Manufacturer

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Knowledge is your first line of defense

Inventory is one of the biggest assets on a manufacturer's balance sheet. It's also one of the hardest assets to measure and track. Thousands of transactions flow through the inventory account each year — and many of these journal entries require subjective estimates, such as overhead allocations, write-offs and valuation adjustments. In addition, many employees have direct daily access to inventory or inventory accounting records, providing an ongoing temptation to steal or cook the books.

Case in point

Consider ABC Manufacturing, a fictitious company that fell victim to a $300,000 inventory fraud scheme involving three trusted employees. Their scam was simple: The shipping clerk sent most finished goods to legitimate customers or company-owned retail outlets. But a few shipments to retail outlets were redirected to the home of the payables clerk. Later, the controller picked up the stolen goods to resell them on the Internet.

ABC's retail outlets weren't invoiced for shipments at the time of delivery. So there was no paper trail identifying what had happened to the redirected shipments. Without physical inventory counts, the perps were able to pull the wool over the owner's eyes for more than 18 months. Eventually, the shipping clerk became overwhelmed with guilt and confessed the scheme to the owner. With stronger internal controls, the scheme might have been detected sooner — or prevented from ever occurring.

When faced with a financial pressure and given an opportunity to steal, an employee may rationalize the theft of inventory.

Inventory 101

Inventory is vulnerable to fraud because it's eventually closed out to cost of goods sold (COGS). This is an expense account that winds up as part of retained earnings at the end of the accounting period. The formulas for computing COGS are:

Beginning inventory + purchases = goods available for sale

Goods available for sale – ending inventory = COGS

These formulas make sense for retailers or distributors that don't add value to the goods they ship and, therefore, handle only finished goods. But they're oversimplified for manufacturers that process raw materials into finished goods.

Manufacturers typically possess three types of inventories: finished goods, work-in-progress (WIP), and raw materials. WIP inventories include charges

for raw materials, direct labor and overhead. Sometimes there are additional charges when the production of components is outsourced to a third party or another division of the company.

In addition, manufacturers can use a variety of techniques to account for finished goods inventories under Generally Accepted Accounting Principles. These include the lower of cost or market; first-in, first-out (FIFO); and last-in, first-out (LIFO). The more complicated a company's inventory reporting process, the more opportunities employees have to commit fraud.

Motives and methods

Small manufacturers often operate like families. Owners can't fathom that a trusted "family member" would ever steal inventory. But it happens more often than you might think. When faced with a financial pressure and given an opportunity to steal, an employee may rationalize the theft of inventory.

For example, personal financial pressures or an addiction may entice an employee to steal inventory or overstate it — especially if he or she discovers a weakness in the internal accounting policies and procedures. The employee may rationalize the theft because he or she feels underpaid, underappreciated or overworked by an owner who takes frequent vacations.

Whatever their motives, employees use a variety of techniques to steal inventory. The most obvious is directly taking items for personal use or resale. Physical controls are the best prevention tools here. To illustrate, warehouses should have a limited number of doors with 24-hour surveillance inside and outside of the facilities, including dumpsters, trucks, foliage and parking lots.

Inventory fraud may also occur within the accounting department. For example, the controller or CFO may try to overstate inventory by artificially inflating inventory counts or values, recording false entries into the general ledger, or failing to write off old, obsolete or damaged items.

Assessing your fraud risks

Global research company IBISWorld recently published its annual list of America's riskiest industries for 2014 and 2015. Several types of U.S. manufacturers made the top 10 list, including apparel, computer, vacuum and small appliance, cigarette and tobacco, and recordable media manufacturers. Most of these have been in a state of decline due to changing consumer trends, overseas production and technological advances.

Managers in these sectors may feel intense pressure to meet stakeholder expectations, which could drive them to commit fraud to hide weak financial performance. If you operate in a declining market segment, regularly assess your fraud risks and talk to your financial advisors about ways to mitigate your vulnerability to financial misstatement and theft by employees.

Moreover, the inventory account may become a "slush fund" for other internal fraud schemes. Inventory overstatements might be used to manage earnings or to meet financial covenants.

To catch a thief

Unearthing financial misstatements involving inventory overstatements is less straightforward than catching people who directly steal physical assets. A forensic accountant can help you by benchmarking financial statement trends, verifying source documents and building a case that will help you prosecute fraudsters in your midst. ■

Uncle Sam wants you to invest in technology and training

The White House recently announced a series of executive actions for subsidies totaling roughly $550 million from NASA and the U.S. Departments of Agriculture, Energy and Defense for investments in advanced manufacturing. These actions provide financial incentives for your company to increase spending on technology and training, if it's not already part of your 2015 budget.

These plans are based on recommendations from the Advanced Manufacturing Partnership (AMP), a working group of government, academic and private sector participants to bolster U.S. competitiveness in industrial manufacturing. They're based on the following three pillars of support.

1. Enable innovation

President Obama has allocated more than $300 million to match private sector investments in advanced materials, including composites and bio-based materials, advanced sensors for manufacturing, and digital manufacturing. In addition, the National Science Foundation, U.S. Department of Energy and NASA plan to work with manufacturing companies and universities to establish "technology testbeds" within two federal research facilities where companies can design and test new products and processes.

In January, the White House revealed that another new manufacturing hub — located in Clinton, Tenn. — will focus on developing new, cost-effective steel alloys that are twice as strong and lighter than those used today. Also on the agenda are projects to develop new processes to eliminate reliance on foreign suppliers and to replace chemicals made using oil with those made from plants harvested on U.S. farms.

2. Secure the talent pipeline

A 2014 Manufacturing Institute survey reports that 75% of manufacturers suffer from shortages of skilled labor, which is compounded by misperceptions the general public has about modern careers in manufacturing. To turn things around, the executive actions include a $100 million American Apprenticeship Grants competition aimed at spurring new hands-on apprenticeship models. The competition is expected to:

- Develop a national system of skills certifications and accreditation,
- Capture the talent pool of returning veterans,
- Invest in demand-driven community college apprenticeship programs, and
- Document best practices in developing career pathways in advanced manufacturing.

AMP members Dow, Alcoa and Siemens have launched apprenticeship pilots and created a how-to guide for other employers looking to use apprenticeships. In addition, the U.S. Department of Commerce will expand its sponsorship of National Manufacturing Day,

an annual campaign in October to teach educators, students and their families about promising career opportunities in advanced manufacturing.

3. Improve the business climate

The U.S. Census Bureau estimates that small and medium-size manufacturers represent 89% of U.S. manufacturing firms, but they often lack the resources to invest in and information to capitalize on technology innovations. So, the U.S. Department of Commerce's Manufacturing Extension Partnership will pilot a competition for $130 million over five years across 10 states to help smaller manufacturers adopt new technologies and bring new products to market.

Sweeten the deal with tax breaks

In addition to these federal technology and training subsidies, manufacturers also may be eligible for tax breaks for qualifying research and development expenditures (QREs), including wages, supplies, and certain consulting and contract research fees related to qualified research activities.

The Tax Increase Prevention Act of 2014 temporarily extends the longstanding research and development tax credit through Dec. 31, 2014. This credit generally equals 20% of the amount by which current year QREs exceeded a base-period amount (subject to a 6.5% maximum). The credit is complicated to calculate, but the tax savings can be substantial.

Claim your share

The competitiveness of domestic manufacturers continues to be a national priority. If you haven't already done so, discuss with your financial advisor ways to cash in on the government's latest federal subsidies and tax breaks for investing in technology and training. ■

Worker classification: What's in a name?

Last year, FedEx lost a class action lawsuit, requiring it to reclassify approximately 2,300 drivers as employees in California. Despite FedEx entering into operating agreements that classified the employees as independent contractors, the California Court of Appeals for the Ninth Circuit noted that FedEx controls the appearance of its drivers and their vehicles, the times drivers work, and aspects of how and when drivers deliver packages.

So its drivers were deemed to be employees under the California Labor Code. This decision contradicts a previous IRS audit of FedEx driver classification that decided *not* to treat the drivers as employees. Keeping track of two separate worker classifications could prove an ongoing administrative nightmare for FedEx.

This high profile case should act as a reminder to all manufacturers and distributors to make a clear distinction between employees and independent contractors. Here's what you need to know to get it right.

3 distinguishing characteristics

Workers generally are employees for federal tax purposes if the company controls and directs the jobs they perform and how they perform them.

The IRS has grouped the degree of control into three general categories of evidence: 1) behavioral control, 2) financial control, and 3) affiliation, including each side's intent and how they respectively perceive their relationship.

In analyzing the status of your workers, pay close attention to such factors as:

Degree of control. If an employer exercises significant control over how and when a worker performs duties or has the right to do so, this factor indicates employee status.

Investment in equipment and facilities. Employees usually rely on their employers for things such as office space and tools. When the worker covers most or all of the cost of equipment and facilities used for the job, this factor indicates independent contractor status.

Opportunity for profit or loss. A given project's success or failure usually doesn't threaten employees' paychecks. Conversely, workers who can realize a profit or suffer a loss as a result of their services are usually deemed independent contractors.

Possibility of discharge. If you can fire a worker, he or she likely is an employee. Contractors generally can't be dismissed as long as they produce the work under contract.

Relationship of work to employer's core business. When the worker's duties relate to the employer's core business it indicates employee status, while work related to a tangential enterprise indicates independent contractor status.

Permanency of relationship. Lack of permanency between the employer and worker indicates independent contractor status.

Additionally, if the employer and the worker believed the same thing at the time they entered into their arrangement, this factor can indicate either employee or independent contractor status, depending on the facts.

Policies to prevent classification mishaps

If you currently use contractors — or are considering doing so — it's a good idea to establish procedures that help ensure you don't inadvertently misclassify any workers. First, require contractors to sign a written operating agreement outlining your relationship with them and ask for tangible evidence of their autonomy. This may include copies of letterhead, invoices, logos, business cards and advertisements. Also record their federal employer identification numbers and equivalent state numbers, if they operate through their own corporations.

Over time, managerial practices may inadvertently violate the original intent of a contractor's operating agreement, crossing the fine line between contractor and employee. So, it's also a good idea to develop a checklist or questionnaire to gather facts about those you classify as contractors. Periodically compare how you're currently treating contractors to the factors described above. Then you should know whether you're properly classifying workers.

Hot button

The issue of whether to classify workers as employees or independent contractors has been a hot button with the IRS and state taxing agencies for several years. Improper classification can be a costly mistake, requiring you to pay back taxes, penalties and unpaid benefits. Consult with your tax and legal advisors to make sure you're playing by the rules. ■

Using an IC-DISC to lower taxes

Manufacturers and distributors who export products should consider the use of an interest charge domestic international sales corporation (IC-DISC) to reduce their tax burden. Here are some frequently asked questions about this strategy.

How does it work?

An IC-DISC is a separate entity that earns a "commission" on the operating company's export sales based on the greater of 1) 50% of net income on sales of qualified export property or 2) 4% of gross receipts from sales of qualified export property. A properly executed IC-DISC isn't taxable at the entity level. So, the operating company receives a deduction for the commission paid at ordinary tax rates and the IC-DISC pays no tax.

The IC-DISC distributes all of its profits as qualified dividends, and the owners pay tax on the dividends at more favorable capital gains tax rates. Depending on the owners' personal income levels, federal capital gains tax rates could be as low as zero or 15% — or as high as 23.8% (the highest federal capital gains rate of 20% plus an additional 3.8% of net investment income tax).

How much federal tax can it save?

To illustrate, let's suppose Widgets, Inc. (a fictional S corporation) ships $2 million internationally and pays $80,000 in commissions to its IC-DISC. Assuming the owners qualify for the highest capital gains tax rate of 23.8%, they'll owe federal tax of $19,040 on qualified distributions from the IC-DISC.

However, the owners also owe less tax on their S corporation earnings. Widgets can deduct $80,000 in commissions paid to the IC-DISC, resulting in a tax savings of $31,680, assuming that the owners are in the highest federal tax bracket of 39.6%.

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The net savings is $12,640 ($31,680 – $19,040), or 15.8% of the commission charge. It's often possible to pay a higher commission using the 50% of net export income calculation, however.

What steps are required?

A properly executed IC-DISC strategy follows these procedures:

1. Form the new IC-DISC entity under state law.
2. Make the IC-DISC election within 90 days of formation.
3. Offer only one class of stock with par or stated value of stock of at least $2,500.
4. Maintain a separate set of books and records for the IC-DISC.

Taxpayers also can establish the IC-DISC in a domicile without state income tax to eliminate the need to file state income tax returns.

Potential for big return on investment

The potential tax savings can outweigh the costs of creating and administering an IC-DISC. If you export a significant amount of products, discuss this strategy with your tax advisor today. ■

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We're here to help.

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We would welcome the opportunity to put our experience to work for you.

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