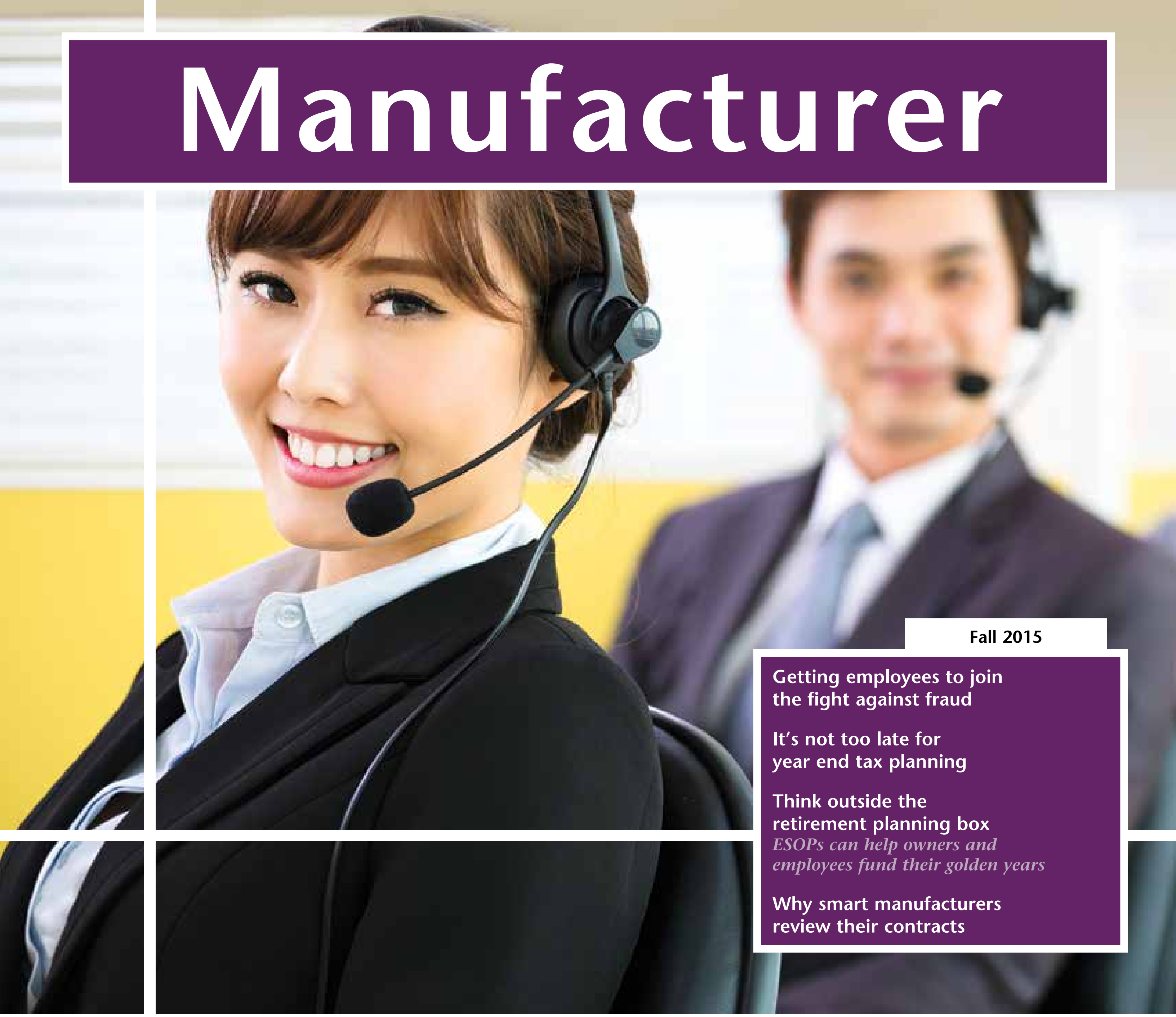
Manufacturer



Fall 2015

Getting employees to join the fight against fraud

It's not too late for year end tax planning

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ESOPs can help owners and employees fund their golden years

Why smart manufacturers review their contracts

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Getting employees to join the fight against fraud

U.S. businesses lose millions of dollars to white-collar criminals every year. The manufacturing sector is especially vulnerable to fraud schemes involving billing, corruption and noncash assets, such as theft of inventory and equipment. Research suggests that businesses that provide a convenient and confidential way for employees to report unethical behavior are more likely to unearth embezzlement and other wrongdoing sooner and suffer smaller losses than those without established "whistleblower" policies.

To catch a thief

Proactive fraud prevention and detection controls can substantially reduce a company's risk of fraud and minimize fraud losses. But all antifraud tools aren't created equal. In each biennial edition of its *Report to the Nations on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) has consistently found that tips are the most common method of detecting fraud by a significant margin.

In the 2014 report, the ACFE found that more than 42% of frauds were detected by tips. About half of these tips came from employees, and the rest were reported by vendors, customers and anonymous sources. The second most common method of detection was management review, which unearthed fraud in only 16% of the cases in the study.

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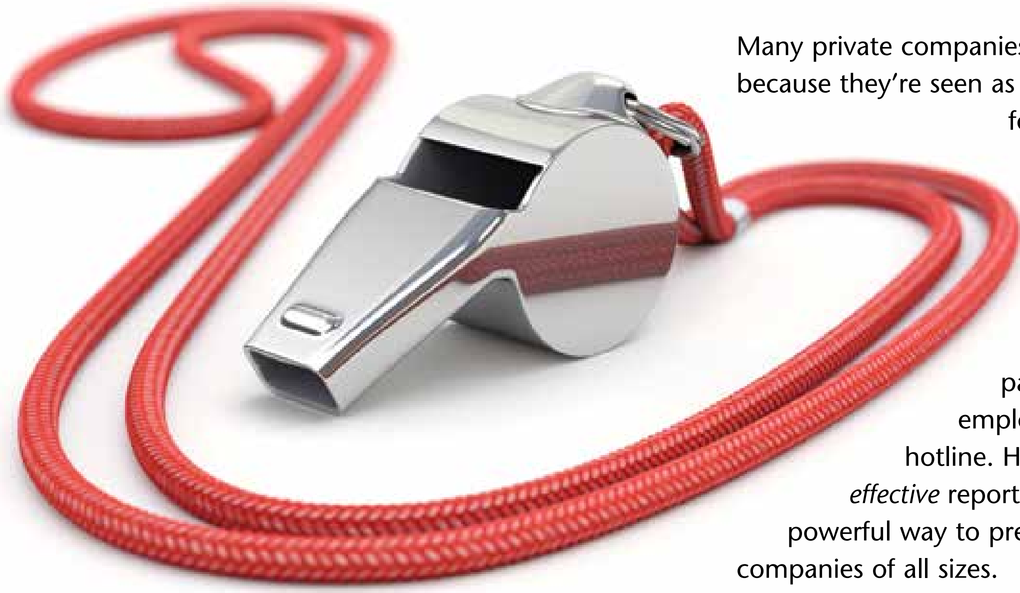
Based on these statistics, it stands to reason that reporting hotlines can be a critical weapon when deterring fraud and minimizing losses. The ACFE reports that organizations without an anonymous hotline suffered about two-thirds higher average fraud losses than those lacking this prevention mechanism.



Many private companies forgo reporting hotlines, because they're seen as expensive and too formal for closely held organizations. Only about half of the companies in the 2014 ACFE study had a reporting hotline in place, but only 18% of companies with fewer than 100 employees used a reporting hotline. However, implementing an *effective* reporting mechanism can be a powerful way to prevent and detect fraud for companies of all sizes.

Minimize the fear of retaliation

Most employees are honest and want to do what's best for their employers. But the prevalence of anonymous tips — which were the source of about 15% of the tips in the ACFE study — suggests that many whistleblowers fear retaliation from co-workers if they speak up against wrongdoers or their allegations don't pan out. This is especially true in smaller companies where it may be harder to safeguard a whistleblower's identity.

An important component of an effective reporting hotline is to establish policies to protect the confidentiality of whistleblowers and prevent backlash, including verbal bullying or job loss — especially when employees report on suspected wrongdoing by their superiors. Often it's beneficial to consult with an attorney to ensure that the company's hotline and related policies comply with employment laws and other regulations that may apply where you operate.

When selecting a manager to oversee the reporting hotline, choose someone who's fair and impartial and engenders trust among people inside and outside the organization. Provide your "ethics officer" with authority and training to act on information conveyed through the hotline. Hotlines can also be managed externally by third-party vendors.

Promote and facilitate reporting

Of course, employees need to know about the hotline before they'll use it. Once you implement a confidential telephone or Internet reporting hotline, conduct a meeting to promote it to both would-be perpetrators and those who might make a report, including employees, clients, shareholders and vendors. The hotline should be convenient to use and available 24/7 in multiple languages.

Distribute guidelines for the reporting hotline when it's first launched, when you conduct periodic fraud prevention training and when new employees join the company. Also create print and electronic promotional materials for the hotline to display in high-profile locations, such as in the lunchroom and on the company's intranet site.

Remember, too, that reporting hotlines can unearth other problems besides fraud, such as unsafe working conditions or drug abuse by co-workers. Some companies even set up their hotlines to serve as an electronic "suggestion box" for ways to improve operating efficiencies or offer new product ideas.

Follow up on tips

Employees are more likely to report fraud if the company acts on tips in a prompt, serious manner and demonstrates a zero-tolerance policy for fraud. The most serious allegations should be reviewed with legal counsel first. Often timely follow-up necessitates the use of an outside forensic accounting specialist who is trained in collecting a thorough and defensible trail of evidence. ■

Know when it's time for professional help

When fraud strikes, the company's ethics officer may feel like he or she is looking for a needle in a haystack. But he or she doesn't need to act alone. Often company insiders lack experience on how to investigate tips or gather evidence to adequately support a fraud claim. The first step when fraud is suspected is to contact legal counsel. The use of an outside forensic accountant can prevent botched investigations and help your company recover from fraud as quickly as possible.

Forensic accountants can also help management deal with the emotional aspects of a fraud investigation. For example, they can help management minimize disruptions to normal business operations and proactively address rumors that might spread during fraud investigations.

Most important, outside experts are generally impartial and unemotional. These traits can be invaluable when owners of a closely held business feel blindsided by unethical behaviors perpetrated by trusted employees.

It's not too late for year end tax planning

Businesses that expect to owe substantial federal taxes in 2015 can still take steps to soften the blow. But many tax breaks hinge on expired tax provisions that Congress *might* restore before it adjourns for the holidays. Here are some last-minute tax-saving strategies to consider before December 31.

Deduct rather than depreciate

Manufacturers and distributors rely heavily on equipment, property and other fixed assets. Some of their biggest expenses are depreciation, supplies, and repairs and maintenance. The sooner they can deduct these costs, the lower their current year's taxes will be.

1. Deduct costs under the repair regs. In general, the IRS's final regulations for tangible property costs (commonly known as the "repair regs") require most tangible property costs to be capitalized and depreciated over several years — rather than deducted in the current year — for federal tax purposes. However, the repair regs include provisions that may warrant additional qualifying purchases or improvements before year end to lower taxable income.

For example, companies can elect to immediately deduct items costing up to $500 that would have otherwise been capitalized. A $5,000 threshold applies to companies with applicable financial statements for the year — generally, companies required to file Form 10-K with the Securities and Exchange Commission and those with audited financial statements.

A safe-harbor rule also allows businesses to deduct routine maintenance costs. In addition, taxpayers with average annual gross receipts of $10 million or less for the three preceding tax years can deduct improvements to an eligible building property if the total amount paid during the year for repairs, maintenance, improvements and similar items doesn't exceed the lesser of 1) $10,000 or 2) 2% of the building's basis before depreciation.

Incidental materials and supplies costs can be deducted in the year they're paid or incurred. These costs include expenditures of $200 or less for noninventory items, as well as costs of noninventory items with useful economic lives of 12 months or less regardless of the size of the expenditure.

2. Make the most of Section 179 limits. For tax years beginning in 2010 through 2014, taxpayers could immediately deduct up to $500,000 for purchases of qualifying new or used assets under Sec. 179. Included in this limit were new and used machinery, office furniture, computer equipment and purchased software.

As of this writing, the maximum Sec. 179 deduction for tax years beginning in 2015 is only $25,000. Manufacturers and distributors should take advantage of this allowance, but it's possible that Congress could restore a higher Sec. 179 allowance before year end. If that happens, be prepared to act fast to lower your taxable income for 2015. Remember that assets must be placed in service by no later than the end of your business's tax year to qualify for the Sec. 179 deduction.

Finally, there's no word yet whether Congress will restore the 50% first-year bonus depreciation allowance for 2015. This tax break applies exclusively to qualifying *new* equipment and purchased software that's placed in service before year end — so also be prepared to act fast if 50% bonus depreciation is restored.

3. Use Sec. 179 for real property improvements, if available. Real property improvement costs have traditionally been *ineligible* for immediate deduction under Sec. 179. But the tax law permitted an exception for qualified real property improvements placed in service in tax years beginning in 2010 through 2014. In those years, taxpayers could claim a first-year Sec. 179 deduction of up to $250,000 for 1) interiors of leased nonresidential buildings, 2) restaurant buildings and 3) interiors of retail buildings.

As of this writing, the $250,000 Sec. 179 allowance for qualified real estate improvements has expired. But taxpayers should be prepared to make property improvements near year end in case Congress restores this tax break for tax years beginning in 2015.

Pay attention to the extenders

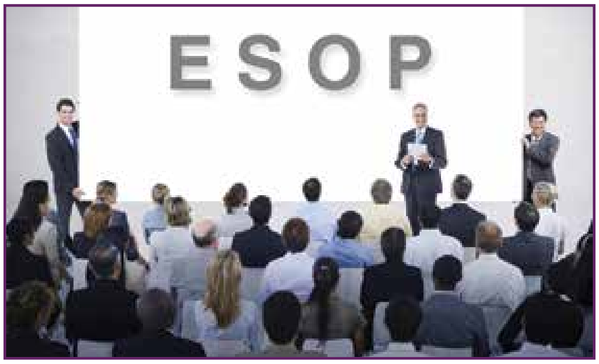
A long list of other federal income tax credits and incentives for businesses — including the research credit — expired at the end of 2014.

In the meantime, document qualifying expenditures and create wish lists of fixed asset purchases, improvements and other expenditures to take advantage of last-minute tax breaks that may be available for 2015. And check with your tax advisor for the latest information — it's possible Congress will have acted by the time you're reading this. ■

Think outside the retirement planning box

ESOPs can help owners and employees fund their golden years

The National Center for Employee Ownership currently estimates that there are about 7,000 Employee Stock Ownership Plans (ESOPs) covering about 13.5 million employees in the United States. Roughly two-thirds of companies offer ESOPs to provide a market for a departing owner's interest in a closely held business. Others may serve as a supplemental employee benefit plan or a mechanism to borrow money under favorable tax rules.



ESOPs are popular among manufacturers and distributors, because their employees — including plant managers, salespeople, machinists, assemblers, dispatchers, drivers and quality control workers — can directly affect profits and productivity.

How do ESOPs work?

An ESOP is a type of retirement plan that invests primarily in the company's own stock. The employer makes tax-deductible contributions to the ESOP, which the plan uses to acquire stock from the company or its owners. Essentially, an ESOP provides a "buyer" for the company's shares.

At the same time, an ESOP provides a powerful incentive for employees to share in the company's growth on a tax-deferred basis. When employees retire or otherwise qualify for distributions from the plan, they can receive stock or cash.

What administrative guidelines apply to ESOPs?

Like other qualified plans, ESOPs are strictly regulated. They must cover all full-time employees who meet certain age and service requirements, and they're subject to annual contribution limits (generally 25% of covered compensation), among other conditions.

ESOPs are subject to rules that don't apply to other types of qualified retirement plans. For example, an ESOP must obtain an independent appraisal of the company's stock when the plan is established and at least annually thereafter. Also, participants who receive distributions in stock must be given the right to sell their shares back to the company for fair market value. This requirement creates a substantial repurchase liability that the company must prepare for.

What financial benefits can ESOPs provide?

An ESOP provides several tax benefits. If it acquires at least 30% of a company, its owners can defer the gain on the sale of their shares indefinitely by

reinvesting the proceeds in qualified replacement property within one year after the sale. Qualified replacement property includes most securities issued by domestic operating companies.

ESOPs also permit a company to finance a buyout with borrowed funds. A "leveraged" ESOP essentially permits the company to deduct the interest and the principal on loans used to make ESOP contributions — a tax benefit that can do wonders for cash flow. The company can also deduct certain dividends paid on ESOP shares. Interest and dividend payments don't count against contribution limits.

Another advantage of ESOPs over other exit strategies is that they allow owners to cash out without giving up control over the business. Even if owners transfer a controlling interest to an ESOP, most day-to-day decisions will be made by the ESOP's trustee, who can be a company officer. However, ESOP participants may have the right to vote on major decisions, such as a merger or sale of substantially all of the company's assets.

Who can answer questions about ESOPs?

ESOPs offer numerous financial upsides. But there are some significant differences in the rules for administering ESOPs, depending on whether the company is set up as a C corporation or an S corporation. Consult with your tax, legal and benefits advisors to decide whether an ESOP is a viable option for you and your employees. ■

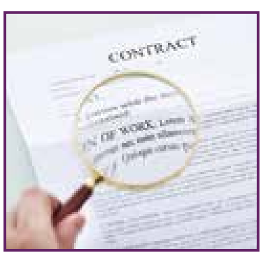
Why smart manufacturers review their contracts

Manufacturers and distributors may enter into various types of long-term contracts, including property and equipment leasing, raw materials, confidentiality, exclusivity and joint venture agreements. You should review these contracts on a regular basis to ensure that the agreements remain enforceable, compliant and financially advantageous. Now the Financial Accounting Standards Board (FASB) has introduced another reason to check up on your long-term contracts.

Hidden treasure hunt

Begin your formal contract review by identifying all major legal contracts. Here are the next steps:

1. Read contracts to determine whether terms and conditions have been met and necessary information is included and updated.
2. Revise or renegotiate incomplete or expired agreements.
3. Create a tracking system to identify expiration dates and other events that might invalidate an agreement.
4. Brainstorm ways to save more money, such as negotiating early-bird discounts from suppliers or bundling contracts to achieve economies of scale.



To illustrate, a custom tool and die shop hired a CPA to review its contracts and discovered that it wasn't charging customers for change orders in accordance with its standard customer contract. The CPA helped implement a change-order monitoring system to improve communications between machinists who handle the change orders and the billing department.

Updated revenue recognition guidance

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which modifies when companies recognize revenue from long-term contracts and requires more detailed footnote disclosures. Manufacturers and distributors will generally report the same *total* amount of revenue under the existing and updated guidance.

But the updated accounting standard will alter the *timing* of revenue recognition, because it requires companies to estimate the effects of variable consideration, such as sales incentives, discounts and warranties. It also could create differences in book and tax recordkeeping.

On July 9, the FASB delayed implementation of the new standard for another year — until 2018 for public companies. But companies that issue comparative financial statements will need to start tracking the changes as soon as possible to meet the FASB's retrospective application requirements.

In addition, many companies are uncertain exactly how to apply the principles-based revenue recognition standard to their contracts. In some cases, management may decide to modify contract terms and conditions to facilitate compliance with the recent FASB update.

Outside assistance

Today's business contracts tend to be detailed and complex, so it's helpful to hire outside professionals to review them with a fresh set of eyes. Often these professionals pay for themselves with the cost savings and risk mitigation that formal contract reviews provide. ■

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