FALL 2013

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Raising Growth Capital

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Business owners face many challenges, but one of the most critical tasks is to ensure there is enough capital to prosper while achieving growth targets. Companies are generally able to generate sufficient revenue and operating profits, but they may not have excess capital to fund a transformational event for continued growth or expansion. For a relatively mature company, an entrepreneurial owner may need to look for capital from an external source to invest in people or equipment, introduce a new product or service, reduce the company's existing debt, or finance a significant acquisition.

Growth capital may be provided by a bank as senior debt, a mezzanine debt lender, or as an equity infusion from a private equity group. Companies that seek growth capital investments are often not good candidates to borrow additional debt, either because of the stability of the company's earnings or because of its existing debt levels. As a result, growth capital is typically sourced from a private equity investor, structured as either common equity or preferred equity, and often equating to a minority investment in the company.

The key to success in raising growth capital is being fully prepared. Since the capital raising exercise may involve providing ownership in your company to the private equity investor, there are several points to consider before engaging in this type of transaction:

- Know the current valuation of your company. If your company is mature and has a track record of profitability, then you certainly do not want to give away too much of the equity in your company. You should have a good idea of the amount of equity you are willing to offer to a potential investor.
- Develop a solid and achievable business plan with an executive summary. It is critical to have a growth plan that defines how much growth capital is needed, how the newly obtained capital will be utilized in the business, and how this capital will enhance growth in revenue and cash flows.
- Understand your growth capital readiness. Is your business attractive to a potential investor? Do you have a solid management team in place? Does the company have solid market traction with proven historical financial results? Is there any significant intellectual property?
- Identify business risks associated with your plan. Potential risks such as changes in competition, significant customer concentrations, technological changes, and global economic factors could impact your business model going forward. A well thought out business plan will address and/or minimize these risks.

Once you address these points and are prepared to seek potential investors, you should consider timing and how to identify the right investor partner. The best time to raise growth capital is when you can, not necessarily when you need it. This means when the market conditions are ripe, investors have the appetite to partner with businesses like yours, and the market views your industry sector favorably. Looking for capital when you desperately need it may not coincide with strong market conditions and, as a result, you may give up too much equity to an investor partner.

Finding the right investor partner is critical to a successful deal. The best partner will have interests that are aligned with yours. They will bring experienced advice and coaching and may have industry contacts and resources that will help your business grow and increase its overall value.

Raising capital can be a challenging and time consuming task for a business owner, but it is a critical component of the long-term success of a growth-oriented business. Whether you are looking to finance a significant acquisition, expand or restructure operations, enter new markets, or finance the development of a new product or service, you should consider all available sources of growth capital. Proper planning for such a transaction will likely translate into a successful deal and may drive increased value and continued growth for your business. **LE**

The Role of Your Board in Risk Management

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Whether you are the owner of a privately held company, a member of the board of a local non-profit organization, or a director on the board of a large, publicly held, multi-national corporation, risk management has become increasingly important.

The SEC's enhanced disclosure about risk, compensation, and corporate governance went into effect on February 28, 2010. Among other requirements, these rules require the following as it relates to risk management:

- Disclosure of a company's policies and practices related to risk management
- Background and qualifications of directors and nominees
- Board leadership structure and the board's role in risk oversight

Also in 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act was signed into law. In addition to its many requirements, certain financial companies must maintain a separate risk committee of independent directors.

These are just two examples of recent legislation and regulation. Even though they are targeted toward public companies, they could certainly find their way into smaller, non-financial, non-public companies going forward. Particularly with the 2012 press on significant investment loss at JP Morgan, the recent indictment of SAC Capital, and the continued economic and political uncertainty around the world, expectations should be that these best practices will have an effect on governance for all types of organizations.

This means that all members of an organization must play a role in risk management, including the board. A board already possesses legal fiduciary responsibilities, but its role in risk management is one of oversight. Its goal should be to work with management to understand the material risks a company faces so they can improve and protect the company simultaneously.

Board members can expect not to be involved in the day-to-day risk management of a company, as the responsibility to execute the risk management process lies with management itself. In its oversight role, the board should have a clear understanding of the risks inherent in the company's strategy. Some of those risks are in the following areas:

- **Financial –** This risk probably goes without saying, because it is usually a primary focus, but potential risks include cash flow concerns, investment volatility and liquidity, and too much leverage.
- **Fraud –** The primary focus should be on understanding the tone at the top and whether the three main risk factors – incentives/pressures, opportunities, and attitudes/rationalizations – exist.
- **Human Resources –** These risks can range from employees' health and safety concerns to employment practices, especially those surrounding discrimination and harassment, but they can also include compensation structure.
- **Insurance –** A board should have an understanding of the risks protected by a company's insurance policies, the costs, the creditworthiness of the insurer, and how the company's program compares to others in the industry.
- **Technology –** Recent news of cyber-attacks on businesses and discussions surrounding privacy make this an increasingly relevant area. Boards should understand the risks associated with mobile devices, the cloud, and social networking.
- **Reputation –** Each of the above categories, and indeed risk in all areas, plays a role in a company's reputation. Whether it is financial mistakes, news related to fraudulent activity, a sexual harassment lawsuit, or an inappropriate tweet, a hit to a company's image has a direct and material impact.

It is the board's responsibility to ensure there is a process in place to identify not only the risks above, but all relevant risk issues and all anticipated future risk. To do that, the board should have access to both internal and external information. The board should also expect to provide feedback to management on a timely basis. Due to the importance of its oversight role, it is essential that board members have the experience, training, and knowledge of the business to make a meaningful evaluation. **LE**

Be Aware of the State and Local Tax Implications of Employees Working Remotely

Thomas Frascella
Director, Tax Strategies

In today's service economy, the traditional office-based workforce has been replaced with a more mobile version. As employees become more flexible in their ability to work from multiple customer locations, it is more critical for their employers to understand the state and local tax implications of a mobile workforce.

Employees who travel to customer locations to perform work can create potential tax issues for your business as well as themselves. Most businesses typically apply the "physical presence" test to determine if there is any filing responsibility in a particular state. If your business is engaged in the sale of tangible personal property, this is generally a good rule to follow if the only connection with another state is for solicitation purposes only.

However, if you are a service-related business, you do not have a physical presence test to rely on to help you avoid additional state compliance burdens. The simple act of sending employees to another state to provide assistance to a customer can inadvertently create filing responsibilities you may never have anticipated. Depending on what your employees are doing at a customer location in another state, you might be required to register to do business in that state and file tax returns. Some states, like Pennsylvania, have a combined registration form that requires a business to register for all applicable taxes at one time; such registrations might lead businesses to register for taxes for which they are not required.

For your employees, working remotely can trigger the need to file:

- Entity level income tax returns, including income tax returns for the owners if the business is a pass through entity
- Net worth tax returns
- Withholding on employee wages earned while spending time at the remote location
- Withholding on pass through income of non-resident owners
- Sales tax returns and gross receipts tax returns

The administrative burden of complying with

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these additional filings can be overwhelming. Often, businesses are not prepared to comply with the additional reporting requirements imposed, such as sourcing revenues or wages to the states where employees may be working.

Plus, your employees may not realize they will have additional filing responsibilities and are often caught off guard when they are notified that taxes have been withheld and remitted to other states where they are not a resident.

Because of the cost to comply, businesses often "take their chances" that a state will not uncover this activity. Unfortunately, states are becoming more aggressive in their discovery techniques and pursuit of non-compliant businesses. As a result, the likelihood of discovery has significantly increased. You would be well advised to continually monitor changes in the way the business operates, including the introduction of new products and services, and determine how those changes might impact your state tax filing responsibilities.

Businesses usually apply a practical approach to state filing responsibilities, weighing the exposure against the cost of compliance. However, you should always be in a position to understand the risks and make an informed choice.

As employees become more flexible in their ability to work from multiple customer locations, it is more critical for their employers to understand the state and local tax implications of a mobile workforce.

Allowing employees to work and serve customers remotely has many benefits in our fast-paced, mobile business environment. However, employers with mobile workforces need a consistent and uniform approach to state taxation. Federal legislation that has been introduced over the years has attempted to create such consistency for businesses. Although none of this legislation has formally passed so far, it is never too early to ensure you have a solid process in place to address the effect on your business of geographic changes to your workforce's location. **LE**

Overview of the IRS Audit Process

Harry F. Murphy
Director, Tax Strategies

The primary objective of the Internal Revenue Service in "picking" tax returns for audit is to promote increased voluntary compliance.

The IRS uses computers and, to a lesser degree, manual identification to pick returns for audit. Tax returns are picked by IRS Campuses or Area Offices – the former IRS Service Centers. The returns are then further picked for correspondence, office, or field audit.

A computer program known as the DIF System (Discriminant Function) is used to identify tax returns. It uses a mathematical formula that assigns weights to certain return characteristics. Returns are ranked in numerical sequence based upon their score (highest to lowest). The highest scores have the most audit exposure.

The DIF System scores all individual returns, corporation returns with no balance sheets or assets under $10 million, and all S corporations with assets under $10 million. It also scores partnership returns, but it is believed the system may also use other criteria.

Over the years, the IRS has continually developed and changed its concentration regarding particular audit issues. Years ago, it used the "prime issue list" – an IRS guess of which tax items of income or deductions would produce the greatest results. In March 2007, the IRS decided to use a tiered classification system and placed audit issues into three tiers. Then in August 2012, the IRS stated it would no longer use the tiered system. While a new approach has not yet been announced, the items in the respective tiers still have significant dollar potential assessment. They include some of the following:

- The domestic production deduction
- Nonqualified deferred executive compensation plans
- Backdated stock options
- Mixed service costs regarding inventory costs
- Research and experimentation credit claims
- Foreign earnings repatriation
- Stock-based compensation
- Deferred home construction contracts
- Use of gift cards to defer income

Even after returns have been selected for audit, taxpayers may still avoid being audited if the IRS auditor believes the audit result would not produce enough tax.

The IRS has a policy against conducting "Repetitive Audits." However, the IRS does not have records readily available to determine if a proposed audit would be a repetitive audit. Taxpayers should immediately respond to the initial IRS contact letter and indicate they were audited in either of the two preceding years and the result was a no change or a small tax adjustment. If the response is received before the initial interview, the audit notice will be withdrawn.

The normal statute of limitations is three years from the due date of the tax return. Presently, the IRS follows a 26 month audit cycle for individual tax returns and a 27-month cycle for business income tax returns. This essentially means that for most income tax returns, if they are flagged for audit, the audit will be conducted within two years of filing the return.

The Whistleblower Awards Program has two types of informant awards. The first has been in place for years. The IRS will pay cash – up to 10 percent of the tax collected – for information it deems "necessary." The second type of award resulted from the 2006 Tax Act. To qualify, business returns must be at least $2 million and for individuals the income adjustment must exceed $200,000 for any taxable year. The amount of the award will be at least 15 percent, but not more than 30 percent, of the collected proceeds. The IRS considers the value of the information provided in determining the percentage to be awarded. **LE**

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