction should also rebound, as foreclosures slow and mortgage rates remain low.

While new construction remains a large percentage of revenue, a shift to modernization and retrofit projects has occurred. Retrofitting older commercial buildings to meet new technology and energy needs will also drive demand, according to the Independent Electrical Contractors. Energy efficiency is also a driver. Three-fourths of facility managers, building executives, and owners reported investments in energy efficiency in the past year, according to Johnson Controls' 2012 Energy Efficiency Indicator Survey for the US and Canada. About 70% of commercial building stock is 20 years old or older.

Some contractors depend on just a few large customers for much of their business, but most must maintain contact with a large number of potential customers, including general contractors, real estate developers, architects, engineering companies, and municipal governments. For small and midsized projects, most general contractors prefer to use subcontractors with which they have had positive experience because it lowers the project risk. Most public-sector construction projects are open for bidding by any qualified contractor, but residential work is often by referral. Success in getting contracts depends on good customer relationships, reputation of the company, safety record, bonding capacity, and experience in specialized fields.

To ensure timely execution of work, sometimes on simultaneous projects, companies use project management software. Contractors typically must coordinate their activities with a general contractor, other subcontractors, and with suppliers of materials and equipment. Software developers write software that specifically addresses contractor needs and issues.

Key factors that can lead to continual profits may include determining bid prices on contracts, planning for uneven cash flow, securing low-cost supplies, evaluating customer relationship management systems, improving project management systems, hiring for uneven workflow, increasing safety training, maintaining strong customer relationships and securing job bid opportunities.

Apples, Oranges & Lemons

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These assets have a useful life greater than a year, so we are required to depreciate these assets over time. Due to favorable depreciation laws, we generally have been able to depreciate the full cost of equipment purchases in the year of acquisition. However, some assets (like building improvements) are generally depreciated over several years, meaning that the cash that was spent in the current year ends up being partially deducted over multiple years. The second common difference is loan repayments. We can only deduct loan interest; principal payments are not deductible. While this may seem unfair, the economic reality is that the loan proceeds were not treated as income when the loan was funded. The result is that a company could report $50,000 in income and have made $50,000 in loan principal payments thus generating a $0 cash increase for the year.

And then there's the accrual-basis entity – cash and net income will rarely ever correlate in these entities. Under the accrual method of accounting, income is recorded when a customer is invoiced and expenses are recorded when a bill is received. If a company's accounts receivable increase $200,000, the company effectively has reported $200,000 of net income with $0 increase in cash. The opposite is true with respect to accounts payable. If a company reduces the accounts payable by $100,000, the cash has been spent but there is no effect on net income (remember the expense was already reported when the bill was received). The cumulative effect of the accrual based accounts can lead to a dramatic difference between cash flow and income.

The best tool for identifying these differences is a cash flow statement. The cash flow statement reconciles net income to the ending cash balance for the company. Let us know if you have questions about reconciling these items for your business. We won't ever be able to make a lemon an apple; but we can assist in finding the differences between the two.

Fraud Could Happen in Your Organization

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A much discussed concept related to fraud is the Fraud Triangle. This concept originated from Donald Cressey. According to his theory, "trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property" (Donald R. Cressey, *Other People's Money* (Montclair: Patterson Smith. 1973, p. 30).

The elements of the Fraud Triangle include:

- **Need**
- **Opportunity**
- **Rationalization**

Often, opportunity is the only element within the organization's control. Thus, appropriate internal control, review, monitoring and oversight is critical. According to news reports, it appears Ms. Crundwell had not only a need but also the opportunity. The fraud was uncovered by a fill-in employee that noticed various accounts that had multiple transactions. Upon this employee's further investigation, Ms. Crundwell's fraud began to unravel.

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Fraud Could Happen in Your Organization

by Kevin Peters

As you may have heard, one of the largest cases of municipal fraud occurred in Dixon, Illinois. According to news reports, Dixon comptroller, Rita Crundwell, has been accused of stealing approximately $53 million from the city over a span of 22 years. Her theft supported an over-the-top and lavish lifestyle which included homes, jewelry, a $2 million RV and championship level horse breeding operation. (*Rita Crundwell: America's New Queen of Municipal Embezzlement.* The Atlantic Cities.com, John Metcalfe, May 2, 2012).

In the 2012 Report to the Nations, issued by the Association of Certified Fraud Examiners, survey participants estimated that a typical organization loses 5% of its revenue to fraud each year. Further, the survey revealed the median loss caused by occupational fraud cases in the study was $140,000 and more than 1/5 of these cases caused losses of at least $1 million. (*2012 Report to the Nations* by the Association of Certified Fraud Examiners). Given these statistics, each organization should be concerned about fraud and the related risk factors that are present.

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This is part one of a four part blog series on fraud. Three of our Certified Fraud Examiners (CFEs) will continue on this theme over the next few months. Make sure you don't miss one by subscribing to our blog!