Second Quarter 2011

YOUR CATALYST FOR STRATEGIES &

SOLUTIONS Newsletter

Private Company GAAP Under Consideration

The Financial Accounting Foundation (FAF) is an organization that, among other things, provides oversight and administration of the Financial Accounting Standards Board (FASB). The FASB is responsible for maintaining the Accounting Standards Codification, which represents accounting principles generally accepted in the United States (GAAP) for nongovernmental entities. In January 2011, the FAF Board of Trustees received a report from the Blue Ribbon Panel on Standard-Setting for Private Companies with the following recommendations:

A) Exceptions and modifications to US GAAP for private companies are needed.
B) A standard-setting board separate from FASB should be created to establish those exceptions and modifications.

The Blue Ribbon Panel was coincidently established by the FAF, the American Institute of Certified Public Accountants (AICPA), and the

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Guidelines and Regulations for Borrowing from a Qualified Retirement Plan

Borrowing from a retirement plan account has become increasingly common in these difficult economic times to help participants meet their financing needs. Many qualified retirement plans allow participants to borrow money against their vested account balances. Each retirement plan that includes a participant loan feature must establish a loan policy relative to that particular plan, and these policies can vary from plan to plan. It is vital for both plan sponsors and participants to understand the rules applicable to their plans before entering into a loan agreement.

ERISA (the 1974 law that governs all retirement plans) permits participant loans from plans that are qualified

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Meal Expense Deductions Take a Bite Out of Your Taxes

Most people believe in the old saying, "There ain't no such thing as a free lunch." While this is usually true, there are various exceptions to the tax rule that allows 50% of their otherwise allowable deductions for business meals. When one of these exceptions applies, you can get a 100% deduction for the meal expense, and nothing tastes better than a free meal!

Meals are 50% deductible when:

1) the meal is purchased when it is necessary for you to stop for substantial sleep or rest to properly perform your duties while away from home on business (generally means traveling at least overnight on a business trip); or
2) the meal is business related. Expenditures for meals are not deductible unless they are directly related to, or associated

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EXCEEDING EXPECTATIONS SINCE 1926

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National Association of State Boards of Accountancy. These recommendations are being taken under serious consideration by the FAF and would result in a substantial change to the current standard-setting process. The impact of such a change is considerable. While there are 15,000 public company issuers, there are over 28 million private companies that will be impacted by a change to the US GAAP standard-setting process.

CURRENT FAF ROUNDTABLE EFFORTS

As a Windes & McClaughry representative, I attended a roundtable meeting in May hosted by the FAF Trustee Working Group that was formed to address accounting standard-setting for private entities. The roundtable meeting was designed to solicit feedback from accounting firms within the top 125 on the challenges private companies face when implementing US GAAP and what type of changes should be made to the current standard-setting structure to respond to these challenges, yet ensure that the needs of the financial statement users will continue to be met. In addition to Windes & McClaughry, eleven other accounting firms were represented at this roundtable. There appeared to be a consensus, consistent with the Blue Ribbon Panel's findings, that many private companies are challenged by recent FASB standards created to account for variable interest entities, uncertain tax positions, hedging instruments, share-based compensation, and goodwill. These standards and others like them were developed with a focus on public companies and their users. For private companies, these standards may be overly complex and irrelevant at times for the needs of management and the financial statement users, such as banks, sureties, and private equity investors. There is a risk that the cost and effort required to comply with such accounting standards then becomes disproportional to the value produced in the financial statements.

The concept of "relevance" was a central focus of the roundtable discussion. For instance, is the fair value of a lender-required interest rate swap relevant to the users of a financial statement if the company plans to hold the instrument to maturity in order to fix its interest rate? Or, should a company consolidate an owner-occupied real estate variable interest entity when its lending covenants require the bank to then deconsolidate this information from the GAAP financial statements? Users of private company financial statements often have direct and ongoing access to management and are often considered insiders, thereby having a clearer understanding of the company's operations and risks. In a public market, typical investors do not have this access and make decisions based on comparative data; thus, a focus on standardization and transparency is extremely important.

SHORT-TERM CHANGES FOR THE FASB

The FASB's ongoing efforts to converge with International Financial Reporting Standards and propose new accounting changes for leases and revenue recognition will no doubt continue to keep the effort to consider structural changes to standard-setting for private companies a top priority for the FAF. The FAF has already held meetings with the Big 4 accounting firms and plans on meeting with bankers and other users of private company financial statements in their continuing efforts to evaluate and respond to the Blue Ribbon Panel recommendations. For the time being, the FASB has already begun to implement some of the following Blue Ribbon Panel's short-term recommendations:

- Considering a delay for private companies of the effective date of major new standards
- Adding board members to the FASB that have private company background and experience
- Developing a "differential framework" so that the FASB has a set of decision criteria to determine when GAAP exceptions should be made for private companies

Currently, the AICPA is pushing for the creation of a separate accounting standard setting board for private companies due to a lack of confidence in the FASB to effectively respond to the reporting issues facing these companies. The FASB Chairperson and the Big 4 accounting firms would like the FASB to continue to be the governing body for all US GAAP for many reasons, which include the risk that a simplified approach may not most accurately reflect the underlying economics of a business transaction and that different standards will reduce comparability of financial statements between entities. Therefore, it appears that any significant changes to the current standard-setting process will not happen overnight.

Windes & McClaughry plans to continue to serve as a resource to the FAF with respect to standard-setting for private companies. Should you have any questions about this information or would like to provide feedback to the FAF on your experiences with implementing recent FASB accounting standards for your private business financial reporting, please contact Lance Adams at **ladams@windes.com** or by phone at (562) 435-1191. The FASB website, www.fasb.org, also offers up-to-date information on the initiatives and progress in the area of standard-setting for private entities.

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under the Internal Revenue Code (the Code). Borrowing from a plan is technically a distribution but is not considered taxable if repaid according to plan terms and the provisions of the Code. Loan balances that fail to meet these requirements result in taxable income to the participant.

Plan loan provisions are optional, and many plans choose not to allow participants any opportunity to access their accounts prior to retirement. Plans that offer loans allow participants the advantage of repaying the loan interest into their own plan accounts rather than to a financial institution. The downside of loans is the potential for default, which results in the loss of assets designated for retirement, immediate taxation and potential early withdrawal penalties, and the loss of tax-deferred growth on earnings. Participant loan payments are not tax-deductible.

LOAN POLICY

A qualifying loan policy must meet the following requirements:

- Plan loans must be available to all participants on a reasonable and equivalent basis.
- The loan must be made in accordance with specific provisions stated in the plan document or an accompanying document incorporated by reference.
- The loan repayment schedule must bear a reasonable rate of interest.
- The loan amount must be adequately secured.
- The loan must be repaid within five years. The five-year requirement is extended if the loan is to be used to acquire a principal residence of the participant (principal residence loan). Refinancing a principal residence generally does not qualify as a principal residence loan.
- Payments on the loan must be made at least quarterly and must represent a level amortization (principal and interest) over the term of the loan.
- The loan must be evidenced by a legally enforceable agreement, containing the amount of the loan, the term of the loan, and the repayment schedule. The agreement must be either:
    a) a written paper document; or
    b) an electronic medium provided under a system that satisfies certain requirements.

LOAN MAXIMUMS

Under the Code, a loan is limited to 50% of the participant's vested account balance, not to exceed $50,000. A special rule allows loans of up to $10,000, regardless of the participant's vested balance. If a plan makes a loan that exceeds 50% of the vested accrued benefit under this $10,000 minimum rule, additional collateral will be required to satisfy the exemption from the prohibited transaction laws. Due to this outside collateral requirement, most plans limit participant loans to no more than 50% of the participant's vested accrued benefit.

If the loan policy permits, a participant may have more than one outstanding loan from the plan at a time. However, any new loan, when added to the outstanding balances of all of the participant's loans from the plan, may not exceed the maximums above. In determining the maximum amount where a participant has an existing or recently repaid loan, the $50,000 maximum is reduced by the highest loan balance during the 12-month period ending on the day before the new loan. In other words, repaid amounts cannot be re-borrowed for at least a year.

LOAN TERMS

To meet the Code requirements for participant loans, the maximum term for the loan may not exceed five years. Suspensions of payments and limited extensions of the five-year term are allowed for unpaid leaves of absence, military service and loan refinancing. If provided in the loan policy, longer terms are allowed for loans designated for purchase of a participant's primary residence.

The interest rate charged on loans must be comparable to prevailing rates charged by persons in the business of lending money for loans made under similar circumstances. The benchmarks for determining the interest rate are dictated by the loan policy, and many sponsors chose an easily determinable rate (e.g., the prime rate plus 2%) to facilitate loan administration.

Loan payments must include a level amortization of both principal and interest. The payments must be no less frequent than quarterly. If the repayment is payroll based, the amortization schedule will mirror the payroll period.

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MEAL EXPENSE DEDUCTIONS

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with, the active conduct of your business. The IRS also requires you to keep a written or electronic log, made near the time that you make the expenditure, recording the following:

- Business that was discussed
- How the discussion was related to your business
- Where the business discussion was held and the meal consumed
- The date of the meal
- Cost of the meal

Note: If you write off business meals through your company and there is a proper reimbursement arrangement in place, you will not be charged with any imputed income for the half that is not deductible, but your company will be limited to a 50% write-off.

Non-Deductible Meals:

Meals while not away from home on business and/or not conducting business are non-deductible personal expenses. Examples include:

- Meals during working hours with no business purpose
- Dinner after working late
- Coffee and snack breaks

100% Deductible Meals:

Finally we get to the good stuff! The following meals and food are 100% deductible under certain circumstances, as follows:

1) Meals for the convenience of the employer and that are furnished on the business premises of the employer. Examples include when:

    - There is a very short meal period allowed
    - There are no available eating facilities outside the business premises
    - Employee must remain on site for business reasons (to meet customers or to trade securities, for example)
    - Required to attend mandatory business meetings

2) Employers who provide their employees with free coffee, soft drinks, bottled water, juices, donuts, or similar items to be consumed on the business premises.

3) The costs of providing food and beverages at recreational, social, or entertainment gatherings primarily for the benefit of rank-and-file employees (as opposed to highly compensated employees). Examples include company picnics, banquets or parties for employees and their guests.

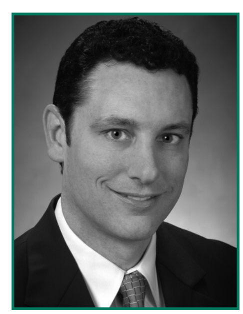
4) Expenses incurred for meals made available to the general public. Examples include free food and beverages at concerts hosted by a shopping mall, free dinners for potential restaurant customers, free hot dogs at a retail store promotion, a free wine and food tasting exhibition sponsored by a liquor dealer, and free hors d'oeuvres furnished by a realtor for a client's open house.

5) When services are provided as an independent contractor, the service provider can deduct 100% of job-related meal expenses by *billing the client separately for these costs*. The client is then stuck with the 50% disallowance rule. If separate billing does not occur, the 50% disallowance rule applies to the service provider.

6) The allowable deduction for the cost of a ticket to a qualifying charity event is 100% deductible even when meals are included. The ticket package must include admission to the event, but it can also include meals and refreshments. To qualify for this exception, the charitable event must give 100% of its net proceeds to a charity and use volunteers to do almost all the work in the event itself. The classic example is a charity golf tournament with a meal included in the deal.

As you can see from the rules above, accounting for meal expenses is not as easy as deducting 50% of all costs. Separate accounts on your company's general ledger should be set up to differentiate meals expenses based on deductibility.

If you have questions regarding meal expense deductions, please contact Jeff Rudich at **jrudich@windes.com** or by phone at (562) 435-1191.



Jeff Rudich, CPA, MS
Senior Manager
Tax and Accounting Services

CLEARING THE AIR REGARDING CLOUD COMPUTING

In last quarter's cloud computing article, we overviewed the fundamentals of cloud computing and some of the benefits and caveats of using a cloud-based service. In this article, we will consider some specific differences between cloud-based and in-house applications, then propose a checklist to help determine which is best for your business.

When evaluating an application, cloud-based or in-house, several factors must be considered. Hardware requirements, Information Technology (IT) know-how, and the ability to update and support the application are elements to be considered for a successful rollout.

In an in-house environment (i.e. within your business), some or all of these elements might already be in place. For example, a physical server might be available; or, perhaps, your IT staff is well-versed in application provisioning and maintenance.

In a cloud environment, most of these elements are handled by the application provider. All hardware and much of the software are managed within the cloud. Support is available through the provider.

Why choose one over the other? If you have a small business where IT infrastructure is minimal, cloud offerings can alleviate the need for internal support. On the other hand, if your business has a well-developed IT infrastructure, hosting the application in-house could be straightforward and cost-effective.

Consider the following checkpoints when choosing between cloud and in-house applications:

- **Up-front and ongoing maintenance cost.** Pricing schemes for software vary. Projecting the licensing and maintenance cost over a period of several years can reveal surprises in the true cost. In the projection, include your user licensing growth and expanding storage needs.
- **Ease of client-side updates.** While many cloud services are web-based and require just a small piece of software to be installed, some require significant software or web browser add-ins. This might lessen the value of the cloud-based application or make it comparable to one that is installed in-house.
- **Integration with other technologies.** Cloud applications are isolated from other common systems, such as Active Directory. Typically, this isolation results in the need to assign users multiple logins and passwords. Consider the effect on user's frustration and the complexity of adding or deleting user credentials as people enter or leave your organization.
- **Mobile Availability.** Quality internet access is required to use cloud-based applications. For office-bound users, this is not an issue; however, consider laptop users who need access to an application or data from a remote site. In-house applications often have a mobile installation option, so they can be used even where internet access is not available. Data is typically synchronized to and from a laptop when a quality internet connection is available. For a person who travels extensively, cloud services might not be practical due to the variableness of mobile internet.
- **Data backup and archiving.** Many cloud services offer only recovery backup, which does not include versioning or long-term archiving. Ask the provider specifically whether these options are available, if they are required for your business.
- **Security.** No discussion of cloud-based applications would be complete without mention of data security. Every cloud vendor will extol the high level of security inherent in its product. Before signing on with a cloud vendor, clearly understand its security process and guarantees. Also review the statements of regulatory compliance and their privacy policy. Collectively, these factors define how well the cloud services provider will protect your data and business information.

In summary, cloud services can be a fine alternative to in-house applications. When comparing the two, be sure you level the playing field to get a true sense of which is most appropriate for your business and IT environment. The guidelines listed in this article are a good starting point for this comparison.

Norm Dubow
Director of Information Services

If you have questions regarding cloud computing, please contact Norm Dubow at **ndubow@windes.com** or by phone at (562) 435-1191.

RECOURSE VS. NONRECOURSE MORTGAGE LIABILITY

The Difference Does Matter

If you are planning to renegotiate the debt on your property, you might be surprised to find there are tax consequences. The source of the income stems from basic tax law, where income is defined as an "accession to wealth." The tax law considers you to have been enriched by the amount of debt you no longer have to pay back. If a lender forecloses on a property, or accepts an amount less than the loan balance, it may result in cancellation of debt income or sales proceeds to the owner. The type of income depends on whether the mortgage is considered recourse or nonrecourse debt and whether the property securing the debt is given up.

Briefly, a loan is nonrecourse if the lender's only recourse upon the borrower's default on the debt is against the property securing the debt. Conversely, a debt is recourse if the lender can look beyond the collateral pledged for the loan and hold the borrower—for a pass-through entity, its owners—personally accountable for the unpaid balance.

When a lender discharges any part of a debt, the owner generally recognizes that amount as ordinary income. This is the basic rule in instances where no property is given up, regardless of whether the debt is recourse or nonrecourse.

NONRECOURSE DEBT TRIGGERS SALE

When a nonrecourse debt is canceled in exchange for the property, the transfer is treated as a deemed sale of the property in an amount equal to the face amount of the nonrecourse debt. Since the amount realized on the deemed sale is the full amount of the indebtedness, there is no "forgiveness" of indebtedness.

Nonrecourse Example

1. Loan balance $300,000
2. Fair Market Value (FMV) $250,000
3. Cost $200,000

Greater of loan or FMV	$300,000
Less Cost	- 200,000
Capital Gain	$100,000

TWO-STEP APPROACH TO RECOURSE DEBT

In the case where property foreclosed is encumbered by recourse debt, there are actually two components. The tax consequences consist of cancellation of debt income ("COD"), which is potentially taxable under Internal Revenue Code (IRC) Section 108, and sale or exchange gain, which may be taxable under IRC Section 1001. With recourse debt, the owner is treated as having "sold" the property to the lender for the property's current fair market value. The amount of the debt in excess of the property's fair market value is characterized as COD income.

This contrasts with the nonrecourse debt above, where the debtor is treated as having sold the property for the outstanding balance of the debt, not its fair market value. The distinction is important since, in addition to determining what constitutes COD income, IRC Section 108 also provides exclusions that permit debtors to exclude COD income if they meet certain qualifications (e.g., insolvency). If the debt is nonrecourse, then none of the gain is treated as COD income and, thus, prevents the debtor from receiving relief from one of the Section 108 exclusions.

Recourse Example

1. Loan balance $300,000
2. Fair Market Value (FMV) $250,000
3. Cost $200,000

FMV	$250,000	Loan Balance	$300,000
Less Cost	- 200,000	Less FMV	- 250,000
Capital Gain	$50,000	COD income	$ 50,000

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RECOURSE VS. NONRECOURSE

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MORE THAN ONE LOAN

It is not uncommon for people to have more than one debt securing a property. Perhaps there is a first mortgage that is nonrecourse and a second line-of-credit loan that is recourse. To determine the COD income and gain/loss on foreclosure, an allocation of the FMV of the property to the particular loans needs to be made. The FMV is allocated to the debts in the order of their legal priority.

Example

Aaron has two loans on his property. $200,000 nonrecourse was incurred upon the purchase, and a $100,000 recourse debt was incurred for improvements. The value of the property dropped to $275,000 and he can no longer make the payments. The basis of the property is $250,000.

The FMV of the property must be allocated to the two debts to determine the amount of COD income. It is allocated to the two debts in order of their legal priorities, i.e., allocated to the $200,000 nonrecourse debt, then to the $100,000 recourse debt, because the $200,000 debt would normally be paid off first.

Aaron has $25,000 COD income and $25,000 of gain.

Nonrecourse debt	$200,000
FMV allocated to nonrecourse debt	- 200,000
Balance	$ 0
Recourse debt	$100,000
FMV allocated to recourse debt	- 75,000
COD income	$ 25,000
FMV	$275,000
Cost	- 250,000
Gain	$ 25,000

Although the transactions may appear economically similar, recourse and nonrecourse loans result in vastly different tax consequences.

If you have questions regarding recourse/nonrecourse debt or would like more information, please contact Jessica Wang at **jwang@windes.com** or by phone at (562) 435-1191.

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Senior Manager
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QUALIFIED RETIREMENT PLAN

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Loans are secured by the participant's vested balance (unless outside collateral is pledged) and are subject to a written loan agreement. Because loans are technically plan distributions, they are generally subject to spousal consent requirements.

LOAN REPAYMENTS AND DEFAULTS

Many employers adopt loan policies that require all loan payments to be deducted through payroll. This procedure avoids the need for the trustee to monitor outside loan payments. When a participant terminates employment, the loan balance is generally taxable at the end of the second calendar quarter from the last loan payment (final payroll). For plans that allow for outside (non-payroll based) repayments, the plan's loan policy will specify how the plan handles a default. A plan may provide a grace (or "cure") period for missed payments before the deemed distribution rules come into play. The maximum cure period under the law is the last day of the calendar quarter following the calendar quarter in which the loan repayment is missed.

Many retirement plans permit participants to borrow from the plan, and it is becoming increasingly common for participants to take advantage of this option. Properly administered, a loan program can be a valuable addition to an employee benefit plan. However, participant loans continue to be a prime audit issue for both the Internal Revenue Service and the Department of Labor, and plan sponsors are responsible for monitoring repayment schedules to determine loan defaults and taxable deemed distributions. The plan sponsors also must follow the guidelines on issuing and administering loans to protect the plan's qualified status.

For more information about participant loan rules and how they apply to your plan, please contact Connie Lee at **clee@windes.com** or by phone at (562) 435-1191.

Connie Lee, QPA, QKA
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Operation Easter Basket

Managing Partner John Di Carlo with some of the Windes employees who assisted in putting together baskets. From L-R: Lisa Johnson, Brandy Casper, Annie Deng, John Di Carlo, Sue Stevens, and Vina Guichard. Not shown: Eileen Harris and Maryilyn Thompson.

In February, Windes worked with the organization, Community Action Team/Operation Easter Basket, to help kids in need. Operation Easter Basket seeks to bring joy and hope to children in desperate situations in our local communities through gift-filled Easter Baskets containing items such as small toys, school supplies, hygiene products, essential clothing items, and Easter candy. The baskets go to a wide variety of facilities, including housing projects, missions, shelters, hospitals, Boys and Girls Clubs, and churches.

The firm underwrote the cost of the project and accepted donations from employees. With the combined funds, staff members contributed their time purchasing baskets, ribbon, and all of the items to go inside each basket. On Wednesday, April 20, Windes employees put together 50 baskets for boys and girls ages eight through thirteen, for this very worthy cause. We hope that our firm's spirit of giving will provide help for those most in need.

The Windes & McClaughry Corporate Gallery Award

Managing Partner John Di Carlo and artist Robert Pokorny stand in the Windes & McClaughry lobby in front of Robert's award winning painting, "The Deluge."

Windes & McClaughry, in collaboration with the Student Arts Program at California State University, Long Beach created the *Windes & McClaughry Corporate Gallery Award*, which is presented biannually to a graduate student in the program.

The *Windes & McClaughry Corporate Gallery Award* recognizes exceptional artists enrolled in the graduate level Studio Arts Program at California State University, Long Beach. Windes & McClaughry has a long-standing tradition of community involvement, and this award is intended to actively encourage and support these art students and their works. By showcasing these artists' works in a corporate setting, our hope is to bring awareness and appreciation of the cultural and creative contributions that artists make to our communities to enhance, beautify, and inspire.

Our first awardee is Robert Pokorny, whose works have been included in a multitude of shows throughout the United States. Robert is a resident of Long Beach and earned his Masters of Fine Art in May 2011. Windes & McClaughry is pleased to recognize Robert with this award and congratulate him on this outstanding achievement. For more information, please visit our website at **windes.com**.

SOLUTIONS

SOLUTIONS is published quarterly for the clients, business associates, and friends of Windes & McClaughry Accountancy Corporation. The information presented in this newsletter is intended as general information and may not apply in every case. Please contact Windes & McClaughry for specific advice about your particular situation.

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