

Perspective

Practical ideas for manufacturers and distributors

Lessons from Recession Increasing Focus on Incentive Compensation Programs

By: Steve Sullivan

As the economy moves out of recession, manufacturing companies are accelerating the move away from traditional fixed-cost compensation plans for executives and other key team members. Companies increasingly are emphasizing incentive compensation options that allow them to better align compensation dollars with key organizational strategies, and that serve to strengthen bonds between the organization and the key performers behind the company's success.

Over the past few years, as manufacturers struggled through the recession, there was little emphasis on compensation strategy beyond cost control. Companies were focused on survival, and employees at all levels were happy to keep their jobs. Bonuses and raises were minimal if awarded at all. Now, however, with the economy slowly recovering, companies need to reconsider how best to reward and motivate their people without adding too much cost.

The recent recession raises another concern from the executives' perspective. Many are finding their retirement savings falling behind. With defined benefit plans all but gone except in the public sector, these executives must rely on a combination of 401(k) plans, private savings and investments, and Social Security to fund their retirements. Yet many saw their plan balances, private portfolios and home equity take a severe hit during the recession. They are now looking to make up ground.

A lesson driven home for companies during the recession was the downside to traditional compensation programs, where performance, and often mere longevity, was rewarded with raises. Companies often found that they were rewarding all employees more or less equally, and, in the process, driving up their fixed payroll costs without any commensurate increase in productivity or other strategic benefits. Now, many companies are focusing on linking compensation more directly to performance, and looking for ways to focus their compensation investment on their high-performing employees without ratcheting up compensation costs across the board.

At the executive level, this often means designing long-term compensation strategies that tie the success of key performer as directly as possible to the performance of the company. For larger, publically traded companies, strategies like stock options have always been a popular option. However, for smaller, closely held enterprises, the dilution of ownership attendant to any

distribution of stock raises other concerns, so alternative methods must be found.

Following are three methods many manufacturers are using to tie executive pay to performance, to bind high performers more tightly to their organizations, and to help alleviate some of the retirement savings issues their key people face.

Phantom Stock Plans

In a phantom stock plan (PSP), key performers are offered "shares" that economically mimic actual shares in the company, but that do not dilute ownership. These shares are designed to track enterprise value the same way that actual share would, but do not reflect actual ownership in the enterprise. Because these are meant to act like real shares, they have a dollar value on the day they are awarded. Because they have this initial value, PSPs are often most appropriate for long-term employees who already have played a key role in building the value of the company. The day-one value of the award recognizes past performance, while the ongoing participation in the company's success is both and incentive and reward for future performance.

Stock Appreciation Rights

Stock appreciation rights (SARs) act much like phantom stock plans, except that they have no value when they are first awarded. Instead, SARs are based on a fractional interest in the difference between enterprise value on the day the SARs are awarded and enterprise value at a future settlement date. Because SARs focus exclusively on future appreciation, they are often most appropriate for either new hires, or for employees just entering the executive ranks.

Performance Units

In some closely held companies, the CEO or a small cadre of owners still make the majority of the strategic decisions around debt, acquisitions and other issues that are likely to have a profound impact on the overall value of an enterprise. Tying incentive compensation to enterprise value in such cases would be ineffective because the key players the company is trying to motivate would rightly feel that the decisions of the actual owners disproportionately affect enterprise value, leaving the success or failure of their compensation program in someone else's hands. In such cases, incentive programs can be tied to other, specific

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How Recent Changes to Depreciation Rules Affect Equipment Purchase Decisions

By: Karen L. Kurek and Jeremy Bivens

Economic conditions the past few years have forced many manufacturers to delay or cut back on equipment purchases. However, Section 179 and bonus depreciation incentives are available that allow manufacturers to write off those purchases far more quickly than would have been possible under previous depreciation limits – in many cases, writing off the entire amount invested in such purchases in the first year. Compared to standard depreciation rules that would have required the purchase price of such equipment to be written off over as many as 20 years, these bonus depreciation options can significantly improve cash flow and make it worth re-evaluating purchases companies were delaying due to market conditions.

Section 179

Section 179 allows taxpayers to write off the entire amount of qualifying purchases in the tax year those purchases are made. The IRS defines qualifying property as:

- Tangible personal property.
- Other tangible property (except buildings and their structural components) used as:
 - An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
 - A research facility used in connection with any of the activities in (a) above, or
 - A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities.
- Single purpose agricultural (livestock) or horticultural structures. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.
- Off-the-shelf computer software.

A series of legislative changes passed since 2008 have expanded the Section 179 deduction limit from \$125,000 for the 2007 tax year to \$500,000 for the 2010 and 2011 tax years. Please note that the Section 179 deduction is schedule to decrease to \$125,000 in 2012

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performance metrics within the organization over which plan participants do have direct control, such as sales or market share.

All three of these plan options offer participants incentives by tying compensation to performance. They help companies avoid the pitfall of ever-increasing fixed payroll costs. And, because these plans can be designed so that the award for performance is or can be deferred, often for extended periods, these plans also can serve to strengthen key employees' retirement positions.

Spiraling costs, uncertainty have employers questioning health benefits

Consistent increases in the cost of providing health benefits to employees, uncertainty as to the long-term costs of such benefits and concern over the effects of the Obama administration's sweeping health care legislation have many companies reconsidering their long-term commitment to providing health coverage for their workers.

– so if you are considering a purchase that would qualify for the deduction, it would be prudent for you to complete the transaction this calendar year, 2011.

The Section 179 deduction was previously an option mostly for smaller taxpayers. For the 2007 tax year, the available deduction decreased dollar-for-dollar for every dollar in excess of \$500,000 spent on qualifying equipment. Therefore, businesses making more significant investments in equipment did not qualify. Recent legislation has increased that threshold to \$2 million, making the Section 179 deduction an option for a much wider group of taxpayers.

Bonus Depreciation

In addition to the Section 179 deduction, a series of recent pieces of tax legislation have introduced bonus depreciation opportunities in an effort to stimulate economic activity. Under these bonus depreciation rules, taxpayers can opt for either 50 percent or 100 percent depreciation in the year purchases are purchased and placed in service. Where taxpayers can use the Section 179 deduction for purchases of used equipment, bonus depreciation is available only for purchases of new equipment. However, the \$500,000 limit and \$2 million threshold discussed above do not apply to bonus depreciation situations, making bonus depreciation an option for even very large taxpayers.

For a more detailed discussion of bonus depreciation concerns, go to <http://mcgladrey.com/Tax-Services/Accounting-Methods-Periods-Federal-Credits-Incentives-Alert>.

Cost Segregation Issues

One common opportunity we see manufacturers missing involves the classification of expenses involved in changes to their physical infrastructure necessary to install new equipment. For example, a manufacturer may have to move walls, reinforce flooring or upgrade electrical or HVAC systems to accommodate new equipment. Often, manufacturers treat these as real property expenses, which

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Consider the following statistics. According to the 2011 Milliman Medical Index report, the cost of health care for a typical family of four has increased from \$9,235 in 2002 to \$19,393 in 2010 – more than doubling in just eight years. Not surprisingly, a recent Towers Watson & Co. survey of more than 500 employers with at least 1,000 employees found that, while 73 percent of respondents in 2007 were confident that their organization would still be offering health care benefits a decade from now, only 38 percent expressed the same confidence in 2010.

“As we work with companies struggling with the exploding costs of health benefits, more and more are considering dropping them altogether,” said Rosemarie Panico-Marino, managing director at RSM McGladrey. “They are looking at the current and projected costs of benefits and finding, in many cases, that the penalties they would owe for not providing benefits under the provision of the Obama health legislation would actually be less than the cost of dropping the benefits and letting their employees seek coverage through the state exchanges.”

Commodities Prices Require New Strategies for Manufactures

By: Steve Menaker

Respondents to the Spring 2011 edition of the McGladrey Manufacturing & Distribution Monitor Report indicated that the rising costs of commodities and other key inputs would present significant challenges in the coming year. Two-thirds of those respondents anticipate that these increases costs would negatively affect margins, as it will be problematic to pass on costs to consumers in an economy that continues to deal with high unemployment. Meanwhile, 40 percent of respondents worry that rising commodity prices could adversely affect their entire business model.

The significant and rapid increase in oil prices in recent months, driven partly by political upheaval in the Middle East, may get the most attention, but prices of everything from cotton and other agricultural products to metals and rare earths have been increasingly volatile as the global economy continues its unsteady rebound from the recent recession.

That's not all bad news. One reason that many commodity prices are on the way up is that increased consumer sales associated with the recovery mean the manufacturers once again are seeing demand for their products. So, while increased demand means increased commodity costs, it also means increased sales. In an economy where it is still difficult for many manufacturers to pass costs on to their customers, however, volatile commodity prices still require a disciplined look at sourcing practices.

How should manufacturers respond? First, take a close look at your entire supply chain to understand what your inputs are where they are most subject to volatility. The answers aren't always obvious. One company that uses a high volume of polyesters to develop specialized protective fabrics for military and other applications found its margins unexpectedly impacted by the fashion industry. As cotton prices spiked, apparel manufacturers were turning to polyester as a lower cost option. This company suddenly was competing with new players for its raw material, creating unexpected pricing pressure. Companies should try to anticipate whether they could expect new competition for their materials – and also should look for lower-cost replacement options.

Make sure you are looking across your entire organization. One company had two different plants the manufactured significantly different products, but products that were made from substantially the same material inputs. Yet sourcing for the two plants was handled by two different managers who rarely if ever coordinated their efforts. By combining the sourcing operations, the company was able to create substantial economies.

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generally have less favorable depreciation schedules than do equipment purchases. In many cases, however, the costs associated with changes to your infrastructure necessary to accommodate new equipment can be classified as part of that equipment purchase, provided they can be appropriately documented.

Your customers are certainly pushing you on price. There is no reason not to push your suppliers. If you have been dealing with the same suppliers for years, take a fresh look at other options. Competition goes both ways.

Some companies are building larger inventories of products, trying to stock up before prices rise further. The Institute for Supply Management reported that February 2011 broke a string of seven straight months of rising inventory levels. Of course, carrying more inventory creates its own risks and challenges. The benefit of buying stock at a lower cost has to be balanced against the costs associated with carrying the inventory for longer periods and the potential risks of obsolescence or a future downward swing in product costs.

Companies are also considering forward contracts and hedging strategies. Southwest Airlines famously locked in lower fuel costs with such strategies during the last big run up in oil prices. And if commodity prices always moved predictably upward, this would be a simple strategy. But volatility is as big an issue with commodity prices as are increases. In fact, in the first quarter of 2011, we are seeing downward movement in some of the commodity prices that had spiked late in 2010. Hedging can be a useful strategy, but it takes careful consideration and should not be approached in a purely speculative manner.

Of course, all companies should take a fresh look at everything from their shop floor to their supply chain and transportation costs to eliminate waste. Strategies to reduce waste that might have seemed too expensive a couple of years ago may be worth another look now. A variety of tax credits are available for companies taking steps to reduce energy expenditures. These also may be worth a look.

For many manufacturers, the real goal in managing commodity costs is as much to create predictability as it is to control costs. Strategies like forward contracts and hedging, approached responsibly, can build some predictability into your costs structure even if they don't end up beating market prices. That predictability can allow you to plan operations for a set period with some confidence about what your costs will be.

Finally, in an uncertain cost environment, try to build more leeway into your contracts. Long-term deals at static prices can quickly turn from profitable deals to losses.

Commodity price volatility will continue to be a challenge for manufacturers for the foreseeable future. Those companies that move to manage these costs most aggressively will have a leg up on their competition.

Obviously, the final decision on any equipment purchase involves a wide number of variables, most of which have nothing to do with tax, but fully understanding the tax deductions available and the impact they will have on your cash flow will help your organization make more informed decisions.



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