Key Components of Internal Control

Taxation of Equity Based Compensation

Google’s Game-Changing SEO Squad
From the Editor - Timothy J. McHale

Welcome to the spring/summer edition of the Bottom Line, the newsletter designed to provide insightful advice to area businesses. Today’s business is grappling with a significant level of issues including:

- Attracting, retaining, and motivating strong talent
- Competition from international marketplaces
- Increased difficulty in securing appropriate levels of financing
- Protecting confidential client information
- Grappling with an unknown regulatory environment
- Keeping up with the rapid pace of changing technology
- Developing stronger systems capabilities
- Increasing efficiencies to control pricing

How do you get a competitive edge? Surround yourself with the right tools, including forward thinking professionals such as C&A. In this issue of the Bottom Line, are articles on how you can use Google’s search engine to maximize your internet presence, establishing an effective internal control environment, and developing equity compensation plans.

If you visit our website at www.ceriniandassociates.com, there is even more information to help you run your business more effectively. And while articles can provide valuable information, there is no substitute for the real thing. Give us a call, we’re here to help.

We’re looking forward to making a difference in your business.

Sincerely,

Tim McHale, Partner

Key Components of Internal Control

Internal controls are one of the most essential elements within any organization. Internal controls are put in place to enable organizations to achieve their goals and missions. Management is responsible for the design, implementation, and maintenance of all internal controls, with the Board responsible for the overall oversight of the control environment. Strong internal controls allow for organizations to achieve three main objectives. These three objectives are: accurate and reliable financial reporting, compliance with laws and regulations, and effectiveness and efficiency of the organizations operations. In order to achieve these objectives an internal control framework needs to be applied and followed throughout the organization. The five components of the internal control framework are control environment, risk assessment, control activities, information, and communication, and monitoring.

The first component, control environment, is crucial since it’s the foundation for the four other components of internal control. The control environment sets the tone at the top of an organization and provides discipline and structure. Within the control environment there are several factors that include the following:

**Ethical Values and Integrity**

Management and employees must show integrity. If management displays issues of lack of integrity, it can trickle down to the employees causing internal control issues and opportunities for fraud.

**Human Resource Policies & Procedures**

Control difficulties can be avoided by sound hiring procedures, training of new employees, and appropriate discipline.

**Organization Structure**

Organizations that have a clear understanding of who reports to whom within an organization will limit the chance for internal control issues.

**Participation of those Charged with Governance**

It is important for those charged with governance (audit committee, board of directors, etc.) to be involved with the organization and monitor internal control functions.

**Philosophy of Management & its Operating Style**

If management incorporates the importance of internal control in its operating style, employees will know the seriousness of the matter.

Responsibilities and authority need to be assigned to different employees throughout an organization. Decision-making responsibilities should not be assigned to one individual.

The second component is risk assessment. Risk assessment is the identification and analysis of risks that could prevent the organization from achieving its objectives. Properly identifying risks will allow management to determine how to mitigate and manage these risks. Risk factors could consist of internal and external factors. Management should evaluate risk on a regular basis, as changes in an organization, such as staffing, new policies, new software applications, new regulations, etc., could all impact an organization’s risk assessment.

The third component is control activities, which are the policies and procedures that help ensure that management directives are carried out. One of the most important control activities is segregation of duties. Different individuals should be responsible for authorizing transactions, recording transactions, having custody of assets, and performing comparisons/reconciliations. Having proper segregation of duties is sometimes difficult for small organizations; however, organizations should try to segregate these functions to the best of their ability. In situations where segregation cannot occur, proper management oversight should be implemented so that any errors or irregularities can be timely caught.

Information and communication is the fourth component of internal control. This relates to the identification and transfer of pertinent information in a timely manner that permits personnel to perform its responsibilities. For instance, having timely financial reporting can allow management to identify anomalies in its operations such as drops in margins, high reserves, etc.

The last component is monitoring, which is a key element of developments responsibilities when it comes to internal control. Top management is responsible for monitoring all controls and to determine if the controls are operating as they were intended. If controls are not operating effectively, management is then responsible to modify these controls. Monitoring is often done through a company’s quality assurance or internal control departments.

If these five components are implemented and are operating effectively, they can help ensure that an organization will achieve its goals while avoiding complications along the way.
In order to attract and retain staff in the competitive talent marketplace, many companies will now need to offer their employees equity compensation along with traditional salaries. How a business compensates their employees with equity depends largely on the structure of their business, whether organized as a Corporation or a Partnership (LLC). Companies need to be aware of the many different opportunities for equity based compensation for their key employees and the tax effects of issuing such alternative compensation on their business.

**Corporations & LLCs Taxed as Corporations**

With an LLC taxed as a corporation, the impact on a business would be the same as that of a traditional corporation. Corporations generally have 3 different methods of compensating employees:

**Incentive (Qualified) Stock Options (ISO)** – ISOs are typically offered to executive level employees and have significant restrictions on their exercise and grant. These options do not offer any corporate level deduction for the company and as such do not have any tax impact upon grant, to the employee.

**Non-Qualified Stock Options (NQSO)** – NQSOs are more common options that can be granted to both employees and other service providers. These options will have a strike price (how much the shares will cost the employee) and often an expiration date. The difference between the strike price and the value of the shares represents the taxable portion of the grant, known as the bargain element. Neither the corporation nor the employee recognizes a taxable transaction on grant; the taxable event occurs upon exercise. The difference between the option strike price and value when exercised represents compensation to the employee and a compensation deduction for the corporation.

**Restricted Stock/Restricted Stock Units** – Restricted stock can be considered the sister of ISOs. Restricted stock refers typically to shares awarded to an executive level employee. The shares are often subject to vesting schedules, with the employee losing any shares that haven’t been vested. The employee will recognize income when the shares vest and are no longer subject to forfeiture; the company will recognize a deduction at the same time. There are some legal differences in contractual nature between restricted stock and restricted stock units; however, their tax treatment is mostly the same.

**Partnerships & LLCs Taxed as Partnerships**

Unless an LLC elects to be treated as a corporation, the entity will default to be treated as a partnership. In early startup years, a partnership benefits owners since the business losses will pass through to their personal tax returns, allowing them to potentially take these losses against other income. Additionally, many investors enjoy the benefits related to a single layer of taxation rather than the additional tax costs of an incorporated structure. Partnerships differ greatly in both the nature and planning opportunities for equity based compensation. There are 2 primary methods for equity based compensation in a partnership.

**Capital Interest** – A capital interest refers to a grant of partnership equity to an employee that includes a right to the equity of the business prior to the date of the grant. Said another way, the employee gets to share in a percentage equal to the grant of all of the value of the business prior to the grant. A capital interest is determined by the liquidation rights on the date of the grant – if the employee is entitled to assets upon liquidation, then it is a capital interest.

A capital interest will give rise to a deduction to the business equal to the value of the newly created capital account, and the employee will recognize ordinary income equal to the deduction taken by the business.

**Profits Interest** – The IRS broadly and foolishly defines a profits interest as “any interest other than a capital interest”. In practical terms, a profits interest represents an interest in the future appreciation of a partnership from the date of grant. From the date of the grant, the employee will share in the profits and losses of the partnership equal to his percentage grant and begin to create a capital account which represents the appreciation of the partnership from the date of grant. An important feature of a profits interest is that the grantee has no liquidation rights on the grant, only on the future appreciation.

Given that at the date of the grant the employee is not being given anything other than a right to future growth, the business will not recognize a deduction for the grant and the employee will not have any income.

Different business structures allow for different methods of rewarding employees with equity compensation, each with different tax effects for the businesses. On top of compensating employees for their hard work, equity based compensation can often align the goals of the business with the goals of the employees to help maximize the value of the entity and to encourage growth. With the multitude of options, it is important for all businesses to make sure they understand their options and how these different forms of equity compensation will affect their taxable situation.
today, Google confirmed last month that Panda is its official core ranking algorithm. Panda rewards high quality sites by improving the sites page ranking and penalizes the low quality ones by reducing the site to a lower page rank.

“I look at Google and think they have a strong academic culture. Elegant solutions to complex problems.”

Mark Zuckerberg
Co-Founder/Chief Executive of Facebook

Panda, Penguin and Hummingbird, Oh My! Over the last few years, Google’s famous animal named algorithms have everyone on their toes restructuring their online content marketing strategies. When a good percentage of individuals are overwhelmed just as the “a” in algorithm starts to roll off of a tech-savvy person’s tongue, this high level overview is a good starting point into this foreign land. You may ask yourself, why as a business owner do I really need to know about SEO and these techy terminologies? If you want to increase your website traffic organically by 10 to 20 percent, then it’s fair to say that a few moments of your time is well worth it.

First, let’s really understand what an algorithm is. Basically, they are computer problem solving search tasks or recipes, and in this case focus on returning the best answers. Over the years, Google created a few algorithms named Panda, Penguin and Hummingbird that changed search engine land for a better and safer internet experience.

Pandas are high maintenance in real life and in the SEO world! In 2011, Google introduced the Panda algorithm and it has been updated over 28 times to the fierce spam-fighter Panda it is still king, knowing semantic phrases users would ask is the ace up your sleeve.

Google’s Webmaster Guidelines
In order for your site to rank well in search results pages, it’s important to make sure that Google can crawl and index your site correctly. Our Webmaster Guidelines outline some best practices that can help you avoid common pitfalls and improve your site’s ranking. Google’s Did you mean and Google Autocomplete features are designed to help users save time by displaying related terms, common misspellings, and popular queries. Like our google.com search results, the keywords used by these features are automatically generated by our web crawlers and search algorithms. We display these predictions only when we think they might save the user time. If a site ranks well for a keyword, it’s because we’ve algorithmically determined that its content is more relevant to the user’s query.

Basic Principles

• Make pages primarily for users, not for search engines.
• Don’t deceive your users.
• Avoid tricks intended to improve search engine rankings. A good rule of thumb is whether you’d feel comfortable explaining what you’ve done to a website that competes with you, or to a Google employee. Another useful test is to ask, “Does this help my users? Would I do this if search engines didn’t exist?”
• Think about what makes your website unique, valuable, or engaging. Make your website stand out from others in your field.

Important Links for Additional Information:

Link to Google’s Webmaster Guidelines
http://bit.ly/1c0hosN

PDF of Google’s SEO Starter Guide
http://bit.ly/1cM4JAVT
http://bit.ly/1ofq6n6

http://bit.ly/1o6Ini6

“Does this
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As accountants, we are exposed to hundreds of businesses, but are also business owners ourselves and understand the challenges that businesses face. We leverage our experience and resources to help fuel growth.

AUDIT & ASSURANCE
Stakeholders have a vested interest in your financial reporting. We can help provide them with credible financial reports as well as tools to discover opportunities within businesses.

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Edward O’Hara, Owner & Sr. Partner
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- Real Estate
- Healthcare
- Manufacturing
- Technology
- Professional Services
- Inbound International Businesses
- Emerging Startups

Business Overview
TAX SERVICES
Our team of dedicated professionals has years of expertise assisting business owners navigate compliance obstacles and minimizing their tax costs.

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