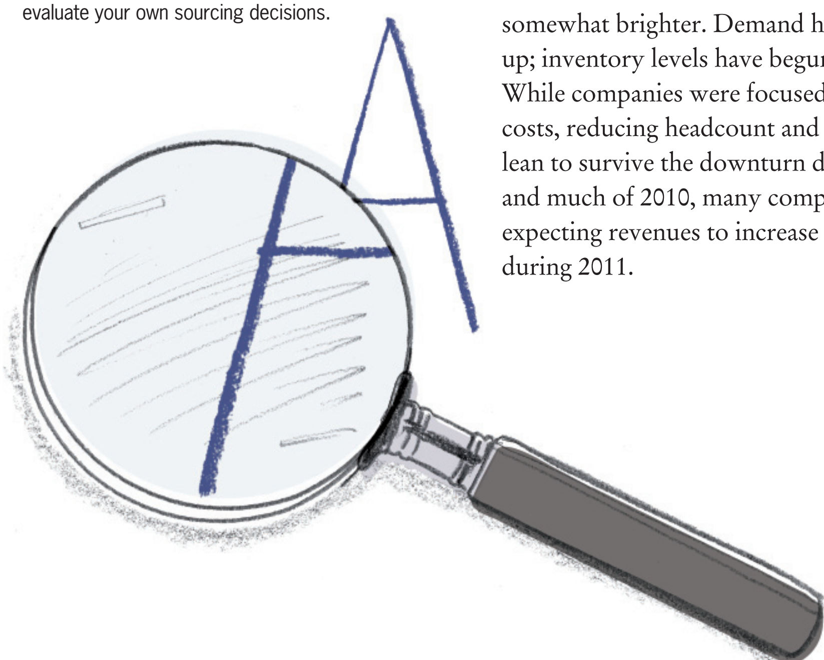
Supply Chain Solutions

Grant Thornton Consumer and Industrial Products practice Part 3 of 3 – November 2010

The supply chain today: Achieving efficiencies, managing uncertainties

Each year, Grant Thornton LLP collaborates with *World Trade* magazine on a series of three surveys concerning supply chain solutions. These surveys are intended to provide a snapshot of issues and opportunities in the supply chain industry. We hope that this 2010 survey (Part 3 of 3), along with targeted recommendations from Grant Thornton's supply chain professionals, offers you insights to help you better evaluate your own sourcing decisions.



Executive summary

As the past two years' perfect storm of challenges — a global recession, falling demand, rising raw material prices, bulging inventories — has begun to stabilize, the outlook for manufacturing, retail and distribution is looking somewhat brighter. Demand has picked up; inventory levels have begun to recover. While companies were focused on cutting costs, reducing headcount and becoming lean to survive the downturn during 2009 and much of 2010, many companies are expecting revenues to increase slightly during 2011.

But raw material costs are also on the rise, prompting many companies to adopt additional cost-cutting measures across the supply chain. Uncertainties continue to linger on a number of fronts, including the impact of health care reform, tax policies and government regulations. International tax policies and transfer pricing issues are growing concerns for multinational corporations.

Grant Thornton LLP's 2010 *Supply Chain Solutions* survey, conducted in partnership with *World Trade* magazine, highlights some noteworthy trends in respondents' sourcing decisions over the past year, as well as what's coming down the pike in 2011.

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World Trade WT100
The Benchmark for Global Supply Chain Business

More optimism about revenue growth in 2011

While 2009 and 2010 have been challenging years for many respondents, 81% of respondents expect to see revenue increases in 2011. Only 6% predict shrinking revenues in 2011. (See the "Expectations for company revenues" table at right.)

What is likely to contribute to these predicted revenue increases? More than three-quarters (76%) expect that sales to new customers will contribute. Two-thirds (66%) say that increased sales to existing customers will boost revenues. In addition, a number of respondents predict increases due to new product launches (38%) and rising export sales (35%).

"Certainly, as other countries' currencies have gained strength relative to the U.S. dollar, U.S. exports have become less expensive," says Wally Gruenes, national managing partner, Consumer & Industrial Products. "This has helped with the current administration's goal of U.S. companies doubling exports in the next five years. But there are some challenges to achieving this goal. Currently just 40% of U.S. exports benefit from Free Trade Agreements (FTAs), while the remaining 60% of U.S. exports are subject to duties. At the same time, the European Union and other nations are entering into FTAs much more aggressively. If this trend continues, it may put U.S. companies at a considerable competitive disadvantage."

More than half of respondents (56%) expect their company's profits to increase between 1% and 10% in 2011 relative to 2010. Sixteen percent expect to see profits grow more than 11%. (See the "Expectations for company profits" table at right.)

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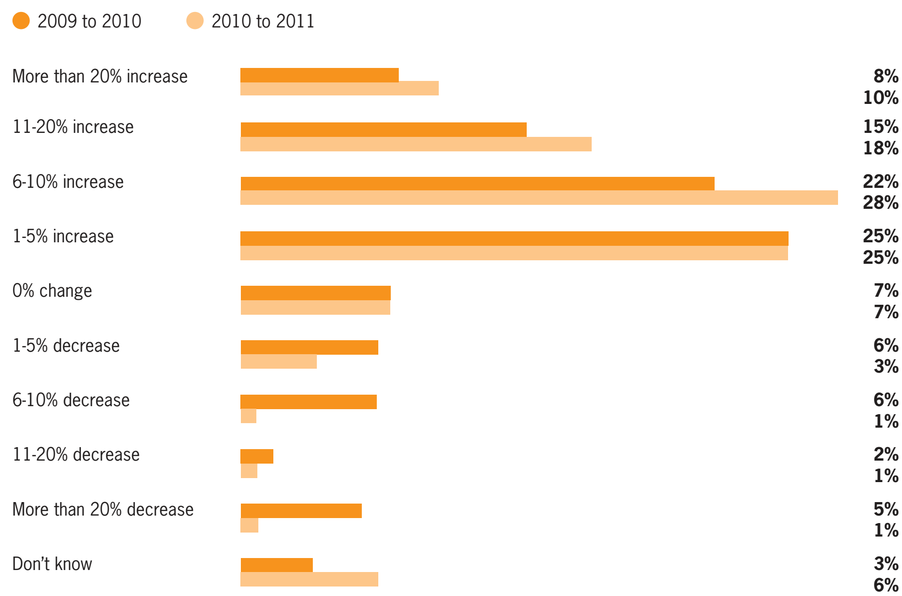
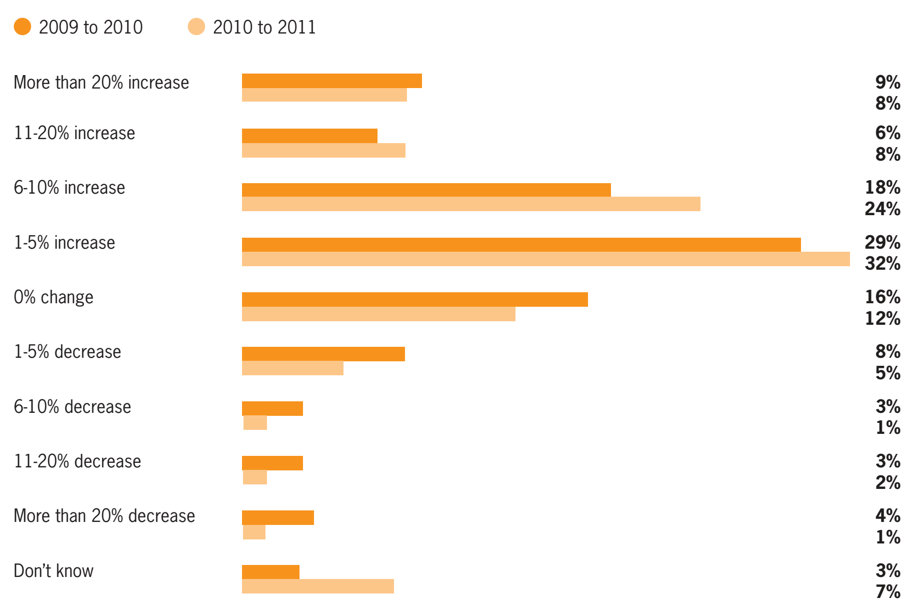
Expectations for company revenues



Expectations for company profits



The supply chain today: Achieving efficiencies, managing uncertainties (continued)

Leveraging technology

The use of technology throughout the supply chain is becoming somewhat more widespread, but there is certainly opportunity for growth. Just under half of respondents (49%) report using technology to measure or monitor key performance indicators. Nearly half are using technology to connect customers with marketing and sales personnel (46%) or to monitor customer complaints (45%).

"It is encouraging that nearly half of respondents are using these types of technologies," says Danny Miller, Business Advisory Services principal. "But there is still a long way to go. Technologies that support these activities are very inexpensive relative to what they cost a few years ago, particularly solutions to monitor customer complaints. This may also indicate that companies need to be more focused on customer satisfaction and retention, which are basic tenets of a successful business," cautions Miller.

Respondents report that their technology currently addresses some business challenges effectively. Among these challenges are financial planning, demand and supply chain forecasting (45%); logistical support for the supply chain and for shipping of finished and/or semi-finished goods (45%); and management and aggregation of shipments of finished and/or semi-finished goods (39%).

Integration of technologies to aid in cross-departmental functions — such as financial reporting, planning, forecasting, analytics, sales, customer service, pricing, supply chain and order processing — could be improved. While more than four in 10 respondents (43%) report that some of their technology systems are integrated, only 16% say that their technology systems are fully integrated. More than one-quarter of respondents (26%) are thinking about integrating their technology systems or are in the process of doing so. But 12% of respondents still use silo systems that require them to manually reconcile data across functions.

Concern over rising raw material costs

When the dollar slips in value, U.S. companies sourcing and operating internationally in countries with currencies appreciating against the dollar can face rising material and shipping costs as well as increasing labor costs. If rising exchange rates are not offset by increased revenues, those costs can put pressure on sourcing and pricing strategies and create operational and strategic risks.

Prices have increased significantly over the past 6 to 12 months for many commodities such as copper, steel, energy, cotton and paper, among others. These rising prices are a major concern among respondents. Nearly three-fourths (72%) are seeing increases in raw material costs in 2010 as compared with 2009. A similar number (76%) expect these costs to increase in 2011. Two-thirds (66%) expect raw material prices to rise between 1% and 10% in 2011. In fact, when asked to select the one factor that had the greatest negative effect on their company's profitability during 2010, the largest proportion of respondents (23%) noted raw material price increases.

Concerns about raw material increases are compounded by worries about customer loss (11%), high fuel costs (11%), increased regulation (11%) and foreign competition (10%). Other factors that have been detrimental to profitability this year include unfavorable currency exchange rates, difficulties obtaining credit, the weak housing market, transportation capacity shortages, and reduced consumer demand.

"There is widespread concern in the market about U.S. income tax policies and about health care, environmental, labor and safety regulations. Many companies feel that these regulations raise the cost of producing and delivering products and make them less competitive globally," says Michael T. Capone, Audit partner.

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The impact of health care reform remains unclear

Almost every company across the supply chain is affected by health care reform, and a number of changes go into effect for plan years beginning after Sept. 23, 2010. For example, these plans must cover children until age 26. For children under age 19, there is no exclusion from coverage due to pre-existing conditions. There is also no lifetime benefit maximum and no rescission of an individual's coverage.

But respondents have a wide range of opinions as to how health care reform will affect profitability. Nearly two in 10 respondents (18%) report that they don't know how health care reform will affect their profitability. Others assert it will hurt profitability. Still others say it will boost productivity and profitability. Twenty-eight percent say their companies are not making any health care reform-related changes at this point.

"There is a tremendous amount of uncertainty about what the effects of health care reform will be. Certain aspects will add costs for employers. On the other hand, many predict that the universal coverage requirement will lower the average cost of health care, because there will be an influx of healthy people newly paying into the insurance pool," explains Eddie Adkins, partner, Washington National Tax Office. "But the reality is that no one will know what the impact will be until 2014 or later, when key aspects of the new law such as state health care exchanges and mandated coverage go into effect. (For more information about this topic, see "Health care reform: Staying on top of the new requirements" at right.)

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Health care reform: Staying on top of the new requirements

Almost every company is affected by health care reform, and now is the time for employers to get down to the business of incorporating its myriad and complex provisions into their employee benefit plans. Failure to do so will bring about costly consequences: An employer that does not comply with health care reform is fined a whopping $100 per day per employee. Clearly, no company can afford to take a passive attitude regarding compliance.

Following are the major new requirements for health care benefit plans, along with other new plan-related rules such as reporting and penalty rules. (Note: Numerous additional rules not listed below apply to new plans that go into effect after March 2010, as well as to existing plans that are modified in certain respects after March 2010.)

2010

Small employers (employers with fewer than 25 full-time equivalent employees with average wages less than $50,000) receive tax credit for providing coverage.

Plan years beginning after Sept. 23, 2010:

- Must cover children until age 26
- For children under age 19, no exclusion from coverage due to pre-existing conditions
- No lifetime maximum on benefits
- No rescission of an individual's coverage

2011

- W-2 reporting of the cost of health care benefits (optional for 2011, mandatory starting in 2012)
- No reimbursements in a health care flexible spending account for over-the-counter drugs unless prescribed by a physician

2013

- Employee contributions to health care flexible spending accounts limited to $2,500 per year

2014

- No exclusion from coverage due to pre-existing conditions, regardless of the individual's age
- No annual dollar limits on benefits
- Large employers (employers with 50 or more full-time employees) pay penalties for providing no coverage or inadequate coverage

2018

- 40% excise tax on high-cost plans (plans with a cost in excess of $10,200 for single coverage and $27,500 for family coverage)

Health care reform will require many changes, but supply chain companies are no strangers to change and the challenges it brings about. The time to get started is now — especially for the provisions that go into effect next year.

For more information about health care reform and what your company needs to do to prepare, visit Grant Thornton's health care reform diagnostics website at www.GrantThornton.com/hcdiagnostics.

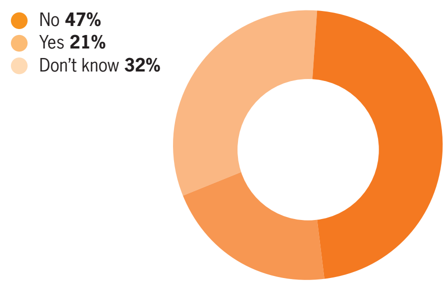
The uncertain tax environment

Companies across the supply chain are hoping for more favorable tax policies, such as an extension of the 2001 and 2003 tax cuts, which are due to expire on Dec. 31, 2010; and other "extenders" such as the R&D tax credit, which expired at the end of 2009. "Uncertainty surrounding tax rates and tax extenders is a factor that is causing companies to be conservative in their approach to expansion and hiring," says Kullen Birkeland, Corporate Tax partner.

Asked which tax law change would have the biggest impact on their business, nearly three in 10 (29%) respondents say that additional capital cost incentives such as bonus depreciation would make the biggest difference, and 26% cite expansion of manufacturing incentives such as the domestic production activities deduction. Nearly one-quarter (24%) believe that hiring incentives such as the wage credit would have the biggest impact.

State taxes continue to be a significant component of tax expense for survey respondents, and states have significantly increased enforcement, including stricter scrutiny and stepped-up audits by many state tax authorities. Respondents are doing a number of things to mitigate their state tax liabilities, including reviewing real and personal property tax valuations (34%); changing the business's operating structure to reduce tax burden (32%); and asking state(s) for assistance related to business expansion (24%).

Actions taken in response to international tax legislation



Respondents were asked: Is your company taking any action in anticipation of or in the wake of legislative changes in the international tax area?

There have been a number of legislative changes over the past year that would fundamentally alter the international tax system and thus have major implications for the global operations of U.S. businesses. For that reason, it is not surprising that respondents are concerned about international taxes. But nearly half of respondents (47%) are not taking any action in anticipation of or in the wake of these changes. Almost one-third (32%) of respondents don't know whether their companies are taking any action. Some of the legislative changes on the horizon relate to the HIRE Act, the Foreign Account Tax Compliance Act (FATCA), and the Education Jobs and Medicaid Assistance Act (HR 1586). These acts will have a major impact on taxpayers and businesses with any overseas presence. (See the "Actions taken in response to international tax legislation" table above.)

"Companies need to review their business structures to identify the impact of these new rules on their financing and their foreign tax credit positions and to determine whether they should modify those structures or transactions to minimize the negative impact of these changes," comments Pete Simpson, International Tax partner.

Companies are concerned about a number of issues related to international taxes. The leading concern respondents report is the overall global tax compliance burden (30% say this is their top concern), followed closely by transfer pricing (28%). Others are most concerned about the tax consequences of repatriation of offshore earnings (18%) and mergers and acquisitions (16%) or about managing tax risks in developing countries (8%).

"For U.S.-based multinational enterprises or foreign-controlled subsidiaries operating in the United States, transfer pricing issues have rapidly emerged as a significant challenge in today's global business environment," says David Bowen, principal, International Transfer Pricing.

(For more information about this topic, see "What companies need to know about transfer pricing" on the following page.)

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The supply chain today: Achieving efficiencies, managing uncertainties (continued)

Looking ahead

Companies that have survived the downturn cut costs aggressively during 2009 and 2010 in order to stop the bleeding. Now that the market has stabilized, most companies are hoping that they can increase prices, sell more product or further reduce costs to improve profits in the coming year. But continued uncertainties about how the economy, raw material prices, tax policies, health care reform and the regulatory environment will affect companies have put an even brighter spotlight on the need for supply chain efficiency.

"A growing number of companies are figuring out ways to collaborate in order to reduce costs, particularly through innovative supply chain collaborations and partnerships," says Gerry Pombo, Audit partner. "Some manufacturers are reconfiguring and streamlining their logistics and warehousing processes in order to reduce the costs of carrying excess inventory. Others are teaming up to take advantage of shared logistics, routing and transportation," notes Pombo.

"While many companies have reduced costs over the last two years, the question remains whether they have also improved processes and eliminated waste in the system. There is still ample opportunity for most companies to make their operations leaner, eliminate waste and redundancies, streamline processes, and at the same time improve products and services," concludes Gruenes. •

What companies need to know about transfer pricing

Transfer pricing refers to the allocation of profits for tax and other purposes among parts of a multinational entity. Transfer pricing can have a major effect on the supply chain, because the companies in a commonly controlled chain (i.e., a company and its related parties) must comply with the arm's-length standard in determining which companies should recognize what amounts of income, deductions, credits and allowances among the various tax jurisdictions in which the commonly controlled supply chain operates. The arm's-length principle requires that the amount charged by one related party to another for a given product must be the same as it would be if the parties were not related. Hence, an arm's-length price is the price that independent companies would pay under the same or comparable circumstances.

For example, consider a manufacturer in Country X, a distributor in Country Y and a retailer in Country Y. Assume that the Country X manufacturer can make the product for $200 and that the Country Y retailer can sell the product for $1,000. How much of the $800 profit should be recognized by each entity in the chain? Because the chain is controlled, the companies could theoretically manipulate the intercompany sales prices, which would affect the income that they report to the tax authorities in countries X and Y. Transfer pricing rules, however, require that the companies achieve arm's-length results.

Recognizing the potential in today's globally connected economy for income to shift to jurisdictions with lower tax rates, governments have become more vigilant in enforcing transfer pricing regulations. This vigilance involves stricter penalties, new documentation requirements, increased information exchange, and heightened audit and inspection activity. Transfer pricing audits have become more aggressive, making it all the more important to carefully and accurately document every aspect of companies' transfer pricing strategies to reflect arm's-length arrangements.

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About the survey

Grant Thornton partnered with Clear Seas Research, a subsidiary of BNP Media, to produce this original research about supply chain strategies. A total of 317 responses by readers of *World Trade* magazine were gathered from Sept. 23, 2010, to Oct. 4, 2010.

About Grant Thornton's supply chain advisory services

Grant Thornton provides a broad spectrum of supply chain solutions, including commodity planning, sourcing process evaluations, pricing reviews, technology solutions, supplier assessments and action planning, risk response protocol analysis, inventory and asset management solutions, and consolidation and resource management.

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World Trade magazine is a business-to-business logistics journal delivering news and information to U.S. subscribers active in domestic and international trade. *World Trade* magazine covers every aspect of the global supply chain, from the movement of products across the United States to the procurement from and delivery to international markets.