

**IN THIS ISSUE****The Woodsman****Malware + Smartphone =  
Identity Theft****A Small Token of Gratitude****New Name for Seasoned  
Practice Group****Blog Launch, "Firm Footing:  
Where we stand on the issues"**

FROM THE MANAGING PRINCIPAL



John M. Chandler, CPA  
jchandler@berrydunn.com

# The Woodsman

He worked and recreated in the woods his entire life—logging, hiking, fishing and hunting. He referred to himself as a woodsman. In 1961 he moved with his wife and baby son into an old cape with an attached ell and a large barn.

**If we are going to get out of the fiscal mess, we need more woodsmen.**

**H**e lived there for nearly a half century, laboring tirelessly on a bountiful vegetable garden to the side of the barn and a magnificent flower garden in back of the house. Over the years he entertained and educated countless visitors on a small front porch as he kept busy with myriad activities from whittling to husking corn to shelling dried beans.

Inside the house was a well-worn recliner with a view of the backyard through the porch door. In the summer, the heavy wood door with glass panes opened to a screen door through which one could feel the fresh air, smell the flowers, hear the running brook, and frequently catch a glimpse of fauna. I visited the woodsman one warm summer day and sat on the couch near the recliner in which he relaxed, ever so briefly, between outdoor activities. As we chatted about contemporary, mostly political, matters, I looked out the screen door at the flower garden in full bloom. In doing so, I observed a small solitary hole in the screen.

I inquired of the woodsman, "How'd you get that hole in your screen?" The woodsman

explained, "I shot a squirrel." "Let me get this straight," I said. "You shot out through the screen at a squirrel?" "That's right," he replied. "Why did you do that?" I asked. "Well, I damned well couldn't go outside and shoot back at the house!" I found it enlightening (but not surprising, given his epic battles with squirrels that raided his bird feeders) that there was no question as to the squirrel's destiny—only an explanation of the most judicious means of effectuating it. I paused. Then queried, "Okay. When do you plan on fixing the hole?" The woodsman looked at me with that familiar twinkle in his eyes and deadpanned, "I dunno. I may have to use it again."

In addition to having great fun at my expense, the woodsman was interested in government and politics. He was involved in town government for years on various committees (one could count on his being the lone dissent on most budget committee recommendations to town meetings) and as a selectman for nine years. A registered Republican, he was what I can best describe as a libertarian. He loved the town meeting format and believed in (CONTINUED ON BACK PAGE)

ADVISOR

# Malware + Smartphone = Identity Theft

**H**ow can you protect yourself and your employees from losing credit card numbers, private personal information (Social Security numbers, addresses, dates of birth), or financial information (bank account numbers, login IDs, passwords) from a mobile phone?

## A moving target

There are now 234 million smartphone users, including many of your employees. At least 47% of mobile phone users have some form of a "feature" phone, so even if they don't have a paid cellular data plan, users with Wi-Fi-enabled phones can surf the web, text to others, and get emails, whenever they access free Wi-Fi. And anytime they go on the open Internet, they potentially expose their devices to malware (malicious software that can disrupt an operating system).

## Where's the risk?

Android phones have the most users, and, not surprisingly, Android has the most malware, with an increase of 580% between September 2011 and September 2012. Android may be the most popular smartphone, but it's also the least secure smartphone. Google created the Android operating system, but it writes very few of the "apps" (small programs that do various activities) that its online "Play Store" sells. The applications are developed primarily by independent software developers, and Google does not review the applications for security risks.

Apple doesn't write many applications, either, but it puts the ones it sells through a thorough vetting process, and only allows iPhone users to install apps via the iTunes store. While there are reports that Google might improve its

vetting process for its own apps, it continues to allow Android users to install applications obtained outside the Google store, which means those apps won't be vetted at all. That's fertile ground for unsuspecting users to download a free game or a knockoff of a legitimate application that contains malware.

## The biggest risk is...

Our mindset. We may still think our smartphones are just phones, but they have the ability to play games, watch videos, send messages, take and store pictures, get email, and surf the web, which means they are as vulnerable as computers. They are computers, just very small ones.

If your employees use smartphones to access your company's systems, you need to account for those smartphones in your IT security planning. Educate your employees about the ways in which their smartphones could become infected by mal- (CONTINUED ON PAGE 3)

## A Small Token of Gratitude: How to account for "de minimis fringe benefits"

### How big is "small"?

**I**f you provide your employee with property or services that have a small (nominal) value, and accounting for them is unreasonable or administratively impractical, this qualifies as a "de minimis" fringe benefit. The value of the benefit is determined by the frequency provided to each individual employee or, if this is not administratively practical, by the frequency provided to the whole workforce. For example, the meal at an annual employee holiday party would qualify as a de minimis fringe benefit. There are special rules that provide limited exceptions for employee length of service or safety achievement awards of tangible personal property (which do not include cash, gift cards or certificates, or other cash equivalents).

### The gift that keeps giving: No taxes on de minimis benefits

De minimis fringe benefits are not subject to income and employment taxes. The IRS has not established a dollar threshold that can be applied when determining if goods and services qualify as de minimis fringe benefits. If a fringe benefit does not qualify as de minimis, generally the entire amount of the benefit is taxable and is subject to all payroll and income tax withholding.

Whether or not the fringe benefits you offer your employees are taxable, you may want to let your employees know.

### Cash doesn't count

Cash or a cash-equivalent benefit (e.g., a gift certificate, gift card, or other stored-value card) is generally not a de minimis fringe benefit. This means that providing employees with nominal amounts of cash or gift certificates (e.g., a \$50 gift card for meeting a goal) do not qualify as a de minimis fringe benefit. The receipt of cash by the employee is always taxable even if the employee uses the cash to purchase otherwise de minimis benefits. For example, cash provided to an employee for theatre tickets is fully taxable even though the value of the theatre tickets given to an employee might be excludable as a de minimis fringe benefit.

### Read the fine print

A certificate that allows an employee to receive a specific item of personal property that is minimal in value (e.g., a certificate for a Thanksgiving turkey), is provided infrequently, and is administratively impractical to account for, may be excludable as a de minimis benefit, depending on facts and circumstances. However, gift certificates that are

redeemable for general merchandise or have a cash-equivalent value are not de minimis benefits and are taxable. For example, an employer's \$35 gift coupon that is redeemable for anything sold at a particular store is a cash-equivalent taxable benefit subject to payroll taxes. Even though the coupon contains several restrictions that limit the time period in which the coupon can be used and stipulate that unused portions are forfeitable, which prevent the employee from converting any of the certificate to cash, such employer-provided gift coupons operate in essentially the same way as a cash-equivalent fringe benefit and so do not qualify as de minimis fringe benefits.

### Deciding what to give

It's a truism that the value of a gift, especially for employee morale, is worth much more than a dollar amount. When you decide which fringe benefits to give your employees, you probably consider several factors: What's the purpose of the benefit? What's appropriate for the employee? What expresses the firms' gratitude best?

While the tax implications of the fringe benefit may not be your deciding factor, it's certainly something to consider.

# New Name for Seasoned Practice Group at BerryDunn

We're pleased to introduce you to our state and local tax experts, collectively known as SALT.

**W**e sat down with John Weaver, head of SALT and a senior manager in our Manchester office, and Dave Erb, Principal and Practice Group Leader for BerryDunn's Tax Consulting and Compliance group, to chat about SALT.

**Q:** You've long been advising clients on state and local issues. Why is it important now to formalize your SALT efforts?

**DAVE:** It's no secret that state and local governments are looking for new sources of revenue. Taxes are certainly one of the items at the top of their list.

**JOHN:** They're more strictly enforcing existing tax laws that may not have been on a company's radar—like sales and use tax. It also means we're seeing new laws and regulations being put forward all the time. And new interpretations of old laws.

## It's increasingly common for businesses to be multi-jurisdictional these days.

**DAVE:** Exactly. Businesses realize they may be facing more liabilities than ever before, but they don't always have the time or wherewithal to keep up on the day-to-day changes. Better technology makes it easier for states to track who is doing business in their jurisdiction, so it's important to get it right.

**JOHN:** That's where our SALT practice comes in. We can offer a collective, one-stop resource on the latest laws and rulings. Clients want to know precisely how a SALT issue might affect them. But because these laws are open to interpretation, there is a lot of confusion. We help people figure out how to address or avoid exposure.

**Q:** What types of companies need to keep an eye out for SALT issues?

**DAVE:** Everyone. It's increasingly common for businesses to be multi-jurisdictional these days.

**JOHN:** So many New England companies conduct business across state borders, whether it's a Maine construction firm providing services in New Hampshire, or a Massachusetts firm with a sales rep in the Midwest.

**DAVE:** This means you not only need to know your local state laws, your company may be subject to regulatory changes across the U.S., wherever you have business dealings.

**JOHN:** And the Internet has changed everything.

**DAVE:** You might not think twice about ordering a \$40 book from Amazon.com for your office. But if all of your employees are doing that, it's easy to quickly rack up the local sales or use tax you owe but not as easy to keep track of it.

**Q:** Looking ahead, what do you see in the future for SALT regulations?

**DAVE:** SALT regulations have been around for a long time, but states have new and better ways of enforcing and auditing for them. Your business transactions and movements can be quickly and easily tracked: 1099s, cellphone call records, credit card receipts, electronic invoices of online purchases, and even electronic toll booth collections.

**JOHN:** We know we're going to see SALT issues ramp up in the coming years, so we're getting our clients ready. We want to help them keep track of everything, look for opportunities in tax planning, and optimize their tax savings. It all comes down to knowing which of the many regulations apply to each company. We want to help our clients gain control over their liabilities and gain confidence that they are paying as little as possible while staying compliant.



(IDENTITY THEFT CONTINUED)

ware, which, in turn, could provide information to the company's systems. Smartphone users must make the same security decisions they do on their computers:

- Don't click on links sent by email or text message.
- Don't call phone numbers sent by texting—even from people you know. It's not safe.
- Don't install applications on Android phones unless they are in the Google "Play Store" or otherwise vetted through a trusted source.
- Don't respond to the emails that ask for your personal information in order to resolve an urgent matter ("Your package is ready," "PayPal is shutting you off," etc.). Legitimate companies never communicate that way. If you're not sure, bypass the link in the email and go directly to the site, or call the company that sent the email.
- Apply a password, and set the phone to wipe (erase) itself if too many attempts are made.
- Don't put confidential passwords in your phone's "notes" feature. If the phone is stolen, all that information is captured, too. Purchase a legitimate application that will secure that information on your smartphone.

Even if your company has not issued the smartphones to your employees, you are still vulnerable. Create company policies and procedures that help your employees help themselves with mobile phone security.



100 MIDDLE STREET  
4TH FLOOR  
PORTLAND, ME 04101

36 PLEASANT STREET  
BANGOR, ME 04401

1000 ELM STREET  
15TH FLOOR  
MANCHESTER, NH 03101

300 CAPITOL STREET  
SUITE 1610  
CHARLESTON, WV 25301

PRSTD STD  
U.S. POSTAGE  
**PAID**  
PORTLAND, ME  
PERMIT NO. 174

**Learn more.** Visit us at [berrydunn.com](http://berrydunn.com) or call 800.432.7202. • Portland, ME • Bangor, ME • Manchester, NH • Charleston, WV

(THE WOODSMAN CONTINUED FROM PAGE 1)

limited government, fiscal prudence, and, above all else, individual liberty. While he understood the necessity of some form of governance, he believed that it should be held firmly in check by the will of the people. He was especially wary of the branch of government he called “fish cops”—game wardens—but he maintained a healthy level of mutual respect with them, and managed to stay within the boundaries of the law.

He cared deeply about family, friends, and fellow townspeople, working tirelessly as a volunteer, raising funds to help the community, and lending a hand whenever a neighbor needed help. He never sought fame or accolades. He just did these things because it was right and made him feel good. If “W” hadn’t wrecked the term for all eternity, I would have thought the woodsman a “compassionate conservative.”

The woodsman was—still is—my father John Royce Chandler, who passed away on October 4, 2012. These few words tell very little about all he accomplished in his life but much about his spirit, character, and the reason he was loved by so many.

Our country engaged in a heated Presidential race. Before the woodsman passed we

asked him who he would support for President. We asked him if he would vote for Romney and he replied in the negative. We asked him if he would vote for Obama and he replied in the negative. He simply didn’t believe that either of them really “get it.” While the woodsman and I weren’t always in lock-step, with that analysis I concur. If we are going to get out of the fiscal mess we need more woodsmen: more people who believe in self-sufficiency and civic engagement, good arguments and good humor. We may need to remember a time when not everything was either/or, and we could see old problems in new ways. Sometimes a door isn’t just a door. It’s a sight.



**To support our brand promise of knowledge sharing, we have launched our blog, “Firm Footing: Where we stand on the issues.”**

Visit [berrydunn.com/firmfooting](http://berrydunn.com/firmfooting) to read:

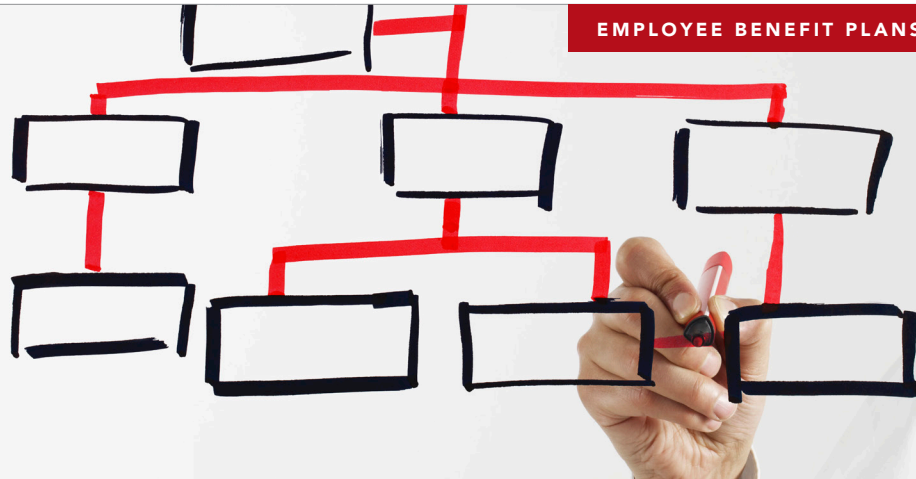
- Our thought leaders and subject matter experts in their own voices
- Incisive commentary on business topics in the news
- Clear explanations and announcements of deadlines and regulation changes

- Answers to frequent questions from our clients and prospects

Please leave comments and questions, and share the conversation with colleagues who can gain traction from our perspectives.



This newsletter supports BerryDunn marketing of professional services, and is not written tax or business advice directed at the particular facts and circumstances of any person. If you are interested in the subject of this document, we encourage you to contact us or an independent tax or business advisor to discuss the potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this newsletter may be considered to contain written tax advice, any written advice contained in, forwarded with, or attached to this article is not intended by BerryDunn to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.



# A Reasonable Approach to Determining “Reasonable” Retirement Plan Fees

Last summer, your retirement plan service providers were in a race against the Department of Labor’s deadline to provide employers with written fee disclosures by July 1, 2012.

**M**ost made the deadline. Employers received the requisite initial disclosures... and then all went quiet.

## Are we there yet?

If you’re like most employers, you have disclosures in hand, but have taken no subsequent action. You have a few more very important steps to take.

The retirement plan service provider fee disclosure rule was promulgated by the Department of Labor (DOL) so that employers would have the information needed to assess, in part, the reasonableness of total compensation, both direct and indirect, paid to retirement plan providers by retirement plans covered by the Employee Retirement Income Security Act (ERISA). Many employers have simply “filed” the disclosures they have received, under the mistaken impression that their work is done. The opposite is true.

## Review the fee disclosures

The DOL, as part of its normal audits of retirement plans, is looking to see whether employers and other responsible plan fiduciaries have followed a process to review the fee disclosures to determine if the fees charged are reasonable in relation to the services provided. Absent any such process, the DOL may determine that the fee arrangement is unreasonable. This

could give rise to a prohibited transaction, and put the plan, employer, and fiduciaries at risk of adverse participant action.

## So why haven’t many employers reviewed their plan’s service provider fee disclosures? Here are the leading causes:

1. The disclosures are often quite long and technical (i.e., hard to read).

**Many employers have simply “filed” the disclosures they have received, under the mistaken impression that their work is done.**

2. The employer does not have the expertise to determine reasonableness.
3. This requirement is brand new, and most employers have no process in place to review fees and services.

## Measure the fees for “reasonableness”

We suggest that an employer that sponsors an ERISA-covered retirement plan (401(k) and 403(b) plans being two of the most prevalent) assess and document that the fees being charged are reasonable in relation to the services provided. An employer can do this in-house, but, in many cases, it may make more sense to outsource the process.

## Here are some broad steps that you can take to analyze fees and services:

- Analyze the disclosure to ensure that all DOL’s required information has been provided.
- Measure the reasonableness of the fees, either through a Request for Proposal (RFP) or benchmarking.

The RFP methodology for determining fee reasonableness can be cumbersome and should probably be saved for those cases where the employer has used a particular provider for a long time or where there may already be service issues with the current service provider. The benchmarking process is simpler and, if done properly, should result in adequate information to determine fee reasonableness.

There are many benchmarking service providers in the marketplace, and each differs in terms of price and methodology. Each provider, of course, claims to be the best. Here is where you may want to turn to your current plan advisors for assistance. Whether from an accountant, attorney, or independent plan advisor, help is available with respect to benchmarking. But it will take action by the employer to put the wheels in motion.

## Learn more

Scan the QR code with your smartphone to watch our video on fee disclosure rules on the BerryDunn website, or visit <http://bit.ly/FeeDisclosureVideo>.



# How to Retain and Reward Your Talent

## Nonqualified deferred compensation benefits for employees

**W**hen your company has management that you want to retain and reward through an incentive compensation plan, you might consider stock-based compensation. It has the advantage of allowing your company to use current cash for purposes other than compensation, and it has a strong incentive component because the ultimate value to the participating employee will depend upon company performance. There are generally two types of stock-based compensation: synthetic equity and actual equity.



## An effective compensation plan aligns employee incentives with the company's goals.

### Synthetic equity: Phantom stock and SARs

Synthetic equity, where an individual does not have actual ownership, includes phantom stock and stock appreciation rights (SARs). By using phantom stock or SARs, your company can provide an equity-based incentive without issuing additional stock. This provides an

attractive alternative for closely held corporations that are reluctant to issue stock to persons other than the current owners.

Phantom stock is a form of nonqualified deferred compensation (subject to Internal Revenue Code Section 409A) whereby an employee's benefit is based on the performance of hypothetical shares of company stock over a period of time. The benefit is typically an amount equal to the fair market value of the hypothetical shares of common stock on the specified distribution date.

SARs, on the other hand, are rights to be paid an amount equal to the difference between the value of a specified number of hypothetical shares of stock on the date the SARs are granted and the value of the stock on the date the SARs are exercised. Some companies favor SARs over phantom stock because SARs provide value only if the company stock gains value, unlike phantom stock, which provides value to the recipient even if there is a decline in the company's stock price. However, phantom stock makes sense in those situations where you want to recognize an employee's past contributions (as well as future performance), because the phantom stock has value to the employee on the day it is granted.

### Actual equity: Stock grants and stock options

Actual equity, whereby the company issues additional shares of stock, includes direct stock grants and stock options in which an employee obtains, or has the right to obtain, an actual ownership interest.

Stock grants can be either restricted or unrestricted awards of company stock at no cost, or at a nominal or reduced cost, to the individual in connection with the performance of services on behalf of the sponsoring company. With restricted stock, the certificates for the shares are issued in the name of the participants but held by the company until certain conditions are met. One of the most common conditions imposed by companies is that the participant continues in the employ of the company for a specified period of time. The restricted shares are subject to forfeiture in the

event the conditions are not met. The holder of restricted stock typically has the right to vote the shares and receive dividends and other distributions from the date of grant, although the shares generally are not transferrable prior to the fulfillment of the specified conditions.

A stock option is a right granted by a corporation to an individual to purchase the stock of the corporation at some point in the future for a specified price. The optionee may, but is not obligated to, exercise the option on the exercise date (or during the exercise period). There are two stock option alternatives: incentive stock options (ISOs) and nonqualified stock options (NSOs). An ISO is a right (i.e., an option) granted by the sponsoring corporation to a group of employees to purchase shares of the corporation's stock, generally at a price fixed at the date of grant, for a specified period of time. The option price may increase periodically, and the exercise of the option may be conditioned on the occurrence of certain events. In order for an option to be considered an ISO for tax purposes, the option must satisfy certain requirements (e.g., options must be granted at fair market value pursuant to a plan and generally exercised within 10 years of the date of grant). As long as the requirements are met, ISOs generally provide better tax consequences for the participants than do NSOs.

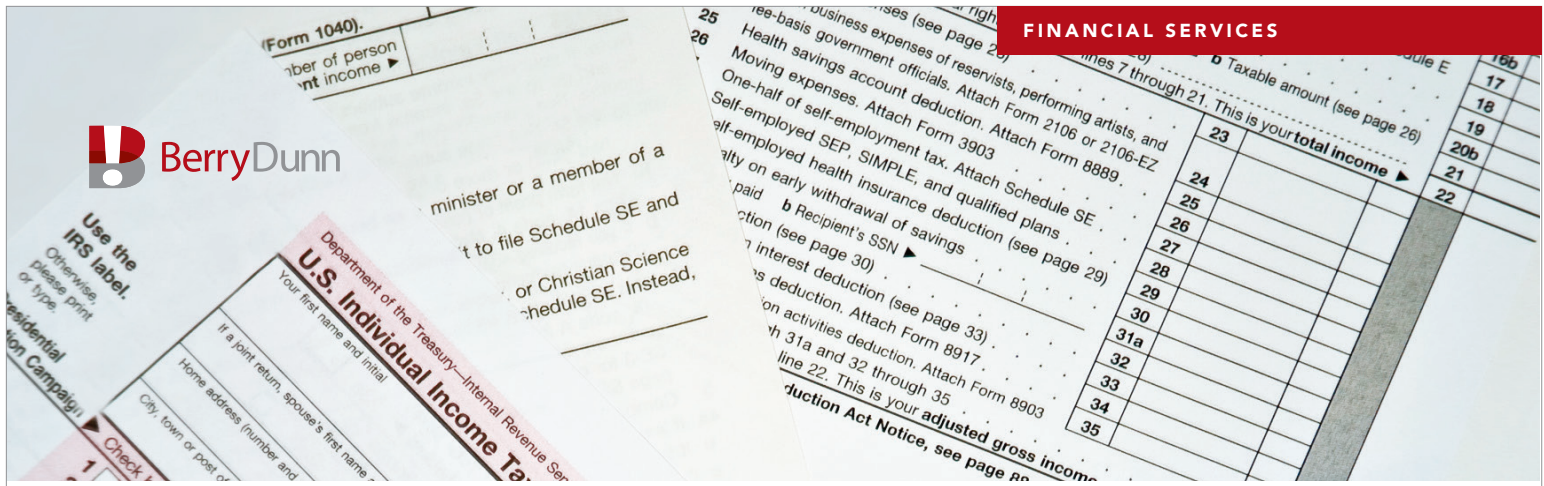
Any option that does not meet the requirements of an ISO, either because it was not designed to be an ISO or because it was so designed but does not follow the requirements operationally, is considered an NSO. NSOs are highly flexible and may be issued pursuant to a plan or individually. Since the enactment of Internal Revenue Code Section 409A, most NSOs are now issued at fair market value on the date of grant.

Some companies favor stock options over stock grants because options, like SARs, provide value only if the company stock gains value, unlike stock grants, which provide value to the recipient even if there is a decline in the company's stock value.

### Vesting schedules

Oftentimes, there is a vesting schedule associated with grants of synthetic or actual equity. This means that the right to receive the benefit is subject to certain conditions (such as continued employment or service). Vesting schedules are important with respect to employee retention.

Keep in mind that each of the plan design alternatives discussed above has compliance requirements that you should discuss with your company's plan advisor. The variety of incentive compensation plans available allows you to put into place the one—or combination—that best suits your company's goals.



# Directors' Benefits:

## Form 1099-MISC vs. Form W-2

If your financial institution provides its directors with compensation in the form of directors' fees and benefits, you already know that the reporting requirements for each type of compensation can be complicated.

**R**eporting the compensation incorrectly to the directors can have negative tax consequences. To help you determine the correct IRS form for your situation, we've laid out the most common scenarios and their respective forms.

### Directors' fees

A corporate director is considered to be an independent contractor, not an employee, in the eyes of the IRS. This means that your financial institution should report fees paid to a director on Form 1099-MISC and not on Form W-2, which is used for employees. The income reported on the director's individual income tax return will be subject to self-employment taxes.

Since the IRS views directors as being in the "business" of serving as a director, they are entitled to deduct ordinary and necessary expenses of carrying on the business on their individual income tax returns. Typically, these expenses are deducted as business expenses, not itemized deductions, and are not subject to limitations based on income. However, if the director is also an investor in the corporation, the expenses may be treated as investment expenses, in which case they would be reported as miscellaneous itemized deductions and would only be deductible to the extent they exceed 2% of the director's adjusted gross income.

### Reimbursements

If your institution reimburses a director for

expenses incurred in relation to duties, the reimbursements should be included on Form 1099-MISC as additional compensation. Directors who file income tax returns as sole proprietors are permitted deductions for amounts reimbursed and included on Form 1099-MISC. For example, if \$1,000 of travel expenses were reimbursed to a director, the reimbursements would be included on Form 1099-MISC as additional compensation and the expenses would be deductible against the income, effectively "zeroing out" the additional income reported on Form 1099-MISC.

This is different from employees who receive reimbursement, who would not include the reimbursement in income, nor be entitled to deduct the same expenses on their personal income tax returns.

### Planning opportunity

Directors may be able to postpone paying tax on income earned in connection with their duties by making deductible contributions to a pension or profit-sharing plan for self-employed individuals known as a Keogh plan. Directors are entitled to make deductible contributions up to 20% of qualifying income (up to a maximum of \$50,000 in 2012). Directors' participation in Keogh plans would be in addition to other qualified pension and profit-sharing plans in which they already participate as employees, and contributions to those other plans do not count toward the limit for contribution to the Keogh plan.

### Other types of benefits

In addition to fees for their services, your directors may receive compensation in the form of benefits. The way in which your financial institution reports these benefits to the directors can vary depending on the type of benefit and the manner in which it is paid.

**HSA contributions:** Since a director is not considered an employee for benefits purposes, HSA contributions made on behalf of directors are included in their income and reported on Form 1099-MISC. This income will be aggregated with their other director compensation and may be subject to self-employment tax. Assuming they meet certain requirements, directors should be permitted a deduction for the HSA contributions on their individual income tax returns.

**Term life insurance:** Term life insurance provided to directors is included in their income and reported on Form 1099-MISC. This income is subject to self-employment tax. The amount that should be reported is the premium payment made on behalf of the director. The same rules apply to group term life insurance premiums.

**BOLI:** Under plans in which a director's beneficiary may receive a death benefit (e.g., the beneficiary receives the benefit in excess of the cash surrender value), an amount of imputed income should be reported to the director on Form 1099-MISC. As this area can be very complex, financial institutions should work with their benefits consultants and outside advisors to compute any amounts that may be considered imputed income. Failure to report the imputed income may result in taxation of the life insurance death benefit.

**Director and employee:** The rules become more complicated when directors also perform activities that would cause them to be considered current or former employees under the IRS employment tax rules. It depends primarily upon whether or not the director performs services that are not directorial in nature, and whether (CONTINUED ON BACK)



## Our Perspective on the Private vs. Public Company GAAP Debate

In August 2012, the Financial Accounting Standards Board (FASB) issued a discussion paper soliciting input on its preliminary recommendations regarding a private company financial statement decision-making framework.

**T**he comment period closed October 31, 2012, and a proposed rule change could be issued in 2013.

### Should there be separate standards for public and private companies?

The debate on whether there should be a separate set of standards for private versus public company U.S. generally accepted accounting principles (GAAP) has been long and hard-fought. The Financial Accounting Foundation (FAF), which oversees FASB, first issued a request for comment in October 2011. The comment request focused on whether GAAP needed exceptions or modifications to better address the needs of users of private company financial statements. FAF outlined a plan to establish a new group to work with FASB to conduct a review of existing GAAP, identify standards that require reconsideration, and vote on possible exceptions or modifications for private companies. Any proposed changes to existing GAAP would undergo thorough due process, including public comment, and be subject to ratification by FASB. The proposed group, now known as the Private Company Council (PCC), would be overseen by the FAF Board of Trustees.

### They're asking the wrong question

BerryDunn issued a response to the request for comment in January 2012, making the argument that the focus of the debate was misguided. We recommended that changes to GAAP should be based on the needs of the

users of the financial statements, rather than the nature of the entity issuing the financial statements. Using a GAAP conceptual framework that focuses on fair value and cash flow information—or a hybrid of those depending on the needs of the users—would be, in our view, a more logical approach. Companies currently have flexibility based on the needs of the users: private company entities have the option of preparing financial statements using GAAP, or they can use a variety of other comprehensive bases of accounting, such as the cash basis or income tax basis.

FAF's proposed changes in the discussion paper do not give consideration to exploring these fair value/cash flow bases of accounting if doing so would be more useful, but instead tie the accounting method to the nature of the company.

### FASB gives guidance, but doesn't go far enough

FASB's 2012 discussion paper outlined that FAF established the PCC as a separate body with the purpose to improve the process of setting accounting standards for private (i.e., nonpublic) companies. FASB staff issued recommendations in the discussion paper to assist FASB and PCC in developing the decision-making framework to be used for circumstances under which recognition, measurement, disclosure, presentation, effective date, and transition requirements should be adjusted for private companies under GAAP.

The discussion paper proposes that FASB and PCC would jointly determine whether the recognition or measurement guidance being evaluated provides relevant information to users of private company financial statements at a reasonable cost, using a pre-determined list of factors to consider in assessing reasonable cost.

But no consideration to the development of two separate conceptual bases of accounting based on the needs of financial statement users in a particular circumstance is currently on the table.

### What is a private company? Our approach solves the definition issue

One of the million-dollar questions continues to be: What is a private company? FASB has issued tentative decisions as to how to define a private company, but stay tuned on that. Answering this question has been a real struggle for FASB, while our recommended approach neatly sidesteps the need to develop a (necessarily somewhat arbitrary) definition.

The full discussion paper can be found at [http://bit.ly/FAF\\_DiscussionPaper](http://bit.ly/FAF_DiscussionPaper). BerryDunn issued a comment letter on the discussion paper reinforcing initial recommendations in the January 2012 response, which can be found at <http://bit.ly/FASBLetter>

### (BENEFITS CONTINUED)

or not those services are performed under an employer/employee relationship. The guides for determining whether a common law employment relationship exists are found in section 31.3121(d)-1(c) of the regulations.

Any compensation you pay to directors in their capacity as employees should be reported to the director on Form W-2 and will be subject to employment taxes. The Internal Revenue Code provides specific exclusions from taxation that apply to employees and not directors. In these circumstances, the institution would need to issue both a Form 1099-MISC and a Form W-2 to the director-employee. The institution would also need to have the director complete Form W-4, and withhold federal and state income taxes on the W-2 wages accordingly.

There are many other forms of compensation and benefits that may be paid to a corporate director. Therefore, we recommend a thorough review of all compensation plans including establishing a monitoring process to properly account for plan modifications and changes. Each form of compensation should be reviewed independently to determine both the amount of compensation and the manner in which it should be reported.





# Mission Critical:

## What Your Organization Needs to Know About Operating Reserves

**A**natural disaster hits New England and your organization's resources are stretched to the limits helping people cope. Do you have a nest egg?

Not-for-profit organizations juggle the need to put every dollar to use in today's programs while attempting to build enough of an operating reserve to keep the organization running in the long-term. Even organizations with substantial resources and solid endowments are not immune to financial short-

**A good rule of thumb for determining the amount of reserve is to first articulate and agree on the reasons for the reserve.**

ages—program cuts and closures, state or federal sequestration, or investment declines.

Few would argue with the need to have a certain level of discretionary resources available to any not-for-profit organization. While some voices contend that retaining more than a minimal reserve is excessive, most not-for-profit leaders, associations, and advisors see sufficient, board-designated operating reserves as a fundamental part of an organization's ability to deliver on its mission in a sustainable way.

### The real questions are:

1. How do you determine the right level of reserves?
2. How do you manage and report the reserves?

3. How do you create a reserves policy that works for your organization for the long term?

### How much is enough?

There are different methods of both determining and expressing how much an organization should designate as an operating reserve. It can be expressed as a ratio, a specific number of months of the annual operating budget or working capital, or even as a board-designated funded reserve of a specific dollar value of unrestricted net assets.

Establishing a specific level of reserves is not an exact science, although the calculation is fairly straightforward. Depending on the organization and its tolerance for risk, a good rule of thumb for determining the amount of reserve is to first articulate and agree on the reasons for the reserve (e.g., to weather a funding fluctuation or to respond to a community emergency). Next, identify what kinds of funds should be included. The nature of the mission and the complexity of the organization are critical components in determining the appropriate level of necessary reserves.

Some organizations include funded depreciation or funds earmarked for fixed asset acquisition; others include only unrestricted net assets, and still others include temporarily restricted activity. Attention to funded depreciation can assist with planning for upkeep and future expansion to reduce reliance on debt financing. Concentrating on unrestricted net assets focuses on the orga-

nization's general operations and cash flow needs. However, understanding the type and level of temporarily restricted net assets that support operations is also a key consideration when determining the appropriate type and level of reserves.

Risk is also central to the calculation. The greater the organizational risk, the greater the level of operating reserves necessary for long-term viability. For perspective, if your organization depends on a few customers and one of these customers runs into cash flow problems or delays in paying the organization, it would be important to have cash available to bridge the gap until you receive the payment owed. Some organizations may choose to do this through a line of credit; however, obtaining or incurring additional debt is not always the best decision.

The Nonprofit Operation Reserves Initiative Workgroup recommends a minimum operating reserve ratio of 25% (at the lowest point in the year) or three months of the annual expense budget.

Ultimately, operating reserves are designed to support an organization through uncertainty, whether that uncertainty is a new opportunity or a funding shortfall. Not all organizations may be able to fund the reserve to the full capacity immediately. Creating a target and a financial road map as part of the annual budgeting process until the organization achieves the desired level of funding should be a priority for management and the board. Knowing the normal reserve levels for similar institutions and programs may help you set your organization's own reasonable targets.

### Develop a flexible long-term policy

A written, board-approved operating reserve policy helps your organization ensure that the operating reserves are used as intended, invested appropriately, and allowed to be reasonably flexible within the guidance. This is particularly true for an organization that might expand programs through acquisitions or that may be heading into a different stage of its lifecycle. Regular (CONTINUED ON BACK)



# New Trends in Not-for-Profit Executive Compensation

**M**any not-for-profit (NFP) entities are changing how they design their executive compensation practices. New rules regarding Form 990 compensation reporting may be driving this process, but greater public, federal, and state scrutiny of deferred compensation certainly plays a part. Knowing the emerging trends can help your organization assess whether it's the right time for you to make changes, too.

## Formalize the process

In general, NFP boards are becoming more formal in how they design and review executive compensation packages. It used to be

**Design incentive measures that both support your mission and reward your executive for strong performance.**

that only the largest NFPs named a "compensation committee" to handle the design, implementation, and review process; these days, no matter your size, you should consider forming a compensation committee. Then, document the process carefully. This is important both from a regulatory standpoint (to demonstrate reasonable compensation) and from a public policy perspective.

Your compensation committee can either engage an outside consultant to assist with

compensation and benefits benchmarking and design, or you can use benchmarking tools available on the Internet. Expanded reporting on the annual Form 990 has contributed to the availability of comparative information.

## Use of incentive compensation is on the rise

While base compensation is still king, the clear trend is for greater use of both short- and long-term incentive compensation. You can use incentive compensation for both recruitment and retention. Annual incentive awards are becoming more common for senior executives, and typically are targeted at 10%-30% of base compensation. This trend toward greater use of pay-for-performance is likely to continue, but the challenge is to design incentive measures that both support your mission and reward your executive for strong performance.

Once long-term incentives come into play, NFPs generally involve an outside advisor because such programs are almost always subject to complex rules in the Internal Revenue Code [Sections 409A and 457(f)]. Failure to comply with these rules can result in painful consequences.

## Defined benefit formulas are losing popularity

In the past, your executives may have received "defined benefit" supplemental executive retirement plan (SERP) benefits, where a certain annual benefit during retirement was promised (often as a percentage of annual compensation) on a nonqualified basis. Today,

you're less likely to see new executives receive a defined benefit arrangement. Most new nonqualified deferred compensation plans are designed as "defined contribution" plans, to which a certain dollar amount is awarded annually or upon a pre-determined event (e.g., retirement). Any benefits paid are based on what has been set aside or awarded, not as a guaranteed percentage of compensation. This change parallels what is happening in the qualified retirement plan marketplace.

The big issue facing many organizations is the continuing uncertainty about the law regarding Section 457(f) plans. The IRS has been promising new, clarifying rules on such plans for the past two years, but the issuance date for proposed regulations keeps getting pushed back. As a result, we know one thing certainly will not change yet: designing a useful and compliant NFP nonqualified deferred compensation plan will continue to be a challenge.

## (MISSION CRITICAL CONTINUED)

policy review can help determine that the reserves are neither excessive nor insufficient for the organization as it evolves.

The policy your organization develops should be driven by the reasons the board or management identifies and agrees to in creating the reserve in the first place. If the reserve needs to sustain the organization through a temporary cash flow crisis or dampen expected funding volatility, the policy—and size of the reserve—should reflect that. If the reserve is meant to respond to community needs or opportunities as they arise, the policy should define the parameters (not too tightly) in order for the board to act consistently in the future.

## When creating the policy:

- Make sure the policy is clearly linked to the organization's mission
- Identify any actions that may be triggered when the reserve goes above or below the ceiling/floor for a specified period of time
- Address the liquidity and investment strategy of the reserve
- Determine the internal requirements and procedures regarding access to the funds

Setting the size of your reserve is based on the unique needs and stage of your organization. There is no precise formula that is right for all organizations of a certain type or of a particular size. The more specific you can be about what risks the reserve is designed to mitigate, the easier it will be for your board to create a policy that addresses the needs and opportunities of a dynamic organization.



# What Can Data Do for You?

## Data's influence in your daily life

Remember the popular United Parcel Service (UPS) commercials asking, "What can brown do for you?"

**W**ell, "What has data done for UPS?" As one of the premier data analytics companies in the world, data drives every facet of UPS's operations, down to whether its drivers make a left or right turn. (Fact: A right turn almost every time—it's safer and saves gas). While delivering boxes door to door may appear to be a simple, old-fashioned task, your UPS driver receives data, direction, and leadership from an organization that continually improves processes based on the mounds of data it collects from customers, workers, and even weather forecasters on a second-by-second basis.

### How to be the UPS of higher education

Like UPS, colleges and universities are in the delivery business. The college experience and learning that faculty and administrators deliver, however, will have a longer-lasting impact on your students than the Amazon box just delivered by UPS.

Most colleges and universities have already created a centralized data repository for student, employee, and organizational data. Ideally, these integrated systems provide campus leadership with a system of record that the president's team can use to make decisions about future program direction and student trends. This, in turn, should enable the organization to streamline operations, provide better student service, and inform strategic decision-making. Unfortunately, the reality for too many schools today is that data

has remained siloed, and, in some cases, lacks integrity and quality. It's difficult to move an organization forward based on information that cannot be verified or trusted by leadership.

You have already invested hundreds of thousands of dollars in information systems, but what good are your systems if they're not helping to improve the services, accountability, and performance of your institution? The potential return on investment with data remains high, if you effectively harness the power of information.

## Like UPS, colleges and universities are in the delivery business.

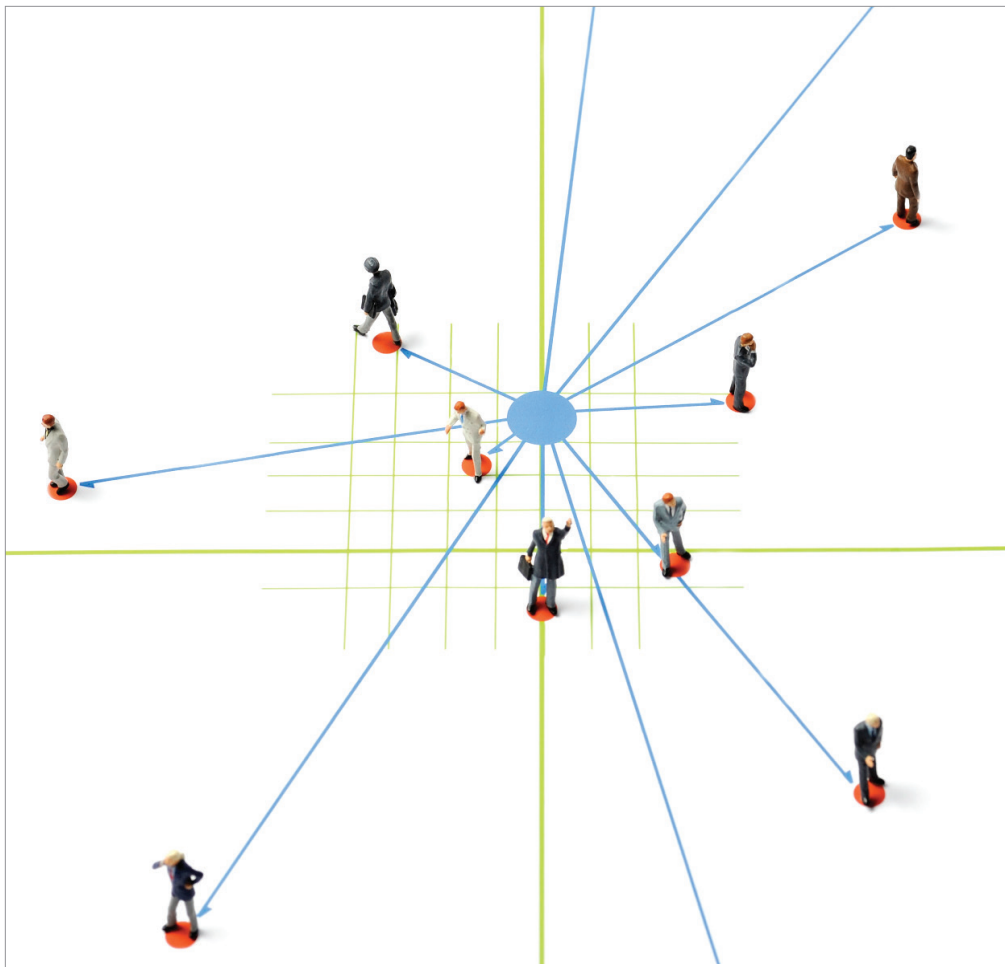
### The human side of data collection

While data collection is a technical task (with today's user-friendly technology, you don't need to be a computer scientist to master it), the outcomes are far from technical. Seemingly impersonal data can personalize mission-critical goals such as empowering students for success, improving learning, and supporting institutions that want to keep connected with students through graduation and beyond.

- **Empowering students for success** Through conventional data analysis and statistics, many universities can determine the likelihood that a given student will graduate. But does the student know this? In the end, it's the students who need to know their academic standing, and learn to adjust to the demands that college life brings. To improve student success at the University of Kentucky, the IT department is developing an enterprise system workflow tool with an in-memory analytics engine that sends alerts to specific faculty members and advisors. This makes escalation and follow-up easier so students can receive preventive help before it becomes too late.

- **Improving student learning** Data collection can help complement—not replace—face-to-face instruction. At Purdue University, the IT department has a tradition of developing tools to assist the faculty in improving learning outcomes. One example of a tool that leverages social media is called "HotSeat." This application uses student conversations on Facebook and Twitter to improve student learning. Software captures student comments about a class and allows everyone (students and teachers) to view the comments. Students can post to HotSeat via their Facebook or Twitter accounts, or can send a text message through the website. Teachers use HotSeat to monitor student participation and pose questions to the class. Questions submitted through HotSeat can indicate to the professor areas that need more focus in order to increase student understanding.

- **Creating lifelong relationships** Opportunities exist outside of day-to-day operations. For alumni relations, a university can use social media data to gain a better understanding of who's actively engaged with the school and thus a more likely financial supporter. In today's age of shrinking sources of traditional revenues, institutions that leverage their social media investments can use the resulting data to stay connected with potential donors. (CONTINUED ON BACK)



# A Campus as Big as the Globe

Imagine the quintessential college campus as expanding rings: a grassy commons encircled by red brick dorms, surrounded by streets of tidy Victorians owned by the college and occupied by professors who walk to class. Now add another ring for your online students and their online professors. Then expand the circle for your faculty on sabbatical and your admissions officers who spend much of their time out of state. You're no longer looking at a college town; you're seeing a universe that spreads out as far as every employee can go.

## The state-by-state case law on nexus is changing rapidly.

### Keep track of your out-of-state employees

Does your college or university offer distance learning? Does your admission officer recruit out-of-state students? When your faculty members and other employees are no longer all local, neither are you. In general, tax-

exempt organizations are subject to the same state jurisdiction rules as any other business organization. Just because your institution is exempt from paying federal and state income tax does not mean that you are exempt from registering in a state, withholding taxes from employees, filing annual reports, and paying annual fees.

### Identify nexus

If your institution hires an employee who teaches from home in another state or who travels for work out of state, you may be required to register and file annual reports with that state. You also need to adhere to rules regarding withholding state income tax and paying unemployment tax. These employment taxes vary state by state, and some states levy taxes other than income taxes that could make a tax-exempt organization potentially subject to tax in that other state.

It all depends on the individual state; in gen-

eral, when you hire an out-of-state employee, you create what is called "nexus," in which you establish a physical connection with another state that causes you to be subject to that state's jurisdiction. The recent big nexus cases, like the Amazon.com sales tax agreements, concerned online retail sales, but the argument that your out-of-state employees create your exposure to nexus issues remains the same. The state-by-state case law on nexus is changing rapidly, but the trend represents increasing exposure to nexus, coupled with heightened enforcement by the states.

### Know your exposure

When your institution has any of the following types of employees, consult your tax advisors about possible registration, reporting, and tax implications in the relevant states:

- Many states have exemptions for not-for-profits, but not all (e.g., Massachusetts has no exemptions).
- Even if you are exempt (e.g., a college), you still need to file the registration form.

### Do your due diligence

Tax-exempt organizations are monitored by each state's attorney general or secretary of state, and getting accurate information about state filing requirements can be a challenge. As more colleges and universities engage in distance education over the next few years, we hope the rules—and enforcement—will become more obvious.

(DATA CONTINUED)

### Ensuring a compliant data governance model

Collecting and analyzing data is not without its concerns. Student privacy is well protected in federal and state regulations, such as FERPA and Massachusetts' CMR 17. Any data collection procedures must adhere to these regulations, especially given that some personal data collection practices have been deemed legally unacceptable. Your organizational data governance model must address these issues, and you may want to consult with an advisor, legal counsel, human resources, or your institution's IT policies to create a data governance model that's both effective and compliant. A comprehensive data governance strategy can help you get significant returns on the data investments that your institution has already made.

With the right planning and forethought, data can improve learning, support student success, and grow revenues—all this in a time when the "new normal" continues to apply pressure on resources and funding. By making better use of your data, you can better support both your students and your institution.