

# THE SHERIDAN ROAD MAP



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## SPRING FEVER?

### CFO optimism returns to prerecession levels.

Although CFOs are still cautious, their optimism has grown since last quarter, climbing back to 2007 levels, according to the most recent Duke University / CFO Magazine Global Business Outlook Survey.

Now in its 60th consecutive quarter, the survey also finds finance chiefs expecting to increase earnings by double digits and boost spending in several key categories over the next year. The uptick in optimism is good news for the economy overall, as the survey has historically shown that an increase in CFO optimism signals stronger GDP growth, spending, and employment within a year, according to John Graham, professor of finance at Duke's Fuqua School of Business and director of the survey.

Fifty-six percent of finance chiefs in the United States say they are more optimistic about the economy than they were last quarter, up from 50% in December. They plan to increase capital spending by 12% on average over the next 12 months, a robust rise that marks the highest level of capital-spending growth since 2004. CFOs say spending on technology will increase by 6%, research-and-development spending will rise 4%, and marketing and advertising outlays will also grow by 4%.

Al Blazek, finance chief at Dunham's Sports, a midwestern sporting-goods retailer with stores in 13 states, says he is "reasonably optimistic" about the future.

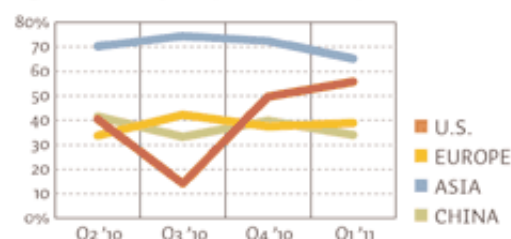
"It seems like people are pushing away from more-expensive purchases, which could be a negative for places that sell very expensive things but has given us a lift," he says. "We have gotten some new customers who might not have crossed the threshold before."

At Douglas Machine, a manufacturer based in Minnesota, CFO Tom Wosepka says he is more confident about his company's outlook than about the economy in general, but that he expects "continued relatively modest growth" in the United States, with more opportunities for faster growth in emerging markets. Douglas Machine, which makes capital equipment used in packaging consumer goods, recently expanded into a new end market — making equipment used by biotech firms. The move has accelerated the company's growth, says Wosepka.

**The Missing Ingredient.** Still, despite growth expectations and strongly rebounding earnings, CFOs remain reluctant to hire. On average, they plan to increase their domestic full-time workforce by just over 1% in the next year. Finance chiefs in

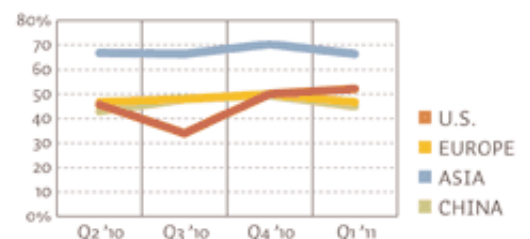
### Better Days

CFOs who are more optimistic about their domestic or regional economy compared with last quarter



### The Yeas Have It

CFOs who are more optimistic about the financial prospects for their own company compared with last quarter



(continued on page 2)

# SPRING FEVER? *(continued from page 1)*

the transportation and energy sectors will do more hiring, expanding their staffs by nearly 5% on average, while communications and media firms and mining and construction companies continue to plan layoffs.

Retailers will increase their workforces by 3% on average, a number that Blazek says makes sense, given the depth of the cuts many retailers made during the recession. "So many retailers have been running for so long with skeleton crews that there were sales left on the table as a result," he says.

Bill Helenberg, finance chief at Precision Machine Works, a maker of aerospace parts, says the company is "trying to avoid massive hiring," making do instead with adding overtime as needed and working as efficiently as possible. "There's no point in building up your production workforce when there's so much uncertainty out there," says Helenberg.

Indeed, certain skill sets are in demand, even as overall hiring remains weak. Finance executives say their companies are seeking skilled and professional workers above all, followed by salespeople, engineers, and product-development staff. Wosepka says Douglas Machine has been continually trying to hire staff ranging from machinists to genetic scientists. The task has been challenging, in part because of the company's suburban location, where the hiring pool is small, he says, and because demand for such workers is intensifying.

Nearly 40% of CFOs say their workforces have returned to prerecession levels, but a fifth say their staffs will never again reach that size. The remainder say they will get there eventually, but not without significant revenue growth.

**Top Concerns.** Consumer demand once again tops the list of external, macroeconomic concerns, while the ability to maintain margins is the top company-specific concern. Many CFOs faced with rising input costs are finding that continued soft demand limits their ability to pass along price increases, resulting in a squeeze on margins. In industries that were hard-hit by the recession, scrambling competitors also make pricing a challenge. "We've seen some competitors get really hungry," says Wosepka. "Unfortunately, when you have desperate competitors, it does not help your ability to price."

CFOs are growing more worried about inflation, citing the cost of fuel and the cost of nonfuel commodities among their top concerns. They expect to increase their prices by just 2% on average over the next 12 months, however, in part due to the pricing pressure described by Wosepka.

"Inflation is a concern from a long-range perspective," says Blazek, who adds that his business has witnessed the skyrocketing price of cotton. "But in the short run, there are just too many dampening activities out there to have inflation get out of control."

## Profit vs. Payroll

12-month percentage change predicted by U.S. CFOs



■ EARNINGS  
■ WAGES

## Some Help Wanted

What job functions are most needed at your company right now?



Note: Respondents were asked to choose up to three titles.

## Top Concerns of CFOs

About the macro economy:

- Consumer demand
- Federal government agenda/policies  
Price pressure from competitors
- Credit markets/interest rates  
Cost of fuel  
Cost of nonfuel commodities  
Federal budget deficit  
State or local government budget deficits
- National employment outlook  
Global financial instability
- Financial regulation  
Foreign competition

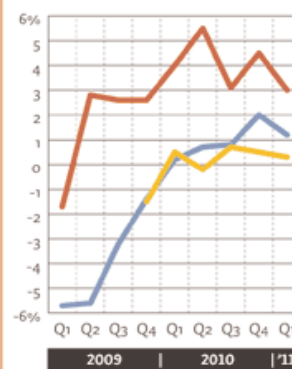
About their own companies:

- Ability to maintain margins  
Cost of health care  
Maintaining morale/productivity
- Attracting/retaining qualified employees  
Working-capital management
- Supply-chain risk
- Balance-sheet weakness

Note: Multiple responses received the same score.

## Now (Barely) Hiring

12-month percentage change predicted by U.S. CFOs

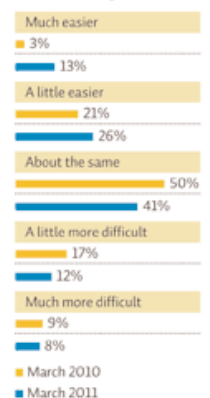


— Number of offshore outsourced employees  
— Number of domestic full-time employees  
— Number of domestic temporary employees\*

\*Did not ask about temporary employees prior to Q2 2009

## Easier Credit

Compared with fall 2009, does your company now find borrowing:



## An Intimation Of Inflation?

12-month percentage change predicted by U.S. CFOs

PRICE OF OWN CO.'S GOODS/SVCS.

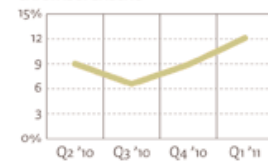


Source for all charts: Duke University/CFO Magazine Global Business Outlook Survey of 854 CFOs—192 from the United States, 181 from Europe, 132 from Asia (not including China), and 84 from China

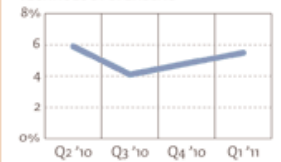
## Loosening the Purse Strings

12-month percentage change predicted by U.S. CFOs across several key categories

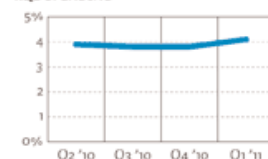
CAPITAL SPENDING



TECHNOLOGY SPENDING



R&D SPENDING



ADVERTISING & MARKETING SPENDING



## DIFFERENT STROKES

### These days, education is about changing behaviors.

It probably should come as no surprise that those ubiquitous darlings of the social media set—Facebook and Twitter—have digitalized their way into the defined contribution marketplace.

Some plan sponsors have discovered that for communicating with their younger workers about 401(k) issues, even e-mail has become a bit passé. Facebook and Twitter are the newest vehicles for conveying messages and education to the youngest participants.

When it comes to educating participants on building retirement income and advising them on investing their 401(k) assets, the mindset is changing rapidly. No longer can sponsors simply rely on holding companywide meetings while urging employees to participate in their 401(k) and encouraging them to defer increasing percentages of their earnings over time. Yes, those goals remain, but the ways of presenting them and assessing their effectiveness are constantly expanding.

“As an industry, we need tools and materials that are really going to impact behavior change,” says Patricia Advaney, Senior Vice President of Participant Solutions for Diversified Investment Advisors, Inc. “It might not always be the best-looking graphics. It’s about what works.”

To make it work, sponsors need to look beyond pretty brochures and discover ways that change participant behavior, leading them to understand the importance of building the source of a future stream of retirement income.

That means turning to education vendors who not only study participant demographics, but also target different messages, while providing a range of media for each segment of the workforce: young employees, women, those nearing retirement, and those belonging to various ethnic constituencies. Each group may look for something different in a 401(k) plan, and each might best respond to educational messages or media designed uniquely for it.

Different materials and different vehicles—the Internet, meetings, the telephone, brochures, one-on-one sessions, Facebook—can be offered to different groups, says Robyn Credico, the Defined Contribution Practice Leader in North America for the employee benefits consulting firm Towers Watson. Sponsors should look for an education provider that can target different groups within their workforce based on language, ethnicity, background, and age. “You want to be sure people are going to use it and get something out of it,” she says of educational programs.

There are other criteria, of course, that sponsors should use in selecting an education campaign that works for its participants.

The cost factor is always critical, and sponsors should evaluate a provider’s technology and personnel, says Bonnie Fawcett, Senior Vice President and Director of 401(k) Services for PNC Financial Services. It also is helpful if a provider can measure the success of its education program once it has been implemented and targeted to each group.

Pete Welsh, Vice President of Product and Marketing Strategy for AUL Retirement Services of Indianapolis, suggests looking for education providers that allow the sponsors to promote their own goals and brand, rather than those of the vendor, and to customize programs to fit the sponsor’s own business ethos.

Many of the same benchmarks can be used in selecting an investment advice provider. Yet, with advice, fiduciary responsibility also comes into play.

Scott Holsopple, President and CEO of Smart401k, a Web-based investment adviser, recommends using the following yardsticks to choose an advice provider: review qualifications and experience of the firm; compare the fee structure with other providers’; determine if the advice provider accepts fiduciary responsibility; see if the provider uses generally accepted investment theories; and check to ensure the vendor’s participant communications practices mesh with your company ethos and workforce.



Illustration by Jillian Tamaki

# STATE INSECURITY

## Faced with alarming budget shortfalls, states are pursuing corporate tax dollars in new and aggressive ways.

When it comes to state-tax enforcement, it's getting scary out there for corporate taxpayers. Witness the Securities and Exchange Commission's entry into the state-tax fray with an apparently unprecedented action against Hudson Highland, a staffing firm based in New York.

The SEC charged that the company allowed its Hudson North America subsidiary to fail to collect state sales tax from its customers. Although such failures are typically regarded as state matters, the SEC charged that federal securities laws were also violated. While the \$200,000 settlement was not a particularly harsh penalty for the \$795 million company (which neither admitted nor denied the SEC findings), the case has sent shock waves through corporate tax departments.

Why the worry? This newfound federal interest in state-tax collection signals a significant intensification of corporate taxation efforts — efforts that were already on the fast track at the state and local level in the wake of the recession. Faced with huge budget deficits and public antipathy to tax hikes, states are aggressively trying to find new ways to raise revenue.

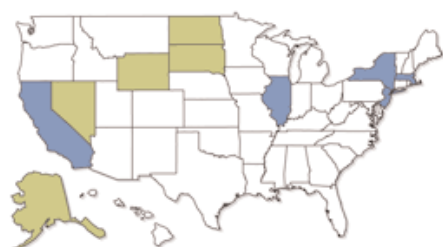
Many are attempting to expand the definition of what constitutes "nexus," a business connection to a given state that provides the state with a basis for collecting taxes — an issue that tax authorities, courts, and companies have debated for years. Others want to claw back the incentives they once happily provided to businesses in order to foster economic development.

The situation doesn't just frustrate companies — it infuriates them. In CFO's 2011 State Tax Survey, conducted in January with KPMG and yielding responses from 151 tax directors and other finance executives, one respondent complained, "The states are in a pure 'money grab' mode and don't care about policy, the law, or fairness."

**THE BUDGET ABYSS.** Driving the dash for cash is a plethora of persistently unbalanced state budgets. No fewer than 45 states are expecting 2012 shortfalls relative to their 2011 outlays, according to the Center on Budget and Policy Priorities, a think tank. (For most states, fiscal 2011 began in mid-2010.) Further, while most states have had budget deficits in the past two years, federal stimulus money helped them fill the gaps temporarily, notes Harley Duncan, managing director in the state and local tax group of KPMG's national tax practice. By the middle

### THE BEST AND WORST

① What is your overall impression of the tax environment in each state?

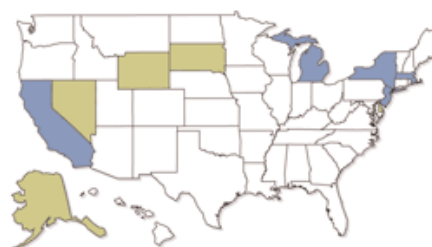


Survey respondents ranked states on a scale, with 1 = very fair and predictable and 5 = very unfair and unpredictable.

### Methodology

This biannual survey, conducted since 1996 with the help of KPMG LLP, the audit, tax, and advisory firm, aims to capture tax executives' impressions about differing tax environments in each state in which they do business. The results presented here represent those opinions, rather than quantitative assessments of actual policies, tax rates, or other criteria. ([www.cfo.com/statetax](http://www.cfo.com/statetax))

② How would you rate each state's stance on asserting nexus positions for corporate income tax when corporations have only an economic presence in a state?



Survey respondents ranked states on a scale, with 1 = not aggressive and 5 = very aggressive.

of this year, however, most of the stimulus money is likely to run out. "State bills are going to have to be paid with real money at some point," Duncan says.

One way states are attempting to raise revenue without tax hikes is through clawbacks of corporate tax incentives. Because of the recession, some companies have not performed as well as

states expected when they provided tax sweeteners in exchange for corporate relocation or expansion. In such instances, the states can make a strong case, experts say. "The company is benefitting from the services and the infrastructure that the state provides... and the company is not paying its fair share of the costs," says Robert Willens, a tax accountant and CFO columnist. "That becomes a very persuasive argument to the courts." Indeed, survey respondents fear that California and Illinois, two of the most financially battered states, are among those "very likely to pursue clawbacks."

State tax officials are reportedly growing more litigious as well. State revenue departments "have moved from seeking the right outcome to using their power to maximize revenue from taxpayers by pushing (or threatening to push) every matter to litigation," says one survey respondent from a \$5 billion communications company.

State courts, for their part, seem quite receptive to aggressive tax collection. In one 2010 decision in which it found against fast-food chain KFC, the Iowa Supreme Court noted that "state supreme courts are inherently more sympathetic to robust taxing powers of states than is the U.S. Supreme Court." Unfortunately for corporations, the high court has recently showed little interest in hearing such cases.

**NEXUS NIGHTMARES.** No issue involving corporate taxpayers is more contested than the matter of what constitutes nexus. Tax authorities appear to be growing bolder about pursuing companies on the basis of sales, rather than physical presence. New York, California, Massachusetts, New Jersey, and Michigan were ranked by survey respondents as the most aggressive states in terms of "asserting nexus positions for corporate income tax over corporations with only an economic presence in a state."

To assert so-called economic nexus is in itself an aggressive posture, since until quite recently states limited themselves to collecting sales taxes from companies that had established a

## STATE INSECURITY (continued from page 4)

physical presence in the state. But the Iowa Supreme Court, in the KFC case, and the Washington Supreme Court, in a case involving Lamtec, a Pennsylvania-based manufacturer of industrial materials, found in two separate recent decisions that there was no such necessity.

"In both cases, out-of-state corporations that had no physical presence in the host [state] were judged to be subject to tax nevertheless. I think that's a big problem," says Willens. Connecticut also implemented a broad version of the economic nexus standard in January 2010.

The basis for economic nexus may indeed be growing more tangential. The Iowa high court upheld the finding that KFC should be taxed on the basis that it licensed its trademark to independent franchise restaurants in Iowa and was collecting royalties as a result of its trademark. Most alarmingly, tax attorneys say, KFC will have to pay income taxes in Iowa. That represents a significantly more aggressive stance than previous assertions of nexus, which merely required companies to collect sales taxes from their customers.

This past January, the Washington Supreme Court chimed in on the nexus issue, ruling that Lamtec, which sells its wares via telephone, had nexus in the state. The court ruled that the company would be required to pay the state's business and occupation tax (a tax on the company's gross receipts, rather than its profits), interest, and penalties.

The court's reasoning: about two or three times a year, a few Lamtec sales employees visit customers in Washington to answer questions and provide information about the company's products. Willens calls such activity "a pretty tenuous connection" for establishing nexus.

Of special interest to state tax officials are out-of-state online retailers. Employing such notions as "click-through nexus," New York, North Carolina, Colorado, and Rhode Island have already enacted laws that incorporate the theory of economic nexus to enable them to tax companies like Amazon, requiring them to collect sales taxes from online shoppers. Says Walter Nagel, a partner at law firm Reed Smith in Washington D.C.: "More and more of the economy is online and electronic, and so the states are trying to tax as much of that revenue as possible."

**HERE COMES THE AUDIT.** Much of the quest for corporate tax payments, however, centers on good old-fashioned investigations and audits. But there are some new wrinkles there as well. In the District of Columbia, for instance, the revenue department has outsourced transfer-pricing audits on a contingency-fee basis to ACS, a Dallas-based provider of

information-technology and business-process-outsourcing services. Since 2008, Chainbridge Software, an ACS subcontractor, has been using statistical analysis to dig up companies that seem likely to have been avoiding taxes in D.C. by shifting income among commonly controlled corporations.

In its work for the District, Chainbridge calculates a particular company's expected range of profit by comparing it with the estimated profit of comparable companies, according to Stephen M. Cordi, deputy CFO in D.C.'s Office of Tax and Revenue. If the income tax paid by the company is lower than Chainbridge's analysis indicates it should be, the firm does what it calls a "transfer-pricing analysis" to see what further taxation is needed to bring the company within the acceptable range, Cordi says.

For such reports, ACS collects a contingency fee of 16% of the tax revenue the District recovers as a result of its work, up to \$30 million, and 14% of the revenue recovered in excess of \$30 million. There is an overall cap of \$9 million on ACS's fees.

Although D.C. has "collected nothing" as a result of the audits to date, it has a \$3 million case in litigation and a number of cases to follow, says Cordi. If the District ends up collecting all the potential revenue identified by the audits to date, "you're talking \$50 million and up," he adds.

For his part, Stephen Kranz, a lawyer with Sutherland, Asbill & Brennan who is representing the corporation currently in litigation with D.C., objects strenuously to at least one aspect of the District's approach. "The contingency-fee aspect of it is particularly offensive to many in the tax world," he says. "And we think that it very well may be developing into a trend." The presence of a contingency fee "creates an unnatural bias for the auditor to inflate the assessment," Kranz contends. "If the auditor gets paid on the size of the dollar figure they're going to deliver, they're going to be biased toward producing a larger number."

**ROOM TO NEGOTIATE.** With state and local governments pursuing corporate taxpayers so aggressively, what's a CFO to do? "I don't think there's a great deal you can do to plan for this," says Willens, reasoning that a corporation doing decent business in a state won't pull up stakes merely for tax reasons.

Still, there may be a faint silver lining in the fact that states are so anxious for revenue. Such eagerness offers corporate taxpayers an opportunity to settle for a fixed-dollar amount rather than pursuing the uncertainty of long-term litigation, according to Reed Smith's Nagel. In their current dire economic straits, states would rather get their money now than later.

*By David M. Katz • CFO Magazine, April 2011*



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