protiviti®
Face the Future with Confidence

Manufacturing and Distribution Industry Perspectives

Your monthly blog and industry news round-up

Inside This Issue

March
2018

It Is Time to Bring Order to the M&D Lease Universe

Public company accounting departments closing the books on 2017 may find it difficult to take a breath. Fresh from filing their 10-K and finalizing their preparation for the FASB's new revenue recognition standard (ASC 606) effective in 2018, it is time to prepare for a new **lease accounting standard** (ASC 842). The new standard goes into effect for fiscal years beginning after December 15, 2018 for public companies (effectively January 1, 2019 for calendar year companies) and one year later for nonpublic entities. Therefore, calendar-year-reporting public companies have only just over nine months left to prepare.

While the new lease accounting rule is generally straightforward, and several lease administration systems are becoming available to manage lease accounting under the new standard, lessees may underappreciate the effort needed to identify, locate, and abstract their current leases. Manufacturing and distribution (M&D) companies may be particularly susceptible due to the fact that their universe of leases generally includes plants, warehouses, equipment and other assets strewn across a decentralized corporate platform. The new lease standard will also require companies to identify embedded leases within service contracts and determine discount rates for lease measurement.

Background

The new standard will require lessees to recognize a lease liability and a right-of-use (ROU) asset for all leases greater than 12 months. The rule is largely designed to provide investors with greater transparency into a company's operating leases by reflecting them on the balance sheet – a move many felt was long overdue.

Significant impacts of the new standard include:

- **Lease classification** – Existing capital leases will be called finance leases, and accounting for them will remain similar to current "on balance sheet" accounting. Other leased assets, such as equipment, which are currently accounted as "off balance sheet" assets, will also become finance leases, and recorded on the balance sheet. Operating leases, such as real estate, will retain their moniker but will now be recorded on the balance sheet.
- **Balance sheet presentation** – Companies will recognize a non-current ROU asset and current and non-current lease liability for all leases regardless of classification.
- **Income and expense recognition** – Expense recognition will differ for the categories of operating and finance leases. For operating leases, the lease expense will be recognized on a straight-line basis, as rent expense. For finance leases, the expense will be accelerated and will consist of amortization expense and interest expense.
- **Impact on disclosures** – Disclosure requirements for leases will include a number of new measurements, such as total lease costs, weighted-average remaining lease terms, and the weighted-average discount rates for finance and operating leases as well as expanded qualitative disclosures.

Steep Start

When preparing for the new standard, M&D companies are likely to encounter their biggest challenges at the beginning of the process. This is due to the fact that M&D companies tend to have multiple locations, decentralized lease agreements and a variety of leased assets, such as buildings, warehouses, machinery and equipment. Getting their arms around the lease universe to eventually determine the opening balance sheet "gross up" and to prepare for income statement amortization could be more challenging or time-consuming than anticipated. Once the companies are satisfied the lease universe is complete, they must then categorize (and prepare to amortize) finance or operating leases appropriately, as well as identify any embedded leases in service provider contracts where the organization enters into a service agreement and equipment happens to come with it.

While M&D organizations can leverage technologies to aid data extraction and lease abstraction to reduce the manual effort during the transition, the initial effort to ensuring the completeness of the lease universe could still take significant time and effort to complete. Further, there are many judgements and assumptions that require management input, e.g., assumptions around renewals, early terminations and discount rates. As they work through the first step of the process, companies may also need to choose a system to automate the accounting and maintenance of those leases on an ongoing basis, particularly if they have a high volume of leases. There are a number of lease administration software programs becoming available to assist companies with this effort.

For accounting departments that logged hundreds of hours preparing for FASB's new revenue recognition rule, the last thing they want to do is start another project that could be as demanding. But with the end of the first quarter of 2018 in sight, and thus a little more than nine months to prepare, M&D companies in particular would be wise to begin planning their transition to FASB's new lease accounting standard as soon as possible. Such a strategy will prevent organizations from being caught off guard by possible complications in the process and can help avoid a frenzied sprint to meet the deadline at the end of the first reporting period.

Disruptive Innovation Front and Center for Manufacturers and Distributors in 2018, According to Survey

Digitalization has been called the **fourth industrial revolution**. New business models are emerging to keep up with the rapid pace of change, and not surprisingly, they are being met with some predictable internal resistance and cultural challenges. As these more agile and automated models rely to an ever-greater extent on technology and third-party suppliers, supply chain risk is an increasing concern as well.

These and other operational worries are the dominant themes to emerge from the manufacturing and distribution (M&D) industry group's responses in a recent survey, **Executive Perspectives on Top Risks for 2018**, from Protiviti and North Carolina State University's ERM Initiative.

The operational focus of this year's top risks is fundamentally different from 2017, when a majority of the top issues were macroeconomic and driven by political uncertainty. I am not particularly surprised by this shift. In December, I **wrote** about how manufacturers are moving from product-centric business models to bundled product-and-service ones, where investments in mobile platforms and innovation are allowing more sophisticated and customized user experiences. Organizations are continually finding new ways to deliver more value to customers — for example, a manufacturer of industrial machines might embed diagnostic technology to bundle maintenance services with products to decrease customer downtime.

Digital transformation and process automation is moving from the factory floor to the back office, where robotic process automation and artificial intelligence can be employed to save money and increase efficiency. Few manufacturers would disagree that the Internet of Things, big data integration and other advances in technology are boosting productivity, streamlining supply and distribution channels, and improving product support.

But **data-rich manufacturing carries its own risks**. Cyber attacks are growing in frequency and severity. The National Institute of Science and Technology (NIST) estimates that cyber attacks and data breaches will cause nearly half of manufacturing supply chain failures over the next couple of years. Supply chain breaches that steal or alter data could result in substandard products, the loss of intellectual property, and backdoor access into the manufacturer's systems, tarnishing brands and diminishing value.

To top off these operational concerns, M&D executives also worry whether their organizations' cultures help or hinder the ability to identify and escalate risk issues for proper attention. Of particular concern in 2018 is whether the tone at the top is reaching down into the rest of the organization and translating into a strong tone in the middle and operational excellence at the bottom, which is where resistance to change can create the biggest reputational and brand damage.

While risks related to disruptive innovation, supply chain volatility and resistance to change all bubbled up to the top to replace the macroeconomic concerns of last year, one issue remained in its top-five position: the ability to attract and retain top talent. At the end of the day, a company's success or failure in the midst of dynamic change is going to depend on the capabilities and preparedness of its people. Not only do organizations need the right talent to support digital transformation and embrace change, but the organizations themselves must embrace innovation and change to be attractive to prospective hires. No one wants to work for a company with its best days behind it.

If I were to sum up M&D's focus this year in two words, it's "look inward." Aside from remaining vigilant for events with the potential to affect the supply chain, M&D executives must clearly focus on their internal operations and seize on opportunities like robotic process automation, AI and data-driven business models, while also fostering a culture receptive to change and willing to identify and report risks.

Download the full 2018 Top Risks survey **here**, and the M&D industry-specific findings **here.**

Check Your Blind Spot: GDPR Poses Veiled Risks for M&D Companies

Executives that participated in Protiviti's latest annual top risks **survey**, conducted with North Carolina State University ERM Initiative, ranked regulatory changes and scrutiny as a top-five risk in 2018. That's hardly a shocker, considering that respondents typically identify regulatory issues as a top concern each year. Companies unaware that regulatory changes could affect them are at even greater risk, however.

For manufacturing and distribution (M&D) organizations that do business in the European Union, an imminent regulatory change requiring immediate attention comes in the form of the **General Data Protection Regulation** (GDPR). GDPR goes into effect on May 25 this year. From an M&D perspective, the bulk of the rule appears to cover business segments unrelated to the principal operations of companies in the industry; nevertheless, GDPR affects M&D companies in ways that they may have not yet considered.

GDPR is designed to give EU citizens more control over their private information amid the growing risks associated with personal data exposure in the digital world. GDPR defines personal data as any information related to any person that can directly or indirectly identify that person. Companies that violate GDPR could face a fine of up to 4 percent of global revenue or 20 million euros, whichever is greater. The specter of a fine of that magnitude warrants attention. We have covered various aspects of GDPR on this blog, which you can **read here**.

The EU does not require that companies demonstrate compliance with GDPR, but it is widely believed that Data Protection Authorities (DPAs) — agencies tasked with enforcing the rule at the local level — will aggressively hunt for violations to fund their new oversight programs. Generally, DPAs will focus on two primary enforcement areas: data breaches and complaints alleging that private information was used in a manner that went beyond a person's consent.

Know Your Sources

The good news is that M&D companies are chiefly business-to-business operations that have tangential contact with consumers. But just because DPAs may not make M&D organizations their specific targets doesn't mean the companies get a free pass on the new regulation. For one, GDPR protects the personal information of employees, which will affect M&D companies that have an EU workforce. What's more, even though the organizations may not deal with customers extensively, there are subtle ways that they collect consumer information, whether the manufacturer is even aware of it. For instance, this information can be collected during warranty service or parts requests, visits from websites that produce cookies, and communication with the employees of vendors or suppliers.

To avoid being blindsided by a violation and fine, we suggest that M&D companies identify and map the different kinds of personal data they gather as well as the ways in which they gather it. We also recommend that companies close gaps and implement **mitigation measures** to minimize the risk of breaches and complaints. Organizations should also be aware that the rights that GDPR confers upon EU citizens may limit a company's ability to lawfully process personal data, which could impact business models. Organizations must have a legitimate right to use the data to perform a service — it cannot be obtained for one purpose and then saved and used for another purpose.

A few examples of information covered by GDPR follow, including data and collection sources that organizations may be overlooking:

- **Fundamental Data/Observable Sources** — This source includes names, home addresses, phone numbers, birth dates, financial and bank information, and email addresses. Certainly M&D companies are going to have this information on their employees, in addition to other potential work-related data such as healthcare information and passport numbers.M&D organizations may also have much of this data for consumers. Consider makers of washing machines or other appliances. While consumers don't buy appliances directly from manufacturers, they may fill out a warranty card to register the product. That information then becomes subject to GDPR, and because buyers registered the appliance for warranty purposes only, manufacturers are prohibited from using the data to market other products to the customers without consent.
- **Digital Data/Automated Sources** — M&D companies also need to be aware that they digitally gather "hidden" personal information through electronic logs or system files. Shoppers beginning their research for a washing machine frequently visit manufacturer websites, for example, and automatically provide the company with their Internet Protocol (IP) addresses. As it stands now, that information is all that is needed to begin inundating web-surfing consumers with washing machine advertisements. But that type of data is also protected by GDPR, which, again, would prohibit that type of marketing without the consumer's consent. Media access control (MAC) addresses, cookies and GPS data also fall into this bucket.

- **Business Customer Data/Company and Vendor Sources** — Personal information on European business contacts is also subject to GDPR, whether M&D organizations are outsourcing functions such as their sales force programs, or are performing them in house. Outsourcing puts a premium on third-party vendor management to ensure that vendors are following the rule, but regardless of how their operations are structured, organizations need to be aware that the same restrictions that apply to consumers apply to business customers. A sales force database typically includes personal information on potentially tens of thousands of contacts. If someone in the database requests that a manufacturer stop sending marketing collateral to him or her, GDPR stipulates that M&D firms or their vendors must delete that contact. Simply flagging the account isn't enough under GDPR.

Those are just a few examples of how GDPR may trip up M&D organizations that do business in the EU. With the GDPR effective date just over a couple of months away, M&D companies that do not yet have a handle on the regulation still have some time to prepare, but must do so with urgency. By focusing on identifying the types of personal information that they collect, and the sources that generate that information, M&D companies can then map out a strategy to shore up weaknesses and position themselves to be compliant on a timely basis. Organizations can find additional resources and information about GDPR to quicken the process **here** and **here**.

The New U.S. Steel and Aluminum Tariffs: A Precursor of What?

Today, the Trump administration announced steep tariffs on steel and aluminum to go into effect in 15 days. According to the administration, these two industries have been targeted for many years and subjected to unfair trade practices resulting in plant closings and decimation of whole communities — a trend that is creating not only economic consequences but also a national security concern. As President Trump announced today, strong steel and aluminum industries are vital to the national security of the United States. Specifically, the president indicates that he intends to build up the country's military using American-made steel and aluminum.

The tariffs will consist of a 25 percent tax on foreign steel and a 10 percent tax on foreign aluminum. No tax will be levied on any product made in the United States. According to the administration, it is open to modifying or removing tariffs on individual countries. Canada and Mexico will be excluded from the tariffs for the time being. The president indicated that if these countries and the United States can come to agreement on the North American Free Trade Agreement (NAFTA) renegotiation, the exclusions will become permanent; the implied message is that if the renegotiation is unsuccessful, tariffs will be applied to all imports, regardless of source.

No one should be surprised at today's actions. The president campaigned on this issue and can be expected to play to his base that this is a "promise kept." That said, there are signs of flexibility for countries willing to make adjustments in the interest of more fair and reciprocal trade. However, any country granted an exclusion would result in higher tariffs for other countries in view of the administration's apparent commitment to maintain a level of protection in defense of domestic steel and aluminum industries.

Critics of the administration's move today have raised concerns regarding the possibilities of strong reprisals and escalating protectionist practices that could lead to full-scale trade warfare, create strong headwinds of slower global growth and higher inflation for exporters and multinationals, as well as consumers and businesses having strong reliance on imports. Given this week's fluctuations in the markets in which there was an abrupt decline followed by a recovery, fears of an extreme response appear to have subsided – at least for now.

These tariffs have understandably raised questions among many organizations in different industries. While this obviously is an evolving situation and much more will develop and become clearer in the coming weeks, I asked some of Protiviti's Global Industry Leaders to share with me their initial thoughts on some of the potential impacts in their industry and the questions their clients are asking. Here's what they had to say:

Manufacturing and Distribution: The proposed tariffs are applied broadly rather than to specific countries, which opens up the risk of retaliation, even from U.S. allies. Clearly there will be winners and losers in the manufacturing industry, based on the particular sector. Obviously, domestic steel and aluminum producers stand to gain the most from these tariffs as they counter cheaper imports "dumped" from heavily subsidized countries like China. However, due to tariffs raising the cost of steel and aluminum in global supply chains, many U.S. industries that use those metals could see decreasing margins, increasing prices for customers and/or a reduction in manufacturing jobs. This could include automakers, machinery and equipment manufacturers, beer and soda companies and the construction industry, to name a few. From a trade partner standpoint, certain European and Asia-Pacific allies who are larger trading partners than China on certain goods could be harmed. If a trade war ensues, no one wins.

Consumer Products and Services: Steel and aluminum tariffs will likely drive up costs on manufacturing equipment and raw materials used in packaged consumer goods manufacturing as well as the finished goods themselves, although no one knows for sure just where the point of levy will be in the value chain. For a long time, companies have taken full advantage of cheap labor costs abroad through outsourcing, offshoring and emphasizing low cost producers in building global supply chains. As a result, U.S. businesses and, in particular, retailers have benefited from less expensive imported goods. Accordingly, the National Retail Federation and the Food Marketing Institute have expressed concern that these tariffs will impact the finances of all Americans with higher costs on basic consumer items, including food and food packaging. Additionally, for many years, Americans appetite for imported goods has increased and a trade war could lead to higher prices for imported goods Americans enjoy. If the administration's trade policies and retaliation by other countries were to increase the cost of imported goods, it is reasonable to expect – at least initially – upward pressure on the prices of consumer goods.

Technology: Although the technology industry is not typically called out as one of the significantly impacted industries, steel and aluminum are major components for many manufactured technology products. A key unknown as of this writing is whether the tariffs will be assessed on raw materials or finished goods. Companies (e.g., Apple) that manufacture components and products outside the United States will fare better if the tariff is on raw materials than those that import steel and aluminum to produce components in the United States. If assessed on finished goods, manufacturing outside the United States will not protect products from cost increases. Companies that have implemented and utilized technological advances to streamline their manufacturing processes, and therefore their use of affected metals, may insulate their import costs as compared with companies that continue to manufacture via less efficient processes. Another significant unknown involves retaliatory tariffs. The EU has proposed very targeted product tariffs so the potential impact on technology industry players remains a risk should their products be targeted by affected countries.

Energy: Margins are already tight in the industry, so this could create a bump in the road to what has been recently on a steady (albeit small) uphill climb. U.S. companies with assets and operations internationally are likely not affected. However, oil field services companies that make rig and production equipment will likely see higher costs to machine their products. These higher costs could be passed on to upstream companies purchasing oil field services materials and services. Pipeline companies would likely incur increased costs. Given that most of their revenues are domestic, utilities are less likely to be impacted by anti-trade policies. They may incur increased costs – probably construction-related costs – that could be passed on to general public in the rate making process.

To sum it up, one thing we can say is this: No matter what happens, protectionist rhetoric is now out in the open. Once that cat is out of the bag, it's hard to stuff it back in.

About Protiviti

Protiviti is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and its independently owned Member Firms provide consulting solutions in finance, technology, operations, data, analytics, governance, risk and internal audit to our clients through our network of more than 70 offices in over 20 countries.

We have served more than 60 percent of *Fortune* 1000® and 35 percent of *Fortune* Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Contact

Sharon Lindstrom
Managing Director
Leader, Manufacturing and Distribution Industry Practice
+1.312.476.6386
sharon.lindstrom@protiviti.com

protiviti®