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Snowflakes, Snowballs, and Blizzards

by Patrick O'Keefe, J.H. Cohn's Director of Economic Research

Other than hermits and isolated aboriginals, can anyone escape the endless flow of economic data? Even those who avoid all forms of media cannot escape it since the economy has replaced the weather as the conversational topic du jour.

This pervasive presence arises not from increased availability, but rather increased relevance. Just as we listen more intently to weather broadcasts as storms approach, so too do we attend to business statistics when economic conditions are turbulent and threatening.

Earlier this decade, when incomes were increasing, jobs were plentiful, and housing prices were soaring, few economic reports made the headlines (a sunny day is hardly front-page news). Instead, most economic reports were relegated to the business section.

Yet, today, the press is as quick to report gross domestic product (GDP) and labor market conditions as changes in crude oil inventories, the cost of insuring sovereign debt, or housing pre-sales. It is a blizzard of numbers, with some snowballs among the snowflakes.

How severe will the blizzard be? No one really knows, in part because the quantity of yesterday's snow (or data) tells us little about tomorrow's.

As an example: on the New York Federal Reserve Bank's website are measures of the U.S. and other economies that consist of literally hundreds of charts. These are just a few indicators for which data are available.

Although each of these statistics is meaningful, clearly they are not equally significant (i.e., most are snowflakes). No matter what their significance may be, they are already on the ground. That is, they indicate what has happened, which provides only limited—if any—information regarding what will happen in the future. A heavy snowfall may imply slippery conditions, except if the temperature rises.

Even for indicators with general significance (i.e., snowballs), the implications for the future are not always readily apparent (which explains why economists often offer differing interpretations).

Individually, snowflakes give only limited insight into general conditions—even though they may be valuable indicators of a particular sector. For example, how much can be inferred from retail sales data for a given month, even when it is accompanied by statistics on the previous month and the prior year?

Assuming the data indicate that activity has changed relative to earlier periods, what does that mean? Is the difference due to seasonal factors or generalized price changes (e.g., inflation)? Are key components (e.g., gasoline sales) behaving differently than the sector as a whole?

In January 2009, U.S. employment dropped and unemployment rose for the 13th consecutive month. Indications are that this pattern will persist through 2009.

Unless these things are readily apparent, or unless an understanding of them is important to your decision-making, let the snowflakes land and move on. What insight is to be derived from irrelevant information? If on the other hand the data are relevant to your business, it rises from snowflake to snowball status and an informed analysis of its context is in order.

This leaves two questions: How to distinguish snowballs from snowflakes,
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Creating a Lean Management Process Can Unlock Hidden Potential *by David Rubin, J.H. Cohn Principal*

Most businesses today are struggling to find ways to reduce costs, maintain profitability, and work through these difficult times. Without a crystal ball, it is impossible to say with any certainty when the recession will end and how deep it will cut, making revenue forecasting difficult at best.

As a senior decision maker, you've probably already eliminated many of your unnecessary costs and put increased controls on discretionary spending. You may have even implemented layoffs, payroll cutbacks, reduced schedules, or plant shutdowns and you're almost certainly pushing suppliers for lower prices. But once you've exhausted these avenues, where will you go next to cut costs and protect profits while maintaining client service and employee morale? One frequently overlooked area: your business processes.

Through the lean management process you can identify your improvement potential and then leverage those opportunities to improve productivity and permanently remove waste. Simply put, if you examine all of the steps in your business processes, the only steps that matter are the ones that add value for your customer or protect your assets. Everything else should be questioned. The basic tenets of waste hold true for companies in all industries and include:

- Excess inventory or excess available labor
- Workflow or production bottlenecks
- Physical movement of materials, paper, or people
- Excessive or inefficient controls
- Rework or defects
- Organizational process boundaries

The results of process re-engineering through lean methodologies can be dramatic. Knowing this, it seems natural that companies would do more to remove business process waste, but the reality is, most companies are stuck in the mire of their own inefficient processes. Management spends so much time dealing with the day-to-day operations that they don't have the time to focus on process improvement. We refer to this as the tornado syndrome, because the tornado picks you up in one place when you arrive in the morning and then puts you down someplace else at day's end. If armed with the proper tools, you may be able to mine your process opportunity.

Identifying the waste in business processes is the first step to success, but it requires understanding. You must know:

- Who the internal or external customer is for each process
- How the process is supposed to benefit the customer
- The required inputs and outputs for completion of the process
- The suppliers of the inputs

This is accomplished through the use of tool called a SIPOC, which stands for Supplier, Input, Process, Output, Customer and provides an overview of the all of the process components and stakeholders in a process. Following completion of the SIPOC, a current-state value stream map—that is, a flowchart that identifies time delays, transaction bottlenecks, manual intervention issues, losses due to quality rework cycles, and potential control issues—is developed.

In most cases value stream maps also clarify where a company is not properly leveraging their investment in technology. To properly leverage your process opportunity, it is important to challenge the status quo and question every step in the process. Manage toward perfection so that the number of steps and the amount of time and information needed to service the customer continually falls.

In today's economy, the clear benefit of a lean organization is lower costs and survival. The added benefit as the economy recovers will be an organization that remains more cost effective and efficient in how it delivers its products and services. As many companies have learned, it's never the wrong time to do the right thing. ■

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Nexus: The Starting Block of State and Local Taxation

by Ernest J. Barbaris, CPA, MST, Partner and Director of J.H. Cohn's State and Local Taxation Group

Nexus—the point at which a state and its localities may be able to tax the in-state activities of a business—is a hotly contested issue that was and continues to be redefined.

The U.S. Commerce Clause grants the U.S. Congress the power to regulate trade among the states. Congress, however, has done little concerning interstate taxation, forcing the courts to deal with the validity of state taxes. Given current budget deficiencies, states are aggressively pushing to broaden their nexus reach. Consequently, a new wave of court cases dealing with nexus has begun and will likely grow unless Congress evokes its power to clearly define what in-state activities give rise to nexus. These debates lead to the question: At what point do the in-state activities of a business give rise to nexus? The following are activities, broadly defined, that we know establish nexus, and others that may, in some cases, establish nexus. Keep in mind that some states are more aggressive than others or may provide specific nexus exemptions.

State of Incorporation—A business always has nexus with the state of its incorporation, organization, or formation. However, some states (viz., Delaware) provide income tax exemptions for businesses that lack any other in-state activities.

Physical Presence—Generally, a business always has nexus with a state where it has an in-state physical presence. Physical presence refers to activities such

as an office, inventory, other personal or real property, and employee activities. However, physical property that remains in transit or employees who travel through the state without performing any other in-state activities do not typically create nexus.

There are some exceptions to the general rules of physical presence. For example, many states have exemptions for businesses that attend certain in-state trade shows, while others include inventory kept at third-party fulfillment, publishing, or public warehouse facilities; the use of call centers; and the delivery of products via company vehicles.

During the late 1950s, Congress became concerned with case rulings that expanded the ability of the states to tax out-of-state businesses. In a rare act, Congress responded by enacting Public Law 86-272 to prevent the states from imposing **a net income tax** on an out-of-state business whose in-state activities are limited to the solicitation of **tangible personal property** via employee or third-party representatives.

However, P.L. 86-272 is a case of needing to read the fine print. It's a narrow exemption in that it fails to protect those businesses that do **not** sell tangible personal property or against taxes that are **not** imposed on net income. There are many other requirements that must be met in order to fall under the law's protection. The more prevalent requirements are: (1) the in-state sales rep cannot perform activities outside of solicitations such as installation, providing technical support, collecting funds, and regularly replacing spoiled products; (2) all orders obtained must be sent out-of-state for acceptance and fulfillment from an out-of-state location; and (3) the business cannot have an in-state office, including a company owned sales rep office.

Attribution of Physical Presence—The physical in-state presence of a third party will generally be attributed to an out-of-state business if the in-state third party either creates or maintains a market share for the out-of-state business. A classic example of this scenario is an out-of-state computer manufacturer that hires an in-state computer repair business to provide warranty services on its behalf. Without this in-state warranty service arrangement, the out-of-state manufacturer would likely have less of an in-state market share. Thus, the physical presence of the in-state repair business is attributed to the out-of-state manufacturer under the rationale that it's no different than if the manufacturer had sent its own employees in-state to perform

To make a final determination of whether it has established nexus with a given state, a business must perform a facts and circumstances analysis.

the warranty services. It matters not whether the in-state third party is legally an agent of the out-of-state business.

Most recently, New York State has further expanded this concept of attribution for purposes of its sales tax, thereby starting a new nexus trend. In brief, New York assumes that an out-of-state business has established sales tax nexus when it contracts with in-state persons, for consideration, to directly or indirectly refer potential customers via a link on an Internet website or otherwise. After certain dollar thresholds are exceeded, New York attributes the in-state physical presence of the "referral network" to the out-of-state internet retailer. Amazon.com and Overstock.com have sued the state over this provision, but they have yet to win in court. Because of this, all eyes are on New York. California, Connecticut, Hawaii, and Minnesota have recently proposed similar legislation while New Jersey has informally stated that they intend to follow New York's lead.

An Affiliate with Physical Presence—Many states consider an out-of-state business with an in-state affiliate (e.g., parent/sub or brother/sister corporate relationship) to have established nexus when both affiliates sell the same or a substantially similar line of products. While many states assert this notion, several have lost in various state court cases.

Economic Presence—Economic presence refers to the in-state presence of an intangible asset (such as a trademark, patent rights, and, potentially, loans) of an out-of-state business. This is where sales tax and income tax nexus splits. Pursuant to U.S. Supreme Court cases, there must be an in-state physical presence in order for a sales tax to be valid. However, when it comes to other taxes (viz., net income taxes) it's uncertain whether physical presence is needed in order to establish taxable nexus. Many states have adopted an economic nexus provision for their income taxes; and consequently, most have been litigated with mixed results. New Jersey enacted such a provision and its courts ultimately upheld the provision.

A few states have indicated they wish to further extend the reach of their economic nexus provisions by way of imbedded economic presence. For example: A business solely located in New Hampshire licenses a patent to a business solely located in New York. The New York business uses such patents while manufacturing widgets at its New York facility. The New York manufacturer sells its widgets via telephone to customers located in New Jersey. Under the imbedded economic presence theory, New Jersey would claim that the New Hampshire business has nexus with the state (because of the imbedded patents within state) and therefore must file and pay New Jersey income taxes. This is a scary proposition. How would the New Hampshire business be able to collect the necessary data needed to prepare a proper (in the state's view) income tax return?

To make a final determination of whether it has established nexus with a given state, a business must perform a facts and circumstances analysis. Due to a large amount of court cases, businesses are faced with much uncertainty when performing such an analysis. Ultimately, this uncertainty will only be solved when the U.S. Supreme Court clearly rules on the matter or the U.S. Congress takes definitive action.

In our view, the U.S. Supreme Court seems frustrated that Congress has done very little concerning nexus and is trying to force the hand of Congress to do something by not accepting new nexus cases. Perhaps if a state attempts to enforce an imbedded economic nexus standard, either the U.S. Supreme Court or Congress will finally act to clearly define what in-state activities create nexus for both sales tax and income tax purposes. ■

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Understanding FAS 157 and Fair Value Accounting

by Wade McKnight, CPA, Partner

When the financial markets began their descent into what is now universally considered a historic downturn, many fingers began to point to fair value accounting, and the possibility of modifying or suspending fair value rules became a hot topic. Fair value—which requires companies to value certain assets at their current market value—is here to stay, and, even with modifications, it impacts companies across all industries.

Wade McKnight, CPA, the office managing partner of J.H. Cohn's San Diego office and chair of the Firm's committee on fair value, responds to questions about fair value accounting and Financial Accounting Standard (FAS) 157, "Fair Value Measurements."

Q: What is FAS 157 and when does it affect me?

A: FAS 157 was issued by the Financial Accounting Standards Board (FASB) in September 2006. The goal of the standard was to clarify the definition of fair value, provide a measurement framework for various classes of assets and liabilities, and improve disclosure requirements. Since the Standard was effective for fiscal years beginning after November 15, 2007, most companies have adopted it or will be doing so as part of their 2008 year-end financial statement filings.

FAS 157 was effective for financial instruments in 2008 (for calendar year-end companies) and non-financial items as of January 1, 2009. Many companies are just beginning to address the application of the Standard to non-financial assets and liabilities.

Q: What guidance does FAS 157 provide for fair value measurements and disclosures?

A: To facilitate disclosures, FAS 157 created a three-tiered hierarchy for inputs. Generally, Level 1 inputs are quoted prices for the identical assets in active markets. Level 2 inputs are quoted prices for similar assets in markets that are active or quoted prices for identical assets in inactive markets or are wholly derived from inputs that are observable. Level 3 inputs have no external market and rely on the reporting entity's analysis of fair value and information that is not observable by outside parties. Level 2 and 3 assets require companies and their auditors to perform considerable work to understand and evaluate the fair value measurement process for instruments such as investments in private enterprises, hedge funds, interest rate swaps, and other derivatives.

Q: Why is FAS 157 often misunderstood?

A: A common misconception is that FAS 157 established standards for fair value accounting, but FAS 157 does not establish any new accounting requirements as it relates to recognizing fair value changes in financial statements. In fact, most investments marked-to-market are valued based upon observable inputs, such as actual market quotes.

Numerous other standards—such as those which establish accounting for investments and derivatives—have been around for years and establish the requirement for companies to follow mark-to-market accounting. FAS 157 deals strictly with the measurement of fair value and tries to establish a more uniform approach to the measurement process.

Q: Most of J.H. Cohn's clients are public and private middle-market companies. What unique challenges does this market segment face as it relates to fair value accounting and disclosures?

A: Our clients are facing accounting standards overload. Clearly, FAS 157 raises the bar in terms of documenting how fair values are determined. If a company has any assets or liabilities in either the Level 2 or 3 categories, we strongly recommend that they work with a firm or individual that is qualified to perform FAS 157 valuations to assist them with their fair value measurements and disclosures. (Your J.H. Cohn professional can provide recommendations.)

Q: What additional steps should companies take when it comes to fair value?

A: By now, most companies have adopted FAS 157 for the financial instruments adoption element. For the non-financial items, adoption will occur in 2009 and now is the time for companies to discuss with their auditors how they will determine fair values and how they will be evaluated. Fair value also impacts impairment measurements and business combinations.

Q: How do current fair value accounting and measurement principles in the U.S. match up with International Financial Reporting Standards (IFRS)?

A: IFRS and Generally Accepted Accounting Principles in the United States (GAAP) both apply fair value accounting but there are differences in the measurement process. Under IFRS, fair value is neither an exit or entry price but the amount that an asset could be sold, or liability settled, between willing parties. Disclosures regarding fair value measurements are currently more extensive under GAAP than IFRS, but I expect those differences to narrow as the IFRS initiative gains momentum.

Q: There's been much discussion about modifying the fair value rules. Can we expect more changes?

A: In December 2008, the SEC issued a report recommending improving, not suspending FAS 157 or eliminating mark-to-market accounting. The SEC's study recommended developing additional guidance for companies and auditors for determining fair value in inactive or illiquid markets. It also asked for the enhancement of disclosures and educational efforts. The SEC called on the FASB to reconsider certain existing guidance and evaluate the need for more disclosure. We can also expect further direction from the FASB related to fair value disclosures in interim financial statements before the end of the first quarter of 2009. ■

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and regardless of the mix, what do they signal about the depth and duration of the current blizzard (recession)?

Distinguishing snowballs from snowflakes is pretty straightforward. First, identify which data sets best capture conditions affecting your business. Those are your snowballs.

Beyond those, there are a few obvious others. Since GDP reflects the general health of the economy, it bears watching. Because it is quarterly, however, it is subject to rear-view mirror limitations (i.e., it reflects what has happened).

For each quarter, the Bureau of Economic Analysis issues three GDP estimates—Advance, Preliminary, and Final—which, because they are based on increasingly complete data, become progressively more reliable.

The preliminary estimate for the fourth quarter of 2008 indicated that the national economy contracted at an annual rate of 6.2% (the advance estimate indicated a smaller decline). That qualifies as a very large snowball—one to consider in your business planning.

A second snowball is the monthly "employment situation" published by the Bureau of Labor Statistics (BLS). This publication reports the data on the national labor market, most notably, the number of employees and the number of unemployed.

Although widely publicized, there is confusion about the data, particularly with respect to the unemployment estimates. The monthly data are based on two separate surveys: one of households, the other of employers (businesses and governments). Since the results are released about two weeks after the interviews, these data are relatively timely (i.e., less prone to rear-view mirror limitations).

Estimates of the unemployed are derived from a survey of 60,000 households which is conducted by the Census Bureau and analyzed by the BLS. The estimate of unemployment is based on responses to specific questions about jobseeking activity. It does not take into account receipt of unemployment benefits. The survey also obtains information regarding those who are "marginally attached" to the labor force (i.e., discouraged jobseekers) and the underemployed.

In February 2009, U.S. employment dropped and unemployment rose for the 14th consecutive month. Indications are that this pattern will persist through 2009.

Those two snowballs, and a lot of supporting snowflakes, provide insight into the depth and duration of the current blizzard (downturn): The economy will continue to shrink through much of the coming year, but the rate of contraction will slow as the combination of fiscal and monetary stimulus bolsters consumer demand and rebuilds balance sheets. ■

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