MANUFACTURING INSIDER

Fall 2015

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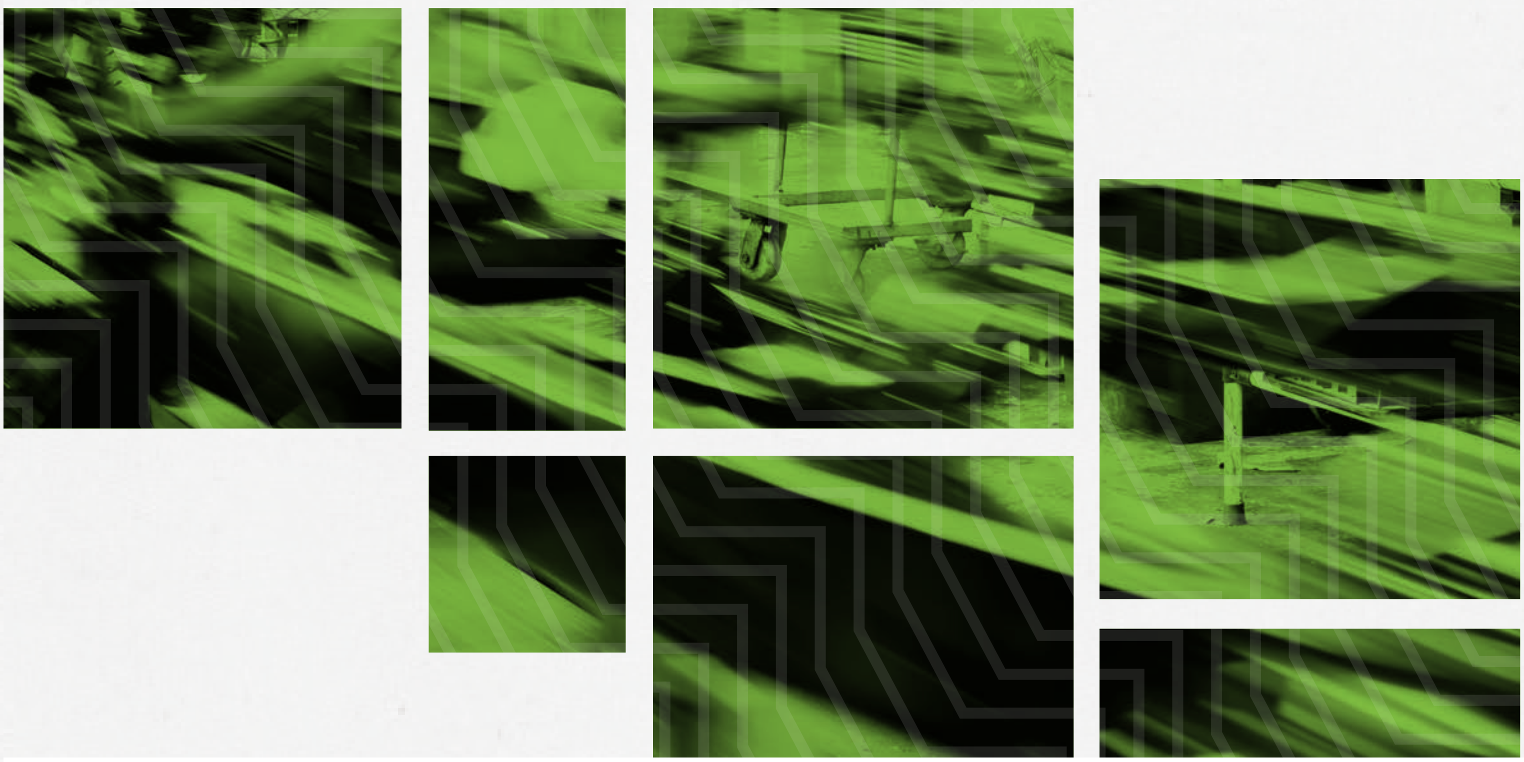

HENDERSON HUTCHERSON & MCCULLOUGH, PLLC
1200 MARKET ST | CHATTANOOGA, TN 37402 | 423.756.7771 | HHMCPAS.COM

CERTIFIED PUBLIC ACCOUNTANTS

PROACTIVE ESTATE PLANNING STARTS TODAY

It's common for manufacturers and distributors to be family-owned. Unfortunately, it's also common for owners to let estate planning fall by the wayside, causing family members to lose out on tax-saving opportunities.

The American Taxpayer Relief Act of 2012 (ATRA) brought some certainty to estate planning, but the current calm could be disrupted by future tax reform efforts on Capitol Hill. If you haven't recently reviewed your plans for transferring wealth and management responsibilities to the next generation, now is the time to do so.

WHAT ARE THE CURRENT RATES AND EXEMPTIONS?

Under ATRA, the top gift and estate tax rate is now 40%. The law also permanently sets the gift and estate tax exemption at an annually inflation-adjusted $5 million. For 2015, it's $5.43 million. As a business owner, you can transfer up to that amount tax-free to your heirs while you're alive and bequeath whatever amount is remaining tax-free upon your death.

The same tax rate and exemption amount apply to the generation-skipping transfer (GST) tax. Generally, this tax is assessed - in addition to the gift or estate tax - on transfers to grandchildren and others more than one generation below you.

The annual gift exclusion remains unchanged at $14,000 per donor and recipient in 2015. In other words, a married couple can gift up to $56,000 to their son and daughter-in-law ($28,000 combined times two recipients) tax-free without using up any of their gift and estate tax exemption. Annual exclusion gifts are also excluded from the GST tax. In addition, you can pay unlimited medical and tuition expenses on behalf of family members without incurring gift tax, if you make the payments directly to the providers.

The unlimited marital deduction for wealth transfers between spouses remains unchanged. But ATRA made the "portability" of the estate tax exemption between spouses permanent, too. This means that, if one spouse dies with part (or all) of his or her exemption unused, the estate may elect to permit the surviving spouse to use the deceased spouse's remaining exemption. (Note: Portability doesn't apply to the GST tax exemption, and some states don't recognize portability.)

HOW MUCH WILL BE SUBJECT TO ESTATE TAX?

Say a retiring plastics manufacturer decides to sell his business to the management team for $5 million in upfront cash and $2 million per year for the next five years. Under the marital deduction, all of the sale's proceeds could be transferred to a surviving spouse estate-tax-free upon the business owner's death.

Following the survivor's death, up to an inflation-adjusted $10 million - the combined amount for both spouses - could be transferred to the couple's only child tax-free, while the remainder of the estate could be taxed at 40%. Additional estate and inheritance taxes may apply at the state level.

WHAT ARE MY OPTIONS?

Some family business owners aren't ready to hand over the reins to their heirs just yet. They want time to groom the next generation to run the show. Various estate planning tools, such as family limited partnerships and certain trusts, help balance the transfer of wealth with the retention of managerial control.

Before you can decide which estate planning tools to use, however, you need to know how much your business is worth. Minority interests in small to midsize companies may be subject to discounts for lack of control and marketability that only a qualified business appraiser knows how to quantify and support. Market values also fluctuate as the economy ebbs and flows, so you'll need regularly updated business appraisals to ensure your estate plan continues to make sense.

CAN'T ESTATE PLANNING WAIT UNTIL NEXT YEAR?

Business owners who neglect estate planning risk leaving behind a significant tax bill when they die. Your business interest is probably your biggest asset. Protect it - and your loved ones - by contacting your tax advisor and attorney about estate planning today.

SUNNY OUTLOOK FOR DISTRIBUTORS

The U.S. warehousing and distribution industry is about to get a whole lot faster, bigger and leaner, according to a 2013 survey by the telecommunications consulting firm Motorola Solutions.

UPBEAT FINDINGS

After years of financial restraint, many warehouse information technology and operations professionals are optimistic about the industry's outlook and intend to loosen their purse strings on spending over the next five years. The 2013 Warehouse Vision Report found that:

- 35% plan to add new locations,
- 38% anticipate expanding their existing warehouses and distribution centers,
- 45% expect to hire more employees,
- 54% intend to increase order volumes and the number of SKUs.

"As the global economy continues to recover, the warehousing industry — after a period of marking time while under intense pressure to reduce inventory levels to free up capital — is now in the position of having to quickly keep pace with today's increased fulfillment demands," concludes the survey.

IMPROVED INVENTORY TRACKING

Many distributors are decidedly low-tech when it comes to inventory management and other day-to-day operations. In fact, more than 40% of warehouses still track inventory using hand tallies. That's expected to change over the next five years.

Nearly two-thirds of survey participants plan to equip employees with mobile devices that sync with networked warehouse management systems. More than 80% expect to transition to bar-coded inventory tracking systems. This transition will improve workplace efficiency and internal controls in preventing inventory misstatement and fraud.

STREAMLINED TRAINING

Adaptable, interdisciplinary employees are the key to implementing these new technologies and responding faster to customer demands. Employee training programs can be expensive. Some distributors are reluctant to invest in training, because turnover among warehouse employees has traditionally been high. Despite plans to become more tech-savvy, respondents seek to reduce employee-training time by an average of 44% over the next five years.

Distributors that invest in new technologies, only to skimp on subsequent employee training, could be making a costly mistake. A skilled, dedicated and agile workforce can be one of your most valuable assets — and, if properly cultivated, can become a competitive advantage.

STAYING GROUNDED

The U.S. economy is improving, albeit slowly. You're not alone if you plan to add or expand facilities, automate inventory tracking, or hire more workers in 2015 and beyond. Avoid getting swept up in the hype and becoming overly optimistic. A financial professional can help you create realistic capital and operating budgets. In turn, these budgets can help attract lenders to finance your expansion plans.

LOOK WHO TOPS THE 2014 FRAUD LIST

IF YOU SUSPECT FRAUD OR WOULD LIKE TO BEEF UP YOUR EXISTING FRAUD CONTROLS, CONTACT A FORENSIC ACCOUNTING SPECIALIST.

Banking and financial services, government and public administration, and manufacturing were the top three sectors that reported fraud cases in the 2014 Report to the Nations on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE). More than 8% of the victims in the latest fraud study were manufacturers, suffering a median loss of $250,000. That's significantly higher than the median loss of $145,000 among all fraud cases.

A lingering question is: Are manufacturers more at risk for white collar crime — or simply more proactive in reporting it?

KNOW FRAUD HOT SPOTS

The ACFE study found that manufacturers are at higher-than-average risk for the following fraud schemes:

BILLING. These scams typically involve fictitious vendors or inflated invoices. A manufacturer might, for example, pay for services not actually rendered to a shell company owned by a corrupt employee - or directly pay a dishonest employee's personal expenses. Billing schemes were perpetrated against 22.4% of the manufacturer victims in the latest study.

CORRUPTION. These cases include bribery, illegal gratuities, extortion and conflicts of interest. Collusion is common in corruption cases. For example, an employee might engage in bid rigging with a supplier in exchange for a kickback. More than half of the manufacturing fraud cases in the ACFE study involved corruption, compared to 37% of all reported cases.

NONCASH THEFT. Manufacturers rely heavily on tangible assets, such as inventory and fixed assets. So, it's little surprise that thieves took more than just cash in 34.5% of the cases involving manufacturers. Smaller finished goods and tools may be easily pocketed by line workers and then sold on the Internet.

Often there's overlap between fraud schemes perpetrated in a case. In other words, a manufacturer that's victimized by a billing scheme might also report corruption or check tampering.

FIGHT FRAUD HEAD-ON

The ACFE study reports that a strong internal control system is the most effective way to reduce fraud losses and the duration of fraud schemes. How do your preventive efforts measure up? Review this top 10 list of most effective control measures and check off the ones you currently have in place:

1. Proactive data monitoring and analysis,
2. Employee support programs,
3. Management review,
4. Written code of conduct,
5. Internal audit department,
6. Formal risk assessments,
7. Surprise audits,
8. External audit of internal controls over financial reporting,
9. Fraud training for managers,
10. Fraud reporting hotline.

The ACFE study compared median losses from fraud cases based on whether the organization had particular controls in place at the time the fraud occurred. These

comparisons showed that each measure on the top 10 list reduces fraud losses by at least 40%. Companies that proactively monitor and analyze data - the most effective measure at reducing losses - are likely to reduce fraud losses by nearly 60%.

Small manufacturers sometimes believe that it's cost prohibitive to implement a formal control program. Several antifraud measures - such as written antifraud policies, formal management review procedures and antifraud training for managers - require minimal financial outlay.

ADOPT A ZERO-TOLERANCE POLICY

Fraudsters frequently test the waters with small schemes and, if successful, move on to bolder, more costly ones. A zero-tolerance policy against any type of unethical behavior can be a powerful deterrent against these crimes.

Encourage employees and customers to report frauds, and take steps to protect whistleblowers from retaliation by co-workers. After all, tips are the most common way companies in the ACFE study first learned that they were victims of fraud.

BRING IN THE EXPERTS

If you suspect fraud or would like to beef up your existing fraud controls, contact a forensic accounting specialist. He or she will know how to effectively and confidentially catch a thief - and how to build a case that will withstand legal scrutiny.

THE QUESTION EVERY MANUFACTURER WANTS ANSWERED:

WHAT'S THE VALUE OF MY BUSINESS?

Nowadays, the value of your manufacturing company depends on a variety of factors, such as what products it manufactures, how it's expected to perform, where it's located and why you're appraising it. Let's take a closer look at the current merger and acquisition (M&A) market and how appraisers use three techniques to value manufacturers.

HOT MARKET

The scene is set for a stunning M&A display for the rest of 2015 and beyond: Many companies are sitting on large cash reserves, banks are offering inexpensive financing options, investors are more confident and equity markets are relatively stable. Reuters reports that worldwide M&A deal volume was up 75% in the first half of 2014 over the same period in 2013 - the highest level in seven years.

Hot manufacturing segments include technology, health care and life sciences, energy, gas and oil, and consumer markets. Sellers in these segments may wind up in a bidding war that drives up their values. But beware that some buyers are still trolling for bargains, so don't take the first offer you receive without obtaining a formal appraisal first.

3 VALUATION METHODS

Appraisers use these three valuation approaches to value manufacturers:

1. COST APPROACH

Manufacturers rely heavily on tangible assets, so the balance sheet is a logical starting point. Some items are worth more (or less) than book value.

For example, manufacturers sometimes use the same depreciation methods for book and tax purposes. Accelerated depreciation methods, including expanded Section 179 and bonus depreciation deductions available in recent years, have significantly lowered the net book values of fixed assets - including machines, large tools, heavy-duty vehicles, computers, software and office furniture - below current market values.

Receivables also may need to be adjusted for bad debts. Inventory may include obsolete or unsalable items. Contingent liabilities - such as pending lawsuits, environmental obligations and warranties - also must be accounted for.

The biggest adjustment is for intangible assets, such as internally developed patents, brands and goodwill. The cost approach generally omits intangible

Sidebar

THE LIMITS OF INDUSTRY "RULES OF THUMB"

Simplified formulas can give owners a "quick-and-dirty" estimate of what their businesses are worth. But these rules of thumb are often ambiguous and unsupported by specific empirical evidence so they should never be used as the sole method of valuation.

One well-known rule of thumb for manufacturers is five times earnings before interest, taxes, depreciation and amortization (EBITDA). This formula is supported by recent market data. In 2013, the median EBITDA multiple for the overall manufacturing sector was 5.69 times, compared to 2.96 times for all major business sectors, according to Pratt's Stats transaction database. Before hanging your hat on this simplified formula, it's important to recognize that manufacturing companies vary significantly - warranting EBITDA multiples above or below this generic median.

Formulas may serve as a helpful sanity check, however. If a manufacturer that reports $500,000 of EBITDA expects to sell for $5 million, the industry formula implies that the owner's expectation seems unreasonable. Further investigation is necessary to definitively value the business.

value, but it can serve as a useful "floor" for a company's value. Appraisers typically use another technique to arrive at an appraisal that's inclusive of these intangibles.

2. MARKET APPROACH

Sales of comparable public stocks or private companies may be used to value your business. Finding comparables can be tricky, however. Many small manufacturers tend to be "pure players," whereas public companies tend to be conglomerates, making meaningful public stock comparisons difficult.

When researching transaction databases, it's essential to filter deals using relevant criteria, such as industrial classification codes, size and location. Adjustments may be required to account for differences in financial performance and to arrive at a cash-equivalent value, if comparable transactions include noncash terms and future payouts, such as earnouts or installment payments.

3. INCOME APPROACH

Expected future cash flows can be converted to present value to determine how much investors will pay for a business interest. Reported earnings may need to be adjusted for a variety of items, such as accelerated depreciation rates, market-rate rents, and discretionary spending, such as below-market owners' compensation or nonessential travel expenses.

A key ingredient under the income approach is the discount rate used to convert future cash flows to their net present value. Discount rates vary depending on an investment's perceived risk in the marketplace.

CRITICAL ADJUSTMENTS

When using the market or income approach to arrive at a preliminary value, the appraiser may need to adjust for excess working capital if you carry more cash or inventory than the average manufacturer. Nonoperating assets are also added back to an appraiser's preliminary value.

Additional adjustments may be required if a business owns its facilities, because real estate ventures differ from manufacturers in terms of risk and return. A real estate appraiser may be called in to value your facilities.

APPRAISAL PROS DO IT BEST

These considerations are just a sampling of the subtle nuances that go into valuing a manufacturer. Each business is unique. Owners who rely on gut instinct or do-it-yourself valuations may leave money on the table when they sell — or risk overpaying when they expand through acquisition. Consider hiring a professional appraiser to value your company before taking any action.

CALL THE HHM MANUFACTURING ACCOUNTING TEAM FOR MORE INFORMATION

KYLE C. CHRISTENSEN, CPA, CCIFP
423.702.7270
KCHRISTENSEN@HHMCPAS.COM

TRIP FARMER, CPA, CCIFP
423.702.8148
TFARMER@HHMCPAS.COM

KEVIN ROSE, CPA, CFP
423.702.8392
KROSE@HHMCPAS.COM