

# Manufacturer



Winter 2010

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# Comparing this to that

## Benchmarking financial performance with ratios

When it comes to finding the source of a problem — or better yet, the source of a success — simply looking at the big picture isn't always the most effective approach. Benchmarking with financial ratios allows manufacturers to break their operations into individual segments to measure effectiveness against past performance, company goals and industry standards. Benchmarking can provide insight into which areas of your business are strong and which need improvement.



### Different ratios for different needs

Financial ratios are calculated by comparing two or more items on your balance sheet or income statement. While this can be done in a variety of ways, some ratios are used more often than others.

For example, the *debt-to-assets ratio* is calculated by dividing your total debt by total assets. The more debt you have, the higher the ratio will be. Because banks will likely take this ratio into consideration when you apply for a business loan, strive for a ratio of 1-to-2, or 50%, to be considered a reliable applicant with manageable debt. (See “Using financial ratios when securing a loan” on page 3.)

The *return-on-assets ratio* shows the profit generated by total assets employed. This is calculated by dividing net income by total assets. The higher the ratio, the better, because it shows you're earning more money on less investment. The *return-on-equity ratio* (net earnings divided by total net worth) shows the profit generated by net assets employed and reflects owners' return on investment. Additional ratios include the:

- *Current ratio* (current assets divided by current liabilities) — a current ratio of 2-to-1 is ideal,

- *Quick ratio* (current assets minus inventory, then divided by current liabilities) — a quick ratio of 1-to-1 or better is usually satisfactory, and
- *Sales to inventory ratio* (annual sales divided by inventory) — this should hover around 6-to-1, meaning you'll need to order new inventory about six times a year.

Another useful ratio, the *times interest earned ratio*, is calculated by dividing net earnings before interest and tax by your interest expense. This reflects your company's ability to meet interest expenses from operations.

### You vs. the competition

In addition to measuring the progress of your business over a certain period and unearthing trends and problems, benchmarking can provide a more tangible view of where your manufacturing company stands in relation to your competitors. Trade associations such as the National Association of Manufacturers provide up-to-date financial figures, including industry averages for rent, utilities, materials costs and employee compensation. Trade journals, as well as the U.S. Department of Labor, can also be helpful sources for relevant financial statistics.

To find the applicable industry statistics, you'll need to know your specific industry segment's North American Industry Classification System (NAICS) code, which recently replaced the Standard Industrial Classification system. You can find your NAICS code by visiting [www.census.gov/epcd/www/naics.html](http://www.census.gov/epcd/www/naics.html).

### **The good and bad of benchmarking**

As with all means of analyzing your company's financial standing, benchmarking with financial ratios comes with its own set of benefits and pitfalls. In measuring your financial strength by comparing it to past company performance and industry averages, your management team will gain insight into which goals the company has achieved and where it's fallen short, with tangible ratios for reference. And it will allow you to examine financial operations on a magnified scale, bringing to light any small problems that could affect your company's overall financial well-being.

On the flip side, calculating and evaluating these ratios can be time consuming. Also, if a number is recorded incorrectly, a ratio is miscalculated or a statistic is out of date, the process could yield misleading information. By working with your financial advisor to calculate and analyze your company's financial ratios on a regular basis, you'll be more likely to start and end with the right numbers and be successful in your benchmarking efforts.

## **Shippers beware**

### Common problems with cargo insurance

Manufacturers know that cargo insurance is vital when it comes to moving valuable products and machinery. But many have found, often too late, that their coverage isn't sufficient, leaving them with lost or damaged goods and little or no compensation. The key to solving the common

## **Using financial ratios when securing a loan**

Your manufacturing business's financial ratios are among the myriad pieces of data a lending institution will evaluate when deciding whether your company is worthy of a loan — and will be dependable when it comes to paying it back.

Especially if you're a first-time borrower, your banker will examine a number of financial benchmarks, including profitability ratios, such as your return on assets; activity ratios, including total assets divided by net sales; liquidity ratios, such as sales divided by working capital; and leverage ratios, such as total liabilities over net worth. The bank will compare these ratios against a baseline or current industry averages.

By regularly evaluating these ratios, you'll have an idea of your company's financial standing *before* you apply for a loan, which will help you foresee your borrowing limits and set goals for securing more funding.

### **Where you've been, where you're going**

Knowing where your manufacturing business stands compared to years past, company goals *and* industry averages is vital when it comes to understanding the strengths and weaknesses of the company you've worked so hard to grow. Calculated correctly, financial ratios could be the key to turning where you are into where you want to be. ■

problems that accompany cargo insurance is to know what they are — and how to avoid them.

### **Giving your carrier the upper hand**

One common way to insure cargo is to obtain coverage through the carrier. In this case, the



carrier is considered the insured, not the shipper. So the policy will pay out to the shipper only if the carrier is considered liable for the lost or damaged cargo. This is where problems often can arise.

Most of these policies prevent the carrier from being held liable in many scenarios. Usually found in the “endorsements” section of a carrier’s policy, exclusions from liability can include certain forms of theft, as well as delivery to a party that has obtained the shipment under false pretenses. “Acts of God” are also commonly excluded. So if, for example, the truck driver gets in an accident because of a snowstorm and damages your cargo, you’re most likely out of luck.

### **Additional problems to consider**

If you’re working with a broker, it’s important to know that, even though the broker may hold a “contingency cargo liability” policy, he or she doesn’t have an insurable interest in your cargo and cannot be issued an actual insurance policy under most state laws. If you have your broker sign a contract claiming responsibility for the shipped goods, however, the broker will be able to pay claims to you.

The financial hardships many carriers have faced in recent years have led to another problem with insurance claims. To deal with cash-flow problems, these companies may stop paying

their customers’ insurance claims because of their inability to pay their insurers’ high deductibles.

Even though the cargo company itself is first held liable, a BMC-32 Endorsement — a provision added to a carrier’s contract — protects manufacturers should their trucking companies file for bankruptcy or go out of business when property loss/damage claims are pending against them. In these scenarios the BMC-32 Endorsement holds a carrier’s insurer liable for the first \$5,000 of damaged goods or property loss per vehicle, or \$10,000 per occurrence.

### **A shipper’s interest**

The most reliable way to secure adequate compensation should your cargo be lost or damaged is to purchase your own “shipper’s interest” cargo insurance policy, also known as all-risk coverage. This policy type, unlike many carriers’ policies, covers all damages and losses, regardless of whether a carrier is found liable. Before you consider purchasing this type of insurance, check your general business insurance policy to see if you’re already covered or can add shipper’s interest insurance to your coverage at a minimal cost.

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Shipper’s interest coverage may not be necessary in every case, but you should consider it if your carrier’s limits of liability don’t cover the type of product you’re shipping. Liability limits can vary greatly among transportation modes, companies and locations, so it’s important to read the fine print of your carrier’s policy. If your product isn’t covered, shipper’s interest insurance can cover many types of specialty cargo, including refrigerated freight, special garments, fragile cargo and more.

You also may want to supplement your carrier's coverage if you're shipping expensive cargo, because many carriers' policies cover cargo only up to a certain dollar amount. For example, if your cargo is worth \$50,000, but your carrier's policy covers \$25,000 worth of cargo with a \$10,000 deductible, you'll probably want to obtain your own coverage. You can also secure a lower deductible if your carrier's is higher than you'd like.

Rates for shipper's interest coverage vary by company and mode of transport but are typically in the area of 0.5% to 2.5% of the total declared value of the cargo. The standard industry formula used to calculate freight value is the cost, plus insurance, plus freight, plus 10% — CIF + 10%.

"Cost" is the value of the goods you're shipping, "insurance" is the insurance premium fee and "freight" is the amount paid in shipping charges. The additional 10% covers unforeseen expenses.

### **Protect your cargo and your financial well-being**

In the event of a loss or accident, carriers, brokers and insurers are all going to favor their own best interests, and it's important for manufacturers to do the same. When researching carriers, pay attention to their level of liability and any exclusions from liability. You can then review your options for shipper's interest insurance with your financial advisor and a cargo insurance specialist. ■

## **On the defensive**

Use available weapons to fortify your manufacturing company against fraud

It's been difficult enough to navigate your manufacturing company through the rough economic waters of the past two years. But while you were busy stemming the tide of customer defections and budgeting for rising raw material prices, another revenue-sapping issue has been growing increasingly problematic: fraud.

### **The facts**

The Association of Certified Fraud Examiners reports in its *2008 Report to the Nation on Occupational Fraud and Abuse* (the latest numbers available at the time of this writing) that U.S. companies lost approximately \$994 billion in revenue to fraud in a two-year period ending in 2008. Even more sobering is the fact that 7.2% of fraud cases occurred in manufacturing companies, accounting for a median loss of \$441,000.

Unfortunately, your employees are a natural culprit because they have the most immediate access to funds and materials. Fortunately, there



are steps you can take to reduce the chances of fraud at your company.

### **Focus on employees**

By knowing and empowering your employees, you can decrease the instances of fraud. How?

## Implement a fraud prevention policy

A good line of defense against fraud is a well-written fraud prevention policy. Explain your company's code of ethics and include specific rules regarding the use of office supplies and company-owned equipment. Your policy should also spell out what constitutes fraud and how you will treat those caught committing it.

Make it clear that employees caught committing serious infractions will be terminated and prosecuted to the full extent of the law. In addition, state that policy violators will have to repay stolen funds or pay for stolen equipment. Finally, require all staff members to sign an agreement stating that they have read and understand your fraud prevention policy.

First, perform background checks when hiring employees — particularly for financial and management positions. A thorough review can uncover any criminal convictions involving embezzlement, theft, forgery or other fraud.

Second, encourage workers to watch what is going on around them and to alert a supervisor when they believe theft or fraud is being committed. Protect employees who report fraudulent acts by providing a confidential means — such as a toll-free hotline — for them to express their concerns.

Finally, ensure employee compensation is competitive. Workers who believe they're underpaid may be able to more easily rationalize committing fraud. Compare your pay rates to others in your industry and ensure that they're competitive.

### Use your CPA's knowledge

Your CPA can be a powerful resource in uncovering fraud and embezzlement. He or she can assist you in creating effective internal controls and help monitor bookkeeping records, invoices, bank statements, payments, journal entries, financial reports and other documents.

Ask your accountant to perform scheduled and unscheduled financial audits. Surprise audits can help identify potentially dangerous gaps in your controls and procedures and let your employees know that fraud prevention is a high priority.

Forensic accountants can also be useful. These fraud experts use their accounting, auditing and investigative skills to detect indications that your staff may be committing financial fraud. One telltale sign of fraud is growing accounts payable and receivable combined with dropping or stagnant revenues and income. Others may include excess inventory, a large number of account write-offs, and increased purchases from new vendors.

A fraud expert will examine your financial statements for these and other dangers as well as assess your company's culture and business practices to determine what conditions may be causing fraud to thrive.

### Don't overlook these functions

Several key functions of manufacturing companies are particularly vulnerable to employee fraud and, thus, demand special attention. They include:

**Cash management.** Employees may steal cash on hand, divert cash receipts or alter bank deposits.

**Inventory and fixed-asset management.** Workers can steal company assets; divert and sell shipments; or use job materials, tools or other assets for non-job-related purposes.

**Accounts receivable.** Staff members might forge checks, grant fake credits or take fraudulent write-offs for bad debts.

**Payroll.** Employees may pay nonexistent employees, pad time records, falsify salaries or commit withholding fraud.

### Protect what's yours

During tough economic times for businesses and individuals, it's natural for fraud occurrences to rise. While you can't completely safeguard your company against fraudsters, you *can* make it substantially more difficult for fraud to happen. ■

# Choose a system that fits your needs and budget

Manufacturers have used transportation management systems (TMSs) for nearly 15 years. The good news is that these supply-chain-management software systems have evolved and improved. As a result, many manufacturers are leaving their third-party logistics service providers in favor of the more convenient, cost-effective alternative a TMS provides.

## Ins and outs of TMSs

You can use a TMS to automate day-to-day freight management. A typical TMS communicates with carriers via e-mail or fax to book a shipment or schedule a pickup. Most systems can also create a database with the rates of various carriers, simplifying the rate comparison process.

In addition, a TMS can solicit bids from carriers, analyze shipment patterns, combine shipments for more efficient and cost-effective delivery, and build loads in less time. During shipping, a TMS can generate alerts regarding delays and, afterward, handle follow-up, such as invoicing. Some



systems record data from past transactions and preserve it for future analysis.

Even though a TMS can reduce transportation costs over the long term, the upfront costs of implementing the system — upwards of hundreds of thousands of dollars — can be a serious drawback. “On-demand” services, however, are growing in popularity. A less expensive alternative to on-premise, licensed software systems, the on-demand TMS option is hosted offsite and provided to you on an as-needed basis.

## Taking the options to task

When choosing a system, determine your company’s needs and what you can afford; then examine the TMS options. The first question to consider is whether you’ll insource or outsource your software. If you have a large budget and an IT staff, you’ll likely have sufficient resources to purchase your own technology.

When deciding on a TMS vendor, make sure the provider is prepared to not only support its technology, but develop the software to fit the evolving needs of the manufacturing industry. Your vendor should also be familiar enough with your specific industry and companies of your size so it can make useful recommendations.

## Greater shipping efficiency ahead

As your company grows, a TMS could be a great step forward, helping to streamline your shipping. By evaluating what you need, what you can support and, most important, what you can afford, you’ll be able to choose a system that best works for your company’s shipping needs. ■



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