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HEDGING AGAINST VOLATILITY

Can You Swap Your Interest Rate?

From time to time companies need to borrow — sometimes for working capital, more often to finance equipment, real estate or other expansion. But when a manufacturing or distribution company, even one with stable and sizeable inventory and receivables, needs to borrow several million dollars or more, it might find itself able to obtain credit only at a variable interest rate. Bankers are reluctant to extend too much fixed-rate credit over a long period of time. The lender might offer fixed-rate financing over a shorter term, but at higher rates.



Variable Rates: Sometimes Good, Sometimes Not

Under these circumstances, a variable-rate loan can look attractive. Over the past two decades, variable-rate financing has often proved less expensive than fixed-rate loans. But as some recent homebuyers are finding out, a variable-rate loan can turn dangerous in a volatile financial environment. For a business, a variable rate makes for less predictable earnings. What can a company do to obtain the stability and certainty of fixed-rate pricing on the credit it needs?

Hedge Against Volatility

An interest rate swap is a method of fixing the rate on a portion of a loan in order

to mitigate the risk of interest-rate movements. It constitutes a hedge in which the borrower gives up a little (points on a fixed rate) to protect against something potentially worse (high resets on a variable rate). Rate swaps can be complex, involving lenders, underwriters and other parties. But for most conventional businesses the transaction is simpler, and most swap agreements for manufacturers and distributors are issued by their primary bank. The amount of the loan that can be brought under a fixed rate through a swap is negotiable. It's called the notional amount, and the swap contract is independent from the loan agreement.

Not All or Nothing

Some owners automatically think that the most conservative play is to hedge 100 percent of the loan, essentially swapping to a higher fixed rate in return for the stability

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Much More Than Employee Leasing

Our last issue discussed the benefits of a human resources audit, which surveys and analyzes a company's policies and practices in the management of its employees. Such an audit, we noted, is most useful when it's the first step in a program of improvement.

Coming out of an audit, many companies consider outsourcing some HR functions. In fact, it's possible today to engage a professional employer organization (or PEO) to manage virtually all of them.

The pioneers in the field were known simply as "employee leasing" companies, but today's PEOs are full-service organizations that manage a wide range of HR and administrative activities for small and medium-sized companies.

A PEO establishes a contractual co-employer relationship with its clients. Most offer a variety of individual services, as well as comprehensive solutions up to and including a fully accessible off-site HR department.

By virtue of their breadth, many PEOs can deliver Fortune 500-level benefits and a much greater level of human resource expertise than a company could afford on its own.

Mitigating Risk

For manufacturing and distribution companies, one key benefit of partnering with a PEO is access to its larger risk pools, whether for purposes of health benefits, workers compensation claims or insurance against litigation.

For example, small companies often face steep costs for medical benefits. By bringing in a PEO as a "co-employer," a company places its workforce in the PEO's much larger pool of employees, bringing access to better benefits at more affordable prices.

Similarly, both workers compensation and liability insurance costs drop when employees are counted in the larger risk pool of the PEO.

In addition, many PEOs provide services designed to reduce risks on the job, a primary consideration in manufacturing and logistics environments. They can conduct safety evaluations, help identify hazards, recommend corrective action and implement safety programs, all based on broad industry experience.

Shifting Administrative Burdens

A second benefit is the ability to move administrative tasks to a PEO, freeing up a company to concentrate on its core competencies and turn out products instead of paperwork.

PEOs today present themselves as single-source solutions for a broad range of "non-core" functions, from initial job postings and recruitment to training and development. They can also assist with performance management, compensation analyses and termination and unemployment claims.

Through aggressive claims management practices and return-to-work programs, a PEO can also help minimize the ultimate cost of workers' compensation issues.

In addressing regulatory compliance issues, companies can benefit by partnering with a PEO. As rules and regulations can change quickly today, it's not easy to stay informed, and even a minor oversight can be costly. By virtue of its breadth in the HR industry, a PEO can often bring a greater level of expertise than a small or even midsize company can muster.

Close Evaluation Needed

Clearly, HR outsourcing can deliver impressive benefits. But it may not be right for every HR function at every company. Before jumping in, perform a cost-benefit analysis, and be sure

the co-employment arrangement is crystal clear about leaving operational control, as well as critical personnel decisions, in the hands of the owner. ■

What a PEO Does

Here are some of the services available from PEOs:

Recruitment. PEOs can formulate job descriptions, advertise in print and online, screen résumés, check backgrounds and assess candidates.

Payroll services. These services can include timekeeping systems, online processing, tax filings, management reports, and arrangements for garnishments and accrued leave.

Benefits management. A PEO can administer medical, life and disability insurance; COBRA extensions; employee assistance programs; and retirement plans.

Employee relations. A PEO's HR representative can oversee administration, employee leave, performance management and compensation statements.

Risk management and safety. PEOs not only bring employees into larger risk pools, at more favorable rates, but also design and implement risk-reducing safety programs.

Regulatory compliance. A PEO that manages many HR functions for many clients can stay current more effectively than a single company can.

of knowing what that rate will be. But if interest rates fall, they can end up paying substantially more than they would have paid under a variable rate. Other owners, put off by elaborate financial transactions, accept a variable rate from the beginning simply because it's easier to understand. They figure they'll deal with volatility as it comes and refinance as needed. But a more nuanced approach — one that proceeds from a careful analysis and involves some strategic hedging — is generally better than either of these all-or-nothing strategies.

Optimal Hedge?

Generally speaking, a 50 percent hedge on a company's debt — putting half at a fixed rate, half at a variable rate — takes interest rate volatility off the table. When rates rise, one portion is protected under a fixed rate. When rates fall, the other portion benefits from the falling variable rate. A company

so hedged knows it will neither win nor lose significantly by rate fluctuations. Consequently, it can budget more surely and focus its efforts on managing and improving its business. But the right hedge for a given company depends on its circumstances. A manufacturer with heavy debt and thin margins can't tolerate much uncertainty, and may benefit by fixing a larger part of its interest payments with a swap. On the other hand, a company with strong equity and predictable margins, even with a fair amount of debt, might not be inclined to hedge at all. It could accept some uncertainty, and choose the simpler course of allowing its interest rates to float over the long term.

Due Diligence on Swap Offers

According to Keith Friedlein, partner-in-charge, *Manufacturing & Distribution Group*, Wolf & Company LLP, "Not every rate swap is right for a company, nor should every interest

rate be locked in. The company that hedges too much or too soon can end up paying interest well above the going rate, or facing a high price to buy its way out of the agreement. The timing of an interest rate swap is critical, but its impact is fully known only after the fact. Predicting the events that move interest rates up or down, such as the actions of the Federal Reserve, is a less-than-perfect science," says Friedlein. For that reason, and because every company is different, determining the benefits of this kind of hedge, as well as an optimal position to take, requires close analysis.

An interest-rate swap can be complex, and every company faces unique circumstances. A business should not enter a swap agreement lightly, but only after strong collaboration with its advisory team. ■

For more information please contact Keith Friedlein at 630-545-4505.

The Triangle Theory of Fraud

Fraud is big business, as U.S. companies lose some \$660 billion annually to it. Since forewarned is forearmed, the roots of fraud are worth examining. In the 1950s Prof. Donald Cressey reported on actual fraud schemes he had studied, in which he always found three elements: pressure, rationalization and opportunity. Cressey believed that all three "sides of the triangle" must be in play for a fraud scheme to develop.

Pressure is a function of the human condition. A spouse is laid off, credit card debt mounts, a trip to Vegas goes sour — these and other events can have grave financial consequences. There are many such events, but generally only one sure cure: money. Rationalization is the invention of the schemer. Everyone is under stress, but not everyone diverts

company funds or pays no-show employees. Most frauds, in fact, are committed by employees who view themselves as fundamentally honest. For them, crime requires a personal twist of morality and reason. (I was only borrowing. Everybody does it. I'm owed. My family needed it.)

Opportunity is the third side of the fraud triangle. A fraudster must see a way to steal without being caught. So if life generates the pressure, and the fraudster provides the rationale, who provides the opportunity? That would be the employer — who can also withdraw opportunity.

Cressey noted that fraud schemes can't develop if one leg of the triangle is missing. People not under pressure are not desperate for cash. Even under pressure, people who can't rationalize criminality will find other



solutions. And without opportunity, even the most committed fraudster — frantic for funds and lost in a dream-world of rationalization — can't steal from you. ■

Our firm can help your company reduce opportunity from the fraud triangle. For more information contact David Kot at 630-545-4518.

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EVA Measures Shareholder Value

There are many ways to measure a company's performance. You can calculate net profit, ROI (return on investment), EBITDA (earnings before interest, taxes, depreciation and amortization) or several other indicators.

For companies with extensive tangible assets, like most manufacturing and distribution companies, one other metric — though not commonly used — might provide a useful gauge. It's called EVA, or economic value added.

No company should rely on a single performance metric, of course. The EVA calculation focuses on shareholder value and whether the company is increasing or decreasing that value — not just

abstractly, but in relation to the real and changing world.

EVA is based upon a company's invested capital and NOPAT (net operating profit after taxes). Then it factors in the opportunity cost of the invested capital. This is determined from the interest rate the company would pay for financing and the average rate of return available to investors in equity markets.

Investors and business owners, if they chose, could easily obtain that average return from diversified and long-term stocks. When they invest instead in a particular manufacturing or distribution company, they naturally expect it to generate returns that exceed the average. A positive EVA tells them it does.

The concept is transparent and easy to explain to managers and employees. If it's promoted well, everyone at the company gains a better understanding of how capital and capital cost fit into the big picture. The company is then better able to allocate resources, align efforts, improve processes and make better decisions — from the shop floor to the management suite.

The EVA calculation itself is fairly easy to perform, and the only information it requires is contained in a company's income statement and balance sheet. ■

Please contact Keith Friedlein at 630-545-4505 if you would like further information on how to perform an EVA calculation.