

# Perspective

Third Quarter 2008

Practical ideas for manufacturers and distributors

## Tough economy changes M&A picture and creates due diligence challenges

Mergers and acquisitions are in limbo waiting to see what happens as the \$700 billion from the Emergency Economic Stabilization Act works its way into the financial system. In a troubled economy, though, healthy companies may find attractive targets in a growing population of troubled organizations. And private equity groups, which have played an increasingly active role as a source of growth capital or as an exit strategy for companies in a number of industries, are sitting on a sizable pool of capital and looking for places to invest.

Buyers must realize that due diligence is a different game in today's difficult economy. Troubled targets make take a variety of steps to try disguise negative trends and poor results and make operating decisions that may have long-term negative effects on the value of the business. A disciplined due diligence process is more important than ever. Take a close look at the following areas if you are considering a deal.

### Last twelve month (LTM) results

In a difficult economy, trends may be more important than raw numbers. LTM EDITDA may be falling, so a close review of the most current results and a comparison to historical results is vital. If results are trending down, the target company may be slow to release financials. Also, watch for accounting changes, such as deferring costs that used to be and should be expensed, or changes in accounting for inventory. The target also may attempt to accelerate revenue by offering incentive and discounts to customers. Normalize for any such activities to get a true picture of results.

### Backlogs

Backlogs can be a leading indicator of declining financial performance. In the current market, sellers may try to avoid or may be slow in disclosing their current backlog, or may delay reflecting cancelled orders. Backlogs also may not be in saleable condition. Be sure to look at comparative backlogs over time so you will know which way this indicator is trending.

### Sales/revenue

In a declining market, effective due diligence not only of the amount of sales and revenue, but also of their quality is

vital. Take a close look at recent lost customers, or at customers who have stated an intention to move their business and find out what is driving those decisions. Credit is obviously a key concern for every business currently, so carefully evaluate the creditworthiness of the target's client base. Is the target offering more generous warranty terms, discounts or other incentives to shore up sagging sales? Look for increases in barter activity, changes in return policies and increases in customer concentration – all could be bad signs.

### Gross margins

A target company may take a variety of steps in a declining market that could adversely affect margins. For example, companies often discontinue less profitable or unprofitable product lines in tight markets – but that could mean that a higher percentage of overhead will be allocated to the remaining product lines, adversely affecting their margins. Discontinued product lines or slumping sales could mean the loss of volume discounts the company enjoyed in better times. The target's suppliers and vendors may be increasing prices or otherwise changing terms.

### Accounts receivable and bad debts

In an uncertain economy, an increase in bad debts is common. Look at the target's receivables aging to see if collections are slowing. Other signs of trouble? Are customers disputing invoices in an effort to defer payments or lower costs? Is the target tightening credit limits, which may lead to lower sales? Remember, deteriorations in receivables will affect the company's borrowing base and loan structure.

### Accounts payable and purchasing

Targets in trouble may adjust their purchasing and accounts payable practices in ways that could affect their value. The target may be slowing payments to vendors and suppliers to conserve cash, or may have been having more disputes with vendors as it tries to return merchandise in an effort to control inventories and preserve cash. Take a close look at the target's

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## The R&D tax credit is back, but still underutilized by manufacturers

In the current difficult economy, manufacturers cannot afford to leave money on the table. Yet, when it comes to the Research and Development tax credit (R&D credit), that is exactly what many manufacturers are doing. According to the 2008 RSM McGladrey Manufacturing and Wholesale Distribution survey, over 40 percent of manufacturers claim no R&D credit. Additionally, many companies that do claim the R&D credit fail to claim the full credit to which they are entitled.

First some rare good news. The R&D tax credit, which expired in December for the thirteenth time since Congress first authorized the tax incentive in 1981, was reinstated as part of the \$700 billion financial rescue package that President Bush signed into law on Oct. 3. Not only does this mean that manufacturers can once again claim the R&D credit, it also means that they can now include the credit in their 2008 financial reporting results and in forecasting project costs.

In the first quarter 2008 issue of *Perspective* an article was published that explains how the R&D credit works (located at [www.rsmmcgladrey.com/RSM-Resources/Publications/Perspective/first-quarter-2008/research-credits-are-you-claiming-them/](http://www.rsmmcgladrey.com/RSM-Resources/Publications/Perspective/first-quarter-2008/research-credits-are-you-claiming-them/)). Now, in this article, some commonly overlooked R&D credit opportunities will be pointed out.

Many activities can qualify for the R&D tax credit:

- Developing new or improved products
- Developing new or improved manufacturing processes
- Increasing automation
- Designing and fabricating tools and dies
- Developing new production equipment
- Developing new or improved software applications

Unfortunately, many manufacturers only think of the efforts involving their products when they consider the R&D credit. The other areas are often overlooked.

Manufacturers should ask themselves the following questions to determine whether they may qualify for the R&D credit:

- Have you recently redesigned your manufacturing processes to improve efficiency? For example, many companies implement lean manufacturing

efforts or significantly change their processes and shop floors. Many of the activities involved in such efforts can qualify for the R&D credit.

- Have you automated any manual processes or developed and implemented new software systems? If these efforts added functionality or improved performance, reliability or quality of your manufacturing process or manufactured product, they may qualify for the R&D credit.
- Have you designed or developed new production equipment, tools or dies? Even if these items were developed only to improve your ability to manufacture existing products, they still may qualify for an R&D credit.
- Have you done any of these things in past years for which you did not claim an R&D credit? It may still be possible to secure a credit for prior years.

One key to qualifying for the R&D credit is documentation. Costs that qualify include labor, materials and supplies used or consumed during the research process, and 65 percent of qualified fees paid to outside consultants. It is vital to have a system in place to accurately track these costs and to demonstrate their relationship to the qualifying activity. The rules are complicated. Companies do not normally keep their records in a way that makes it easy or practical to extract data that can accurately measure costs under the tax definition of R&D. Many small and midsized manufacturers do not have the in-house expertise or manpower to apply these complex rules or to do the recordkeeping necessary to quantify the qualified activities and related costs. R&D credits are also a “Tier 1” issue for the IRS, which means the IRS has determined it to be one of the issues creating the greatest compliance risk, and as such they have developed a standardized process to audit claims, with a focus on documentation created at the time research was performed. This makes appropriate documentation of the R&D activities even more important.

Given the potential opportunity for savings, manufacturers should take a close look at their activities and operations, and discuss the potential savings available through the R&D credit with their tax advisors. In this market, no company should overlook this valuable tax incentive.

### Recent surveys track energy cost concerns

In July 2008, RSM McGladrey conducted an energy survey as a follow up to the 2008 RSM McGladrey Manufacturing and Wholesale Distribution survey, conducted in April. The new survey polled the same respondents concerning expected cost increases in energy, raw materials and transportation. A majority of respondents were from private companies, offering rare insight into the strategies and challenges of private manufacturers and distributors.

From April to July, the number of companies expecting cost increases greater than 10 percent rose from 30 percent to 48 percent. For raw materials, the number jumped from 28 percent to 43 percent. And for transportation, an astounding increase from 20 percent to 53 percent.

While companies are taking immediate action to offset the impact of rising costs, it's important that they also consider a long-term strategy to managing the structural cost changes being driven by the

new realities in commodities pricing and transportation costs.

In September 2008, at an executive summit in Oak Brook, Illinois, RSM McGladrey polled manufacturers and distributors for an update to energy cost projections. The number of executives expecting energy costs increases greater than 10 percent fell back to 44 percent from July levels of 48 percent, those expecting sharp increases raw materials were down from their July levels, but still higher than April at 35 percent, and transportation costs concerns were still sharply higher than April levels at 40 percent.

Escalating energy costs have slowed recently, primarily due to the contracting economy, but these costs are still very high. With the economy tightening and revenues harder to come by, MWD companies should be sure to accurately track and take steps to control these costs.

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purchase obligations — are volume guarantees and associated penalties likely to become an issue? Is the target switching vendor relationships to control costs or stretch cash? This could lead to quality issues. Finally, even if the target itself is healthy, the failure of a key vendor could lead to interruptions and higher costs as the company scrambles to find a replacement, so you also must assess the health of the company's key suppliers.

#### Inventories

If sales are falling, a company's inventories often will creep up, which creates a higher risk of excess and obsolete inventory and related write-downs. If the target's customers are experiencing slower sales or other issues, then returns are likely to increase, which also can cause inventory to increase. The target also could be allocating idle costs to inventory. All of this puts a drain on cash as increased inventory costs push working capital requirements higher.

#### Compensation and staffing

Payroll is usually the largest expense for an employer, so it's no surprise that a troubled company make take steps to reduce its personnel costs. Has the company reduced, eliminated or deferred bonus payments, or has it forced salaried personnel to take unpaid leave? If so, be sure to consider the likely effects on morals and retention of key personnel, as well as potential future

costs to make up for skipped or delayed payments. If the company has laid off workers to save money, make sure that those cuts are sustainable.

#### Restructuring charges

Depending on their size, restructuring charges could cripple or destroy the target company. Watch for targets establishing restructuring charges and adding the results back to EBITDA. Also look for changes in reserves designed to artificially boost earnings.

Effective due diligence in a poor economy raises other considerations as well. For example, can you differentiate between declining results due to economic conditions, which may turn around when the economy does, and poor results due to lost market share or other reasons, which may not. A close review of the target's management team also is in order. Managers who built a company during a period of strong growth may not be the right team to lead it through a downturn or turnaround. Lending relationships need especially close examination during the current credit crunch. An economic downturn can present unique acquisition opportunities, but also present very real due diligence challenges. More, and more effective, due diligence can be the difference between buying a troubled company and becoming one.

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