

“Swipe Fees are Causing Headaches for All!”

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Abstract

The objective of this white paper is to research and cohesively present some of the most important data regarding recent legislation and judicial action focusing on debit and credit card “swipe” or “interchange” fees.

We will begin by addressing the contextual background of credit card interchange fees that retailers have historically paid to MasterCard, Visa and other financial institutions. We will discuss the circumstances that led up to the recent class action lawsuit and the settlement that resulted. We will report some of the options available to retailers, their reactions, and the potential repercussions they could face as a result of customer backlash.

Further, we present the current and future significance of the settlement for retailers and consumers, from their unique perspectives. We will share insights and reactions from consumer groups, various retail trade associations and their leaders and members, and the viewpoints from the individual states that rejected the settlement. We will provide an update of the activity in Trenton regarding New Jersey’s reaction to the proposed settlement.

Lastly, we would be remiss if we did not include a brief overview of the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and its impact on the retail sector, including banks, retailers and customers, regarding debit card interchange fees.

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1. A Historical Look at the Credit Card “Swipe Fee” Proposed Settlement

Where It All Began

In 2005, a class action antitrust lawsuit was filed by merchants, including some very large supermarket and drugstore chains, against Visa, MasterCard (who together control 80% of the credit card market) and their banks because these retailers claimed that the credit card companies colluded to fix the fees that the stores pay to accept their credit and debit cards. Because Visa and MasterCard do not lend to the people who use the cards that bear their logos, they charge fees, which are called “interchange fees” in the industry.

These fees, which average about 2% of the price of a customer’s purchase, are set by card-processing networks, but are collected by, and split with, the banks that issue the cards. Along with the charges of collusion, the lawsuit also sought approval to charge shoppers a fee at checkout (referred to as a “swipe fee”) to help recoup some of the retailers’ processing costs. It is important to note that these fees are significant, representing a rapidly growing cost to merchants amounting to more than \$48 billion (\$31 billion in credit card fees) annually.

Where We Stand Today: Terms of Settlement

The terms of the settlement proposed in October 2012, based on *The Payment Card Interchange Fee and Merchant Discount Antitrust Litigation* (United States District Court for the Eastern District of New York), includes the following:

- A cash payment of approximately \$6 billion to a class of approximately eight million retailers;
- A temporary reduction in transaction processing fees worth approximately \$1.2 billion; and
- Striking the language from payment processing agreements that precludes retailers from directly passing on their payment processing costs to customers who are paying with credit cards, thereby allowing retailers to charge a swipe fee to their customers.

In an article dated March 4, 2013, the National Retail Federation (NRF) stated that retail merchants will basically have just these three alternatives:

- Accept the settlement money and therefore be barred from ever again being part of a challenge to Visa and MasterCard practices, and accept injunctive relief of questionable value;
- Accept the settlement money and be barred from challenging bad practices, but object to the injunctive relief; or
- Turn down the settlement money and maintain the ability to join challenges and object to the injunctive relief.

It is for these reasons that the proposed settlement is not without controversy.

There are many who have criticized the overall intent of the settlement, complaining it has the potential for alienating customers by casting the retailer as greedy, while at the same time providing too little compensation for the merchants, as well as forcing them to give up their right to future legal action against Visa and MasterCard. The merchants also feel that the settlement does not address their problems going forward.

Jeffrey Shinder, a lawyer for retailers and industry trade groups, said the settlement had “fatal legal defects,” most specifically because it bars the retailers from filing future lawsuits against credit card companies.

In addition, the proposed \$7.25 billion settlement gives United States merchants, both brick and mortar and online, the option to pass on the cost of interchange fees—the payments merchants make to the credit card issuers—to their shoppers in the form of a swipe fee when purchasing goods or services. This option was set to commence January 27, 2013. **It is this option that is attracting the attention of consumers and consumer relief organizations.** The fee is intended to help defray the cost of the interchange fees charged to the merchant by Visa and MasterCard, but it can be a bitter pill for the shopper to swallow.

If retailers accept the proposed settlement, there are some criteria guiding how swipe fees would be charged to consumers:

- Swipe fees are illegal in ten states including California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma and Texas. The laws of each of these states would determine whether it would be legal for companies, based in other states, to charge swipe fees to residents of its state.
- Retailers are only allowed to charge a fee that is equivalent to what they pay to accept the card, which in the United States is estimated to be 1.5% to 3% of the total purchase, although a maximum of 4% is permitted.
- The disclosure on the receipt must list the amount of the swipe fee, the fact that the merchant is imposing the charge, and that the fee is not greater than what it costs the retailer to accept credit and debit cards.
- Swipe fees can vary for different kinds of cards, such as reward or premier cards—so a merchant may offer a discount for paying with a specific card network.
- A merchant may not set a minimum purchase amount for paying with a debit card.
- A merchant must clearly disclose any discounts or incentives they offer.

While some consider this part of the “deal” a victory, many worry about the response of angry consumers.

It may be a moot point. As of May 21, 2013, actions taken by 17 major retailers could put the final approval of this proposed multibillion-dollar legal settlement in jeopardy, or, at least, postpone its acceptance. Leading retailers Target, Macys and Kohls—with the backing of the NRF which announced that it, too, would formally oppose the proposed settlement—were among those who filed a lawsuit with less than one week to go before the deadline for stores affected by the settlement to decide whether or not to give up a share of the settlement proceeds and pursue their own legal action. Visa and MasterCard have now retaliated by suing those 17 retailers and the NRF for backing out of the settlement.

The retailers' last-ditch counter-lawsuit and their refusal to accept the settlement draws a line in the sand. But even for those merchants who might want to vote to accept the money, it is anticipated by the NRF that the average small retailer could end up receiving only a few hundred dollars in retribution, while the banks and credit card companies continue to collect fees that are estimated to total \$4 billion per month or over \$50 billion per year.

2. How Have U.S. Retailers and Their Trade Associations Reacted to the Proposed Settlement?

One Perspective: Not Such a Great Deal!

The settlement states that, commencing in January 2013, retailers, in all but the ten states noted above, have the option, if they so choose, of charging a swipe fee to customers to help mitigate the costs they pay to banks for processing credit card transactions.

Although retailers have been fighting credit card processing fees for years, this settlement brings a whole new set of challenges instead of the solutions they'd hoped for. They would now have the option of passing these fees on to the customers; however, they must consider the reaction it could invoke from frustrated, price-conscious shoppers. The retailers involved in the lawsuit attempted to persuade the judge overseeing the case to reject the settlement, but to their dissatisfaction, the settlement remains offered as-is.

Some retailers believe that because the settlement was, in part, crafted by the credit card industry, the terms should be carefully scrutinized regarding the impact on the average merchant operating in the U.S.

Most of the retailers' objections stem from the fact that the settlement fails to achieve the original goal of reforming the near monopolistic system where Visa and MasterCard set the schedule of swipe fees allowed by virtually all of the banks that issue their cards. Since accepting the settlement would preclude the class from suing Visa and MasterCard in the future over interchange fees or payment technologies, this could potentially serve to further empower Visa and MasterCard.

It is, of course, up to each retailer to walk the fine line and make the decision regarding the new fees. The smaller retailer is more likely to charge swipe fees, although few retailers want to be the first. No one wants to take the chance that consumers will walk away. "We have no intention of trying to pass any of this cost on to the consumer in new fees and we doubt it would be well-received by the consuming public by any merchant who does," observed Rob Armstrong, Vice-President, Bennett Enterprises, which owns Ralphie's, Frisch's Big Boy, and four hotels in Ohio.

The big chains, such as McDonald's, Wal-Mart and Target agree. From the outset they came out strongly against the settlement, arguing that the fees were unfair to begin with. They believe that they cannot accept a settlement that endorses the fees' continuing existence, regardless of who pays them. (As of mid-May 2013, 17 retailers now oppose the billion-dollar settlement and have opted out. See above for details.)

Retailers will have obligations if they charge swipe fees. As mentioned in Section 1, retailers will be expected to:

- Limit their fees to the transaction cost (up to a maximum of 4% of the purchase);
- Impose the surcharge on credit card transactions only (not on debit cards);
- Disclose the dollar amount of the surcharge on the customer's receipt;
- Disclose that the fee is being charged by the merchant and not by the card issuer;
- Disclose that the fee does not exceed the merchant's cost to accept/process credit cards;
- Post signs at store entry and point of sale that state checkout fees are imposed on credit card purchases; and
- Disclose the fact that they are not imposing any charges that are higher than the costs they assume when accepting different types of cards.

Seth Broman, Vice President of Business Development with Merchant Cash and Capital, believes that, in terms of public perception, it may be unwise for a small business to add the surcharge. "As we have transitioned into a cashless society, a smarter competitor to a restaurant charging a surcharge is one that advertises it doesn't charge a surcharge," Broman said.

A Different Perspective: It's Not Such a Bad Deal After All!

While some retailers worry that the terms of the settlement are too stringent, it does provide them with the means to pass interchange fees through to the consumers. Should they choose to do so, there is the potential for significant relief from the interchange fees they have been paying.

For this reason, some retailers will embrace the decision as a positive step forward. As MasterCard spokesman James Issokson reminds the industry, "The provisions of the settlement, including the flexibility for merchants to impose checkout [swipe] fees, [were] reached with the assistance of the court and [were] supported by the merchant class representing millions of large and small retailers, and prominent trade groups across the country," thus giving the settlement decision credibility and sustainability, reinforced by support from retailers themselves.

And in spite of the escalating momentum against the deal, Merrill Davidoff, attorney with Berger & Montague, one of the lead counsels for the class, said he is confident that the settlement is a very good deal for merchants.

A Retail Trade Association Leader Makes a Point

In an article published in *The Shelby Report* on February 7, 2013, Linda M. Doherty, President and CEO of the New Jersey Food Council, a Trenton-based trade association representing New Jersey supermarkets, convenience stores, independent grocers and food distribution companies, writes:

“When the card companies hike up hidden swipe fees, merchants have no choice but to include this cost in the price of the goods they sell. No business owner can absorb this kind of expense and keep the doors open for long. In turn, everyone has to pay more regardless of if they are paying with cash, check or credit card.

The New Jersey grocery industry employs 150,000 people in several thousand stores across the state. We are an essential resource for feeding families and an important part of the economy. The grocery industry is also an extremely competitive industry with retailers competing for customers by trying to offer the most value at the lowest cost. With razor-thin profit margins, around 1 percent annually, grocery stores are always looking for ways to save the consumer money.

It’s one thing when food prices go up because a drought decimated the corn crop or because rising gas prices make it more expensive to bring food to our stores. We still negotiate with suppliers in a competitive market to get the best deal.

It’s another thing entirely when we are forced to pass along rising costs for one reason alone—because the credit card companies and big banks hide from competition and fix fees instead. Retailers have never been able to negotiate with VISA and MasterCard for lower fees on credit card transactions.”

3. How Are Consumers Impacted?

The average American household currently pays hundreds of dollars a year in credit and debit card swipe fees, which are part of the cost of virtually every transaction they make, in the form of increased retail prices. Nearly \$2 of every \$100 that consumers spend in retail stores is paid out by retailers as interchange fees.

It is easy to see from these statistics that we live in a plastic-driven, cashless society. A report issued in 2011 by the Federal Reserve noted that there were 46.7 billion credit card transactions—totaling \$1.82 trillion, up 24% in volume and up 27% in dollars charged, in just two years. With so many Americans relying on their credit cards, there can be a significant impact resulting from the proposed swipe fees.

Now that merchants can legally pass additional swipe fees on to the consumer, *Wise Bread* suggests that consumers need to know how credit card swipe fees work; who will charge these fees; and what can the shopper do about these new fees.

How Do Swipe Fees Work?

Beginning in January 2013, U.S. merchants, both brick and mortar and online, have the option to pass on the cost of interchange fees—the payments merchants make to the credit card issuers—to their shoppers in the form of a surcharge when purchasing goods or services. Up until now, retailers have absorbed these costs. These fees, which average about 2% of the price of the purchase, are set by card-processing networks but are collected by, and split with, the banks that issue the cards.

Who Will Charge Swipe Fees?

The retailers can determine the price of certain products and services and what types of payment they accept. There are fee limits and disclosures included in the settlement, but it is up to the retailer whether or not to leverage the ruling to obtain extra fees. Consumers should be aware that there is an added charge to the transaction and that can help them make an educated purchasing decision.

How Can Consumers Handle Swipe Fees?

Complaints are being brought to the public by various consumer advocacy groups and trade organizations, warning about the changes. The group *Consumer Action* has provided resources for consumers to keep them informed and a website—KnowYourCard.org—is also sharing relevant information.

Knowledgeable consumers may begin to pay cash only for large purchases, or they may opt to negotiate prices when paying with cash. Finding alternative methods of payment could be the best way to keep costs down. Consumers may also shift their spending to merchants

who have not opted to charge swipe fees. Certainly, they will find it more difficult to make “apples to apples” price comparisons between various merchants.

4. How Are the Individual States and Consumer Groups Approaching the Settlement?

Swipe Fees Are Like a Hot Potato

Although the proposed settlement was supposed to be a mark in the victory column for retailers, 10 out of 17 retailers and trade groups that were parties to the original lawsuit in 2005 say they are trying to block the ruling because all it would accomplish is to enable the credit card industry (Visa and MasterCard) to keep taking advantage of small merchants and their customers.

Despite the billions of dollars of awards going to retailers as a result of the landmark decision, the anticipation of rising fees for customers has put everyone on edge. But Ed Mierzwinski of the U.S. Public Interest Research Group says consumers need not be frantic yet. He supports his perspective by noting that, "...the checkout [swipe] fee or surcharge would be a sure way for business owners to lose customers, and they definitely don't want this to happen." Nancy Kyle, President of the Retail Merchants Association of New Hampshire concurs with this assessment by saying, "I think you are going to see retailers be very hesitant to pass costs along to their customers." She believes it is unlikely that stores that rely on retail sales will be taking advantage of this option that is so unfriendly to consumers. And to add fuel to the fire, Jeff Lenard of the convenience stores' group adds, "We are first among the plaintiffs to reject the deal and I suspect we won't be the last. This proposed deal offers temporary relief to merchants at best. At worst it is a stunt in a trap."

As one may imagine, spokespeople for both the NRF, which is the world's largest retail trade association and the voice of retail worldwide, and Consumer Action Group also doubt that the surcharges will be very popular. NRF spokesman Craig Shearman reflected that most retailers don't even plan to enforce the surcharge at this time—fearing that imposing the fees would chase away business.

New Jersey Retail Merchants Association President, John Holub, emphasizes that stores won't make customers pay swipe fees. "Consumers over the last few years, especially since 2008 when the recession hit, have become extremely price conscious. So the last thing you're going to do is add an additional price onto a product," Holub said. "Retailers are just not going to alienate the consumers that way."

"It is more likely that the fee will be introduced gradually," commented Ruth Susswein of Consumer Action. Wal-Mart, Target and Costco are expected to decline the option, according to John Ulzheimer, President of smartcredit.com. "Their pitch is that they are the cheaper alternative so it is unlikely they will be adding on costs to the consumer right now."

The National Association of Convenience Stores adds its voice to the other groups like the Merchants Payments Coalition, fighting for a more competitive and transparent credit card fee system that is fair for both consumers and retail merchants as they speak out against

the settlement, saying they oppose it, aligning with others in the consumer protection arena.

Some States Speak Out—Ban Settlement

Ten states have passed laws prohibiting the surcharges. These states are California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma and Texas.

New Jersey Takes a Stand

The new surcharge, which applies to retailers in most states, allows them to pass the cost of processing credit card transactions on to the consumer. But closer to home, a measure before the New Jersey Senate would put a stop to the additional fees, as New Jersey lawmakers are considering taking preventive action.

New Jersey Senate Bill S-2533 would make it illegal for retailers to impose a surcharge on customers who pay with a credit card. Under the law, stores that did impose the fee would be subject to a \$10,000 fine for the first offense.

“Retailers have already built the cost of credit card fees into their prices,” Senator Robert Gordon, a Bergen Democrat, said in a statement. “This change in regulation is, in essence, allowing retailers to double-dip into their customers’ pockets—customers who are already paying interest fees to the credit card companies for their purchases.”

The Bill, sponsored by Senators Robert Gordon, Jim Whelan and Nia H. Gill, was introduced during a February 4, 2013, hearing of the Senate’s Commerce Committee.

Here is the current chronological progress of the Bill:

- Received in the Assembly without Reference, 2nd Reading (Feb. 7)
- Passed Senate (31-4) (Feb. 7)
- Senate Motion to Table (23-14) (Weinberg) (Feb. 7)
- Senate Motion to Senate Amendment (Kean) (Feb. 7)
- Reported Out of Senate Committee with Amendments, 2nd Reading – Senate (Feb. 4)
- Introduced in the Senate, Referred to Senate Commerce Committee – Senate (Feb. 4)

Under the proposed settlement, State Sen. Jim Whelan, D-Atlantic, says that swipe fees could be as much as 4%. “Credit card companies and the banks both seem to be doing OK. We want to protect the consumers. They’ve been fine without it,” Whelan said in February

2013, speaking on behalf of a ban. “We don’t see any reason why they would need it going forward.”

Whelan says he’s not aware of any merchants in New Jersey who are actually making consumers pay a swipe fee; however, “...we want to get the bill in before it becomes commonplace,” Whalen explained. “It could be up to as much as 4% and if we were to go out and try to raise the sales tax by 4%, people would jump up and down and scream—rightly so.” Under terms of the proposed New Jersey ban, stores that do impose the surcharge could face a fine of as much as \$20,000.

“Merchants in New Jersey have no desire to surcharge and no plans to surcharge,” said J. Craig Shearman, a vice president of the National Retail Federation. “The concept of widespread surcharging is purely card industry propaganda.” Shearman said New Jersey merchants are “theoretically” allowed to charge customers for Visa and MasterCard charges, “...but anyone seeking to do so would have to meet a complex set of requirements” few retailers could meet.

“At this point in time there is no way we would consider doing that,” said Scott Gillman, who heads the company that brought the Smashburger franchise to New Jersey. “It’s going to upset a lot of people and that’s not something we’re interested in doing.”

5. What Is the Durbin Amendment and How Does it Impact Debit Card Fees?

Understandably, much of the focus over the recent few years has been the lawsuit of 2005 and the resulting suggested settlement regarding the charges of collusion and the methodology for addressing the rising cost of credit card swipe fees.

However, the critical issue of debit card fees was not ignored. In fact, it was addressed in 2011 when the Federal Reserve issued its final ruling on interchange fees.

The debit card interchange fee is much like the fee that is imposed when a credit card is swiped. The fees are mainly assessed to defer the cost of fraud prevention and the cost of processing the transaction. Since the chance of a fraudulent charge on a debit card is low (when a PIN is required), the resulting fees are low as well. While swipe fees amount to \$48 billion a year, only \$17 billion of that is generated by debit cards.

The Durbin Amendment to the Dodd-Frank Act (added by Senator Dick Durbin, D-IL) created the “controlled environment” surrounding debit card interchange fees. It creates a limit on debit card interchange fees, which is set by the Federal Reserve at a “reasonable level.” The Federal Reserve would determine this “reasonable level” as it identified the true cost of fraud prevention—limiting the debit card interchange fees to an appropriate level based on reality.

On July 30, 2013, U.S. District Judge Richard Leon ruled that the Federal Reserve considered data that it was not empowered to use by the Dodd-Frank Act in setting caps on debit card interchange fees. The Fed had set the limit at 21 cents per transaction after considering a cap as low as 12 cents; the 12 cent cap was abandoned after banks complained that it was too low.

Judge Leon’s ruling sent the Fed back to the drawing board to rewrite the rules governing debit card interchange fees. The judge noted that he is inclined to force the Fed to rewrite the rules in “months, not years.” While awaiting new or interim regulations, the existing regime will remain in place.

6. Final Thoughts

This is a situation in great flux. The retailers in this instance find themselves having much in common with David when he went into battle with Goliath. For many years, they have struggled against the duopoly of the twin giants Visa and MasterCard. Unfortunately, when a settlement was finally handed to them, it seemed to be a double-edged sword.

On one hand, they were given the tools to collect on the crippling credit card processing fees by instituting a swipe fee on their customers at checkout. On the other hand, they were 'handcuffed' regarding other areas, including taking future legal action if they accepted the cash and the terms of the settlement.

It is a conundrum. Some states flatly rejected the settlement right from the start with others poised to follow their lead, and now some of the major retailers and the sector's most prominent trade groups are backing away as well.

Only time will tell what the final result will be. But one thing is for sure: consumers need to be alert and vigilant, watching for any additional charges when they make their purchases.

Interestingly, interchange fees are coming under scrutiny in other countries as well. In July 2013, the European Commission unveiled legislative plans to cap interchange fees at 0.2% and 0.3% for debit and credit cards, respectively.

Credit card fees are center stage, especially given the fact that the settlement has not been widely endorsed or accepted. But that doesn't mean that debit card fees have been ignored. The difference is that the Dodd-Frank Act and the Durbin Amendment were passed into law, making it accepted policy to control the fees by means of a fair capping system, without much controversy.

Going Forward

We will continue to monitor the situation, both across the country and at home here in New Jersey. As changes occur, we will provide an addendum to this paper and share the updated information with you in a timely manner.

7. About Sobel & Co.'s Retail Practice

Sobel & Co., a regional public accounting and consulting firm located in Livingston, New Jersey, has been adding value to the area's business community since 1956! Our retail clients benefit from the depth of experience of the professionals in the Retail Industry Services Group. This team offers real-world experience gained from working with clients whose business revenues range from \$5 million to \$350 million, across a range of sub-niches from grocery store chains to drugstore chains to apparel stores.

This expertise enables us to work closely with clients, earning their trust and delivering exactly the scope of services that they find most relevant. Our team is involved in several industry trade associations and is knowledgeable about the trends and changes that are impacting our clients in this sector.

At our clients' suggestion, and working in tandem with them, our Retail Industry Services Group offers traditional auditing, accounting, tax and business consulting along with:

- Cash flow management
- Consulting services
- Financing alternatives
- Forensic accounting/Litigation support
- Fraud vulnerability studies
- LIFO inventory
- New site valuation
- Cost segregation analyses

For more than 50 years, Sobel & Co. has served the retail sector with experience, business acumen, technical skills and a dedication to understanding the unique situation facing retailers in a constantly changing business climate.



8. About the Retail Practice Group Team

DAVID CALOTTA, CPA Audit Manager

David Calotta joined Sobel & Co. in July 2011, after graduating from Ramapo College in New Jersey in 2008 where he earned a Bachelor of Science degree in Accounting. He went through the ranks at the firm, quickly advancing from senior level to manager because of his knowledge and technical competencies, his values, and his strong sense of responsibility and accountability. His proactive approach to client care and his technical skills in accounting make him a favorite at the firm and with the clients.

Dave works across a range of industry sectors but has begun to develop a specialty in the retail sector, serving as one of the mentors in this practice group while working to educate other staff members on the constantly changing and evolving trends in this niche.

Dave works with Sobel & Co.'s retail clients in areas including financial statement audits, tax return preparation, cash flow projections, tax projections, and internal controls. Dave leads the firm's new hire training program and he is actively building meaningful relationships in the New Jersey business community.

A member of the New Jersey CPA Society (NJSCPA) and the American Institute of CPAs, Dave earned his CPA license in May 2011. He has written articles for the NJSCPA Newsletter, *Tomorrow's CPA*, and over the last five years his contributions to the firm and to the business community have been recognized, resulting in his being included on the prestigious NJSCPA "30 under 30" list in 2011.

Outside of work, Dave enjoys spending time training for endurance events as well as hiking and kayaking with his wife, Danielle, and his dog, Tucker.

HAROLD R. SOBEL, CPA
Member of Firm

Harold Sobel, Member of the Firm of Sobel & Co., is highly regarded for his skills as a business advisor. Harold has developed expertise in the area of closely held business planning, including budgeting, cash flow management, forecasting and succession and estate planning.

Harold is actively involved in consulting to the retail industry, especially to retail chains in the supermarket niche on cash management, new site analysis, budgeting, LIFO accounting, and special depreciation issues.

Harold is a Certified Public Accountant in the state of New Jersey. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants. He is an active member of the New Jersey Food Council. He is also a frequent speaker on various aspects of financial reporting.

In addition, Harold serves as treasurer of Hilltop Country Day School, a non-profit, independent school.

Harold is a graduate of Bentley University in Massachusetts, where he received a Bachelor of Science degree in Accountancy.

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