THE BP PULSE

Distribution and Manufacturing Survey – 2019

Berntson Porter & COMPANY PLLC
Certified Public Accountants & Consultants

CONTENTS

In collaboration with these valued partners:

Archbright WORKPLACE PERFORMANCE EXPERTS
CAMPS CENTER for ADVANCED MANUFACTURING PUGET SOUND
nextLevel
Northwest Trade Adjustment Assistance Center (NWTAAC)
Washington Manufacturing Alert — The Newsletter of the state's most important industry

EXECUTIVE SUMMARY

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INDUSTRIES REPRESENTED

Aerospace

Industrial Manufacturing

Wholesale Distribution

Medical Device Manufacturing

INTRODUCTION

Welcome to 2019 and the third edition of the BP Pulse! We're heading into 2019 with some incredible insights into what manufacturing and distribution companies are facing this year. In our third year of the survey we received quality feedback from all participants. For that I heartily thank you! The data and insights contained in this document are for the benefit of everyone, specifically closely-held, mid-market businesses within the Puget Sound Region. This is your document as much as it is ours.

In this year's BP Pulse we tackle some of the current hot topics, including tax reform and tariffs. The responses from participants, as well as the expert commentary in both of these arenas, is very interesting! We also look at the trends in areas that have been covered in previous years, including workforce and revenue growth. Additionally, we dive into topics whose answers change annually, such as current challenges, opportunities and technology. From the responses I can see that people are excited about the year to come. Most companies are forecasting growth, although the lack of skilled workers and concerns about labor costs continue to be pain points for respondents.

We worked hard to obtain responses directly from manufacturers and distributors. In fact, over 90% of the responses are from manufacturers (67%) and distributors (25%), with over 60% of the responses coming from the top of the company – owners, presidents and C-suite executives. This means we're reaching the right people who can provide appropriate insight into the challenges and opportunities, as well as the risks and rewards that businesses are facing in the current environment.

These companies operate in a diverse range of industries, with aerospace topping the list, followed closely by industrial products and food and beverage. This is representative of activity within the State of Washington, which means that we've reached the right cross-section of participants. Additionally, the majority of respondents have employee headcount between 26 and 50 employees, with revenues ranging from $10-$100 million. Overall, survey responses are representative of the clients that Berntson Porter professionals work with on a daily basis.

I invite you to take the time to dive into this report and meet the team of Berntson Porter professionals. We've also partnered with some of the best experts that we know to provide additional commentary in their areas of expertise. With this collaboration, we're offering an in-depth look into these industries which mean so much to our local economy.

As always, I'm here for you. Let's take some time this year to sit down over coffee or lunch to discuss how Berntson Porter can be of service to you and help your company reach its goals.

Thank you for your contributions and interest in this initiative!

Nicole Wright, CPA
Senior Manager, Assurance Services and Distribution and Manufacturing Practice Group Leader

PROFILE OF PARTICIPANTS

OVER 52% of respondents indicate they are Owner, President or CEO

64% report annual revenues of $5 Million + per year

90% of respondents are distributors and manufacturers

CAMPS INVOLVEMENT

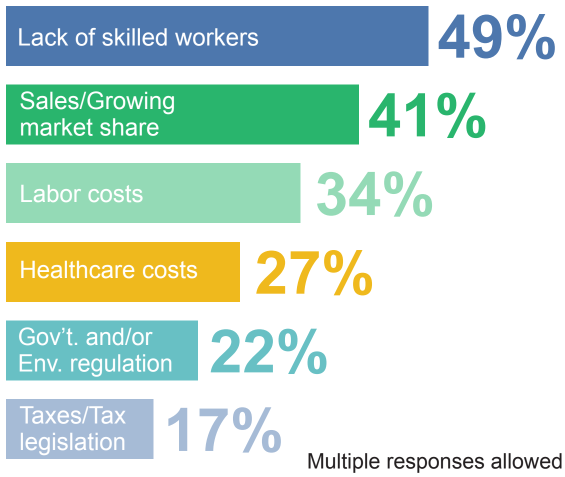
Berntson Porter is honored to continue our partnership with CAMPS (Center for Advanced Manufacturing Puget Sound) to reach a broader audience of manufacturers and distributors in the area. CAMPS is the premier non-profit membership organization in the Puget Sound region that represents small and medium sized manufacturing businesses, supply chain partners, business advisors and strategic partners, all working together to drive innovation and find 21st century workforce solutions.

CHALLENGES AND OPPORTUNITIES

FINDINGS

Nearly one-half (49%) of the survey respondents agreed that a lack of skilled workers is one of their main challenges, which was an increase from 32% in our 2018 survey. Other challenges respondents cited include growing their market share (41%) and increasing labor costs (34%). In our open ended question, responses were overwhelmingly focused on growth opportunities via expanding their space, obtaining government contracts and through technology and innovation. Unsurprisingly, manufacturers see development of labor force and technological advances as having the biggest impact in their industry for the near future.

TOP CHALLENGES YOUR ORGANIZATION IS FACING



BP INSIGHT FROM AUSTIN

With recent tax reform, volatile tariffs, and other changes in the economic environment, manufacturers are increasingly worrying about their workforce. It seems now may be the time to invest in more training for current employees, more apprenticeship offerings for future employees and a focus on employee retention.

Regarding opportunities, technology seems to be growing faster than ever and, perhaps as a way to combat a lack of skilled workers, companies want to dive into AI and other ways to facilitate lean manufacturing. For companies that are investing in research and development activities, we see later in the survey that manufacturers have little knowledge of the R&D credit which can provide a substantial tax break.

WHAT DO THE EXPERTS SAY?

"It will come as no surprise to anyone who monitors manufacturing in this region that workforce issues were decisive winners when survey respondents were asked about the top challenges they're facing now and expect to confront in the years ahead," states **Bill Virgin, Publisher of the Washington Manufacturing Alert**. "No topic has dominated the conversation for so long among manufacturers as has the matter of finding trained or trainable workers.

It's not just the technical skills, or lack thereof, in the available workforce that has manufacturers worried. It's also the "soft skills": showing up for work in a fit mental and physical condition and being able to follow directions. In a tight labor market, the competition for workers with those traits gets ever more expensive.

The problem is only going to get worse. Note that in response to the question of pressing issues for U.S. manufacturers over the next five years, more than a quarter cited the retirement of Baby Boomers. As the silver tsunami of retirements accelerates, manufacturers will see a lot of experience, expertise, money invested in training and institutional knowledge walk out the door. How will that be replaced? Can it be replaced?

It's not an unknown or ignored problem for the industry, but effective answers are tough to come by. One approach is to beef up vocational and technical training, both in high schools and community colleges. That includes revamping the structure of such training, and moving to more flexible programs that are faster to complete, with students building credentials and certificates instead of waiting for a full degree.

But moving the educational bureaucracy takes time and money. Increasingly, manufacturers are realizing that if they want the job done, they'll have to do a lot of it themselves. Thus they're building up their own internal training programs. They're tapping pools of promising candidates such as military veterans. And they're getting involved with schools through internships, tours and presentations to get students thinking about manufacturing careers long before graduation."

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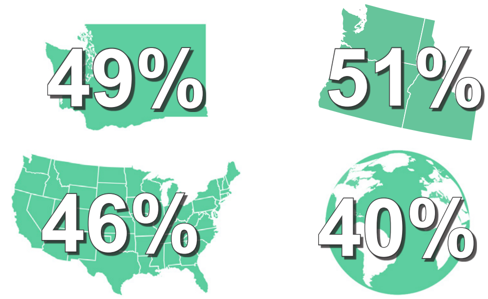
FINDINGS

Foreign trade and competition are grabbing headlines as the Executive Office of the President has focused its attention on creating hurdles for foreign business affairs – deterring many businesses from creating or expanding their foreign operations.

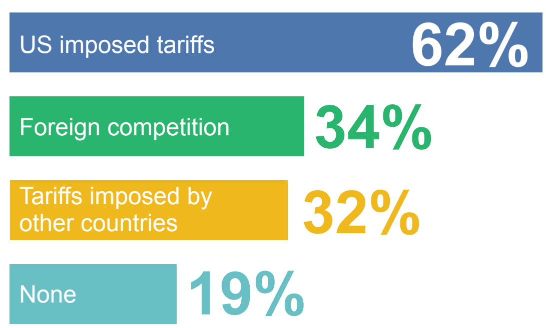
Forty percent (40%) of respondents currently report having international operations. Of those without international operations, over 60% reported they do not plan to expand internationally in the next five years. Among the 40% currently operating internationally, three-quarters (75%) reported their activity as customer shipments only, with the balance citing international facilities, sales representatives, or outsourced operations. This demonstrates that close to 90% of respondents have limited to no international operations. International operations have become increasingly costly and risky as foreign trade policy continues to evolve. Many of the policy changes have taken the form of import tariffs on raw materials that distributors and manufacturers in the Pacific Northwest rely upon.

Over 60% of respondents indicated that US imposed tariffs are affecting their business negatively. The effects are being felt in increased input prices, inability to source input materials, changing suppliers, highly volatile pricing of foreign goods, decreasing margins, and loss of customers due to an increase in pricing to counteract the cost of the tariffs. Respondents are reporting these effects as a tariff on inputs will constrict supply causing an inward shift of the supply curve in a competitive market. This will increase prices and decrease output as suppliers are less willing to produce the same quantities without an increase in price as their costs have increased. Additionally, the market will demand less of the product as the price has increases, likely decreasing the market size. Depending on the price elasticity of the market, the additional cost of inputs could be borne more by the consumers or the suppliers.

CUSTOMER BASE



WHICH OF THE FOLLOWING WILL ADVERSELY IMPACT YOUR BUSINESS IN 2019?



Multiple responses allowed

BP INSIGHT FROM JAKE

While the tariffs have affected manufacturers and distributors of finished goods adversely, respondents have indicated that tariffs have been an overall positive to US manufacturers and distributors of materials. Foreign supply of materials has declined as the cost to supply to US manufacturing firms has increased for foreign material suppliers. This has allowed US based material suppliers to increase their prices due to reduced competition. Overall, this will most likely end up being a net negative as the market cap for finished goods manufacturers and suppliers is greater than the market cap for material manufacturers and suppliers.

Many countries are taking action against the US imposed tariffs by enacting tariffs on US imported goods. Over 30% of respondents are being adversely impacted by tariffs imposed by non-US countries, which may explain why so few in our survey

Continued...

INSIGHT *Continued*

are planning to expand internationally in the next five years. Many countries are responding to the US imposed tariffs with their own tariffs and the cost of doing international business has risen. Many businesses simply do not forecast profitable foreign operations.

Another effect of tariffs is the rise in interest prices. As the tariffs increase prices, inflation will also rise. In order to combat inflation, the Federal Reserve increases interest rates to reduce the amount of cash in circulation. These increases will further affect businesses negatively as their borrowing rates will increase. During 2018, the prime rate as published by the Wall Street Journal increased 0.75%.

Tariffs can create a shock to many businesses that are already operating at competitive prices and set margins. The cost of tariffs can often erode the already thin margins of many businesses and can even cause unavoidable losses in the short-run when businesses are unable to maneuver their capital constraints and pricing practices. Rarely are manufacturers able to pass the cost of the tariff fully onto the customer as the customer may find a comparable, cheaper good – either because they lack income to support the entire price increase, or are simply unwilling to buy the product at the increased price. It is currently a volatile time in the international landscape and manufacturing firms must stay alert to changes in foreign policy and competition to best maneuver their operations and remain profitable in the wake of constantly shifting competition and pricing. Recognizing changes and planning accordingly will be imperative to the success of local manufacturing and distributing firms.

WHAT DO THE EXPERTS SAY?

"Import competition can arrive suddenly and many companies don't see it coming," warns **David Holbert of the Northwest Trade Adjustment Assistance Center (NWTAAC).** "The span of industries and products that are affected is surprising – import impact is not confined to predictable sectors. When faced with a sudden challenge, for example a 50% price disadvantage, the companies that tend to succeed recognize that something must change in their business. They can't win by just trying harder. Often this change entails moving toward customization, more responsive service, verifiable quality, or rapid delivery – all areas in which domestic companies have natural advantages. Such changes are often introduced or facilitated by outside expertise in myriad areas. To demonstrate – between 2005 and 2017 NWTAAC tracked 200 companies averaging $15M in sales. They all had had declines in sales and employment - often steep. They all fought back in the manner described above. Aggregate results for those companies showing an 8.9% per annum sales increase for the several years following the introduction of a plan for change focused on outside expertise. This is a strong endorsement of the idea that with better knowledge, targeting, and tools, domestic companies can overcome the significant challenges of import competition."

WORKFORCE AND REVENUE GROWTH

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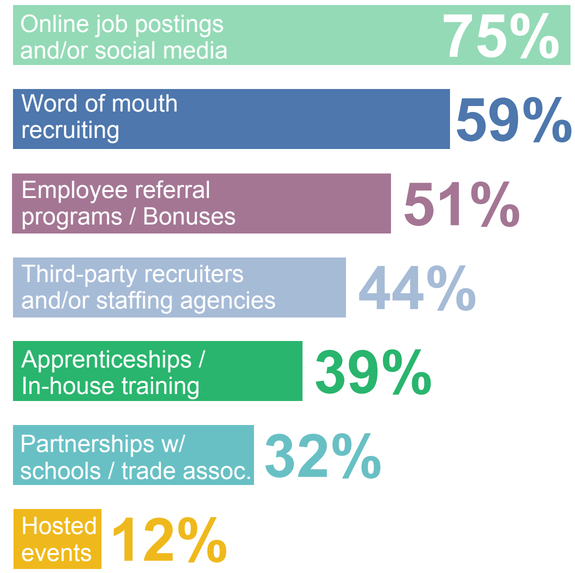
FINDINGS

Over 83% of survey responders expect revenue to grow slightly or significantly over the next year. As a result of company growth, there is a corresponding increase in demand for skilled labor. Nearly 80% of survey responders expect their workforce to grow slightly or significantly in 2019, a 26% increase from the responses last year. While there is high demand for a skilled workforce, as previously noted, over 50% of survey responders indicated that one of the biggest challenges in the industry is the lack of skilled labor.

WORKFORCE GROWTH

WHAT ACTIONS ARE YOU CURRENTLY TAKING TO ATTRACT WORKFORCE TALENT?



Multiple responses allowed

BP INSIGHT FROM KATIE

In order to keep up with increased sales and customer demand, distribution and manufacturing companies will need to re-evaluate their hiring and marketing strategies to attract top talent. Consistent with last year's results, online job listings was the most common method of attracting workforce talent followed by word of mouth recruiting. With the retirement of baby boomers, a new tech-savvy generation is entering the workplace. Social media and online recruiting allows companies to increase their visibility and reach a broader and larger group of people. Although this may increase the volume of interested laborers, it does not guarantee that they will already have relevant skills or experience. In order to get the most out of this recruiting strategy, it would be in the best interest of companies to consider investing in training programs and apprenticeships. Surprisingly, only 40% of responders currently take advantage of apprenticeships or in house training programs. In order to meet the rapidly increasing demand for skilled labor, companies will have to reconsider how they hire and start to develop talent internally.

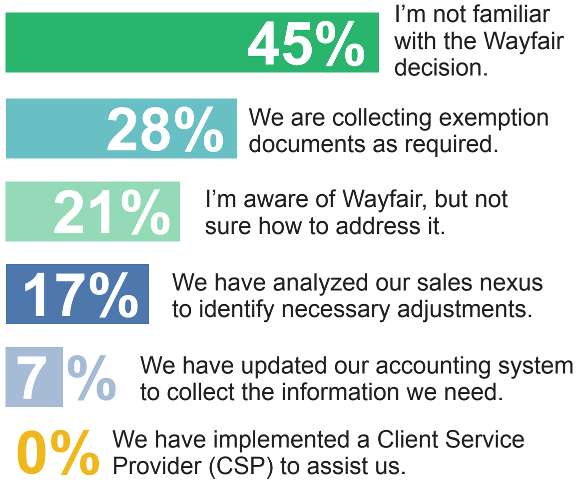
WHAT DO THE EXPERTS SAY?

"The survey confirms that the region's businesses are growing and competing against each in their efforts to enlarge their respective workforces," says **Joseph Marth, PhD., Vice President, Workforce Innovation for Archbright.** "Northwest human resources professionals continue to struggle to source and fill in this very tight labor market. So, we advise organizations to market price key positions to assure that they are competitive in regards to compensation and benefits. Also, don't forget that candidates need to be sold on the intrinsic benefits of working for an organization – its mission, values, culture, and flexibility in working. Recent studies show that flexible working options is a top attractor/detractor for joining or leaving an organization. The bottom line: Organizations must utilize multiple strategies to attract talent in this very competitive labor market. The most effective means for sourcing talent continues to be online postings, social media, word of mouth, and referrals from current employees. LinkedIn is the top social media platform for job seekers."

FINDINGS

When asked how their businesses are responding to the Wayfair decision regarding sales tax nexus, nearly two-thirds of respondents indicated complete lack of awareness (44.8%) or uncertainty about how to address it (20.7%). When the remaining respondents were asked to specify the systems they have in place to address Wayfair, most cited an in-house solution and maintenance, with some indicating they had performed some analysis, but didn't feel like the decision was relevant to their business.

HOW IS YOUR BUSINESS RESPONDING TO THE WAYFAIR DECISION REGARDING SALES TAX NEXUS?



Multiple responses allowed

BP INSIGHT FROM RACHEL

The responses to the questions regarding sales tax nexus changes from the Wayfair decision suggest many companies have not adequately addressed this issue and could be taking unnecessary risks with their business.

With this change, it is easier for states outside a business' home state to require a business to register, collect and remit their sales taxes. While sales tax should be a consumer cost, if a business never collects it they can be on the hook to pay it if audited. These unaddressed liabilities can also reduce the sale price when owners decide to sell their business.

There were two misconceptions we saw in the responses. First, these changes apply to any business making sales to customers outside their home state, including catalog or phone sales; not just online retailers. Secondly, it does impact wholesalers – if your business is not collecting the applicable resale or exemption documentation in the states where you make sales, how will you prove they are exempt from tax?

Interestingly the question relating to what systems businesses have in place to address these changes got the lowest response rate in the survey. There are options available for businesses to comply with the additional registration, collection and filing responsibilities. For businesses that choose to address these in-house, be sure to periodically review the applicable state's sales tax rates and taxability of your products as these do change over time.

WHAT DO THE EXPERTS SAY?

"2018 was a big year for tax policy," says **Krysta Smith, CPA, Tax Senior Manager at Berntson Porter**. "Along with the Wayfair decision, the federal government passed comprehensive tax reform. Changes to the internal revenue code often affect the states as well. Over the course of this past year, states have slowly responded to the changes, including whether or not they will conform to aspects of the new law.

During the next tax filing season, business owners should keep in mind the impact state conformity can have on their bottom line. Poor tax planning can lead to large state addbacks due to non-conformity, resulting in unexpected state income tax bills. A nexus analysis performed by state and local tax professionals can help you make the most out of the new tax law."

WAYFAIR AND STATE CONFORMITY

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REVENUE RECOGNITION FINDINGS

Many distributors and manufacturers in our survey are preparing for the upcoming revenue recognition standard; one-third (33%) reported they are fully prepared and 36% indicated that are somewhat prepared for the standard, which goes into effect this year. This new standard will have an impact on all companies regardless of their business. The goal of this new standard is to eliminate inconsistencies between recognition across industries, remove industry specific guidance and improve financial statement disclosures.

The new standard uses a 5-step model to guide companies to recognize revenue as they fulfill their promises to provide a good or service. The five steps include:

1. Identify the contract – In order to be a contract it must include approval and commitment of parties, identification of the rights, and identification of payment terms, commercial substance and collectability is probable.

2. Identify the performance obligations – A performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. Performance obligations in a contract must be distinct, meaning they can provide benefit on their own and the good or service is separately identifiable from other promises.

3. Determine the transaction price – Transaction price is defined as the amount of consideration to which an entity expects to be entitled to in exchange for transferring promised goods or services to a customer.

4. Allocate the transaction price amongst the performance obligations – The transaction price should be allocated proportionally to the different performance obligations. Determine the selling price using one of the following methods: adjusted market assessment approach, expected cost plus margin, or residual approach.

5. Recognize revenue – Revenue should be recognized when the company satisfies the performance obligations within the contract. This could be at a single point in time or over time.

WHAT DO THE EXPERTS SAY?

"The new revenue standard is going to impact every company differently," comments **Natalia Daniels, CPA, and Assurance Services Manager at Berntson Porter**. "While companies may think that the change will be minimal, they will still need to go through the process to apply the five steps required by the new standard to determine the impact. Application of the new standard will likely result in the same amount of revenue in total, however, timing of when revenue can be recognized may change. Companies that provide bundled goods and services will need to be cognizant of the intricacies of step two and the judgement involved in determining the performance obligations in a contract. Companies that offer warranties, loyalty programs, discounted renewal options, volume discounts or other vouchers or rebates will need to keep in mind that the new guidance will likely require a change to how they are recognizing revenue and that they may need to evaluate their internal processes to be able to better track information related to these goods and services. Even for companies that do not anticipate a significant change after applying the new guidance there will be expanded financial statement disclosures that will require certain financial data that may not be readily available under current software. The new guidance will require significant judgments and could potentially influence internal processes, software, tracking, and how companies are structuring their contracts with customers. The five steps appear simple at first glance but have the potential to have an extensive impact on many facets of a business."

LEASE ACCOUNTING FINDINGS

Within our survey, 27% of participants indicated they were somewhat prepared and 25% indicated they were fully prepared for the new lease accounting standards. Effective in 2020, companies will be required to begin disclosing leases on their balance sheet. The goal of this new standard is to increase transparency by eliminating off-balance sheet leasing transactions.

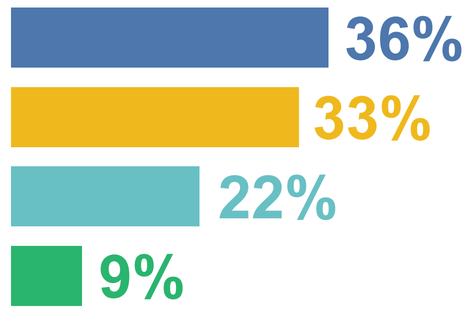
This standard also uses a five-step model to determine if a lease should be capitalized onto the balance sheet.

1. **Identify a lease –** Under the new standard there are three requirements to be considered a lease: an identified asset, such as a piece of equipment or building, the right to control the use of the asset, and the terms for the period of time an identifiable asset may be used must be defined.
2. **Determine lease term –** The lease term is the noncancellable period for which a lessee has the right to use the identified asset. If the lease has an option to extend and it is reasonably certain that the lessee will exercise that option then the period should be included in the lease term.
3. **Determine lease classification –** The lessee must determine if the lease is a finance lease or an operating lease. To be a finance lease it must have one of the following criteria:
   - Ownership of the asset transfers to the lessee at the end of the term
   - Lease includes a purchase option that the lessee is reasonably certain to exercise
   - Present value of the sum of the lease payments equals or exceeds the fair value of the underlying asset.
   - The asset is specialized in nature and it is expected to have no alternative use to the lessor.

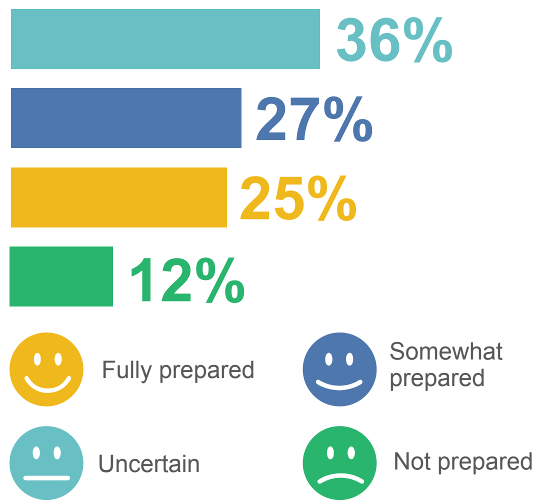
   Leases that don't meet this criteria are classified as operating leases.
4. **Record right-of-use asset and lease liability –** For both types of leases, a lease obligation and right of use asset are recorded on the balance sheet. For finance leases, the lease obligation is amortized over the life of the lease. Operating leases are expensed on a straight-line basis over the lease term.
5. **Subsequent measurement –** A lease should be revaluated when the lease is modified and not accounted for as a separate contract, when a variable lease payment becomes a fixed payment or if there is a change in the lease term.

HOW PREPARED IS YOUR COMPANY TO ADDRESS THE FOLLOWING?

New accounting standards for revenue recognition



Lease accounting changes



WHAT DO THE EXPERTS SAY?

"While implementation isn't until 2020, it's never too early for companies to begin preparing for a wide array of effects from this standard," comments **Connolly McHugh, CPA, MAcc and Assurance Services Senior of Berntson Porter**. "Preparation could include examining leases to determine qualification as finance or operating leases and calculating any asset and liability resulting from such leases. Additionally, companies should adequately disclose all leases now, so financial statement users are not surprised when those leases are added to the balance sheet. The addition of these items to the balance sheet will have an impact on company's financial ratios. Specifically, this update could result in a deterioration of liquidity and leverage ratios, which may affect compliance with bank and other covenants. Companies should consider the impact to existing and future covenants."

TAX REFORM

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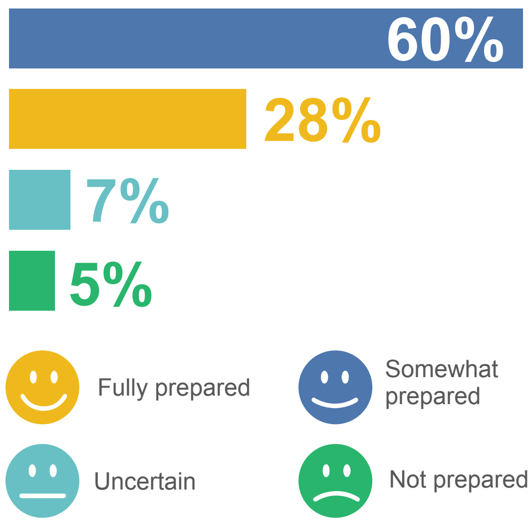
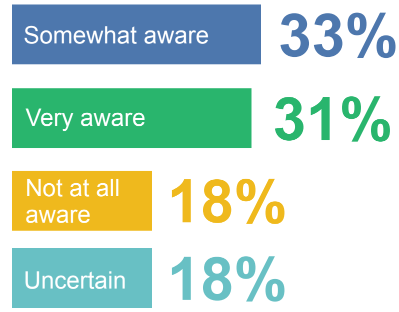
FINDINGS

The majority of respondents, 88%, said they were at least somewhat prepared to address tax reform, with only 7% saying the overall impact will be negative. The biggest benefits of the reform as cited by respondents were C-corp tax reductions, 199A deductions, and depreciation changes, with response rates 26%, 32%, and 26%, respectively. Finally, only 30% of companies said they were very familiar with the Research & Development (R&D) tax credit.

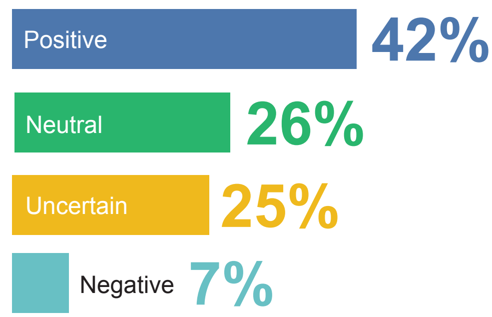
HOW PREPARED IS YOUR COMPANY TO ADDRESS TAX REFORM?



HOW AWARE / FAMILIAR IS YOUR COMPANY WITH THE FEDERAL RESEARCH & DEVELOPMENT (R&D) TAX CREDIT?



OVERALL, DO YOU BELIEVE THE IMPACT OF TAX REFORM WILL BE ________?



BP INSIGHT FROM DAVID

Despite the vast majority of companies saying they were at least somewhat prepared for tax reform, only 28% of companies said they were fully prepared. This, when paired with 25% of respondents that indicated uncertainty on the overall impact of tax reform to their company, indicates companies may need to seek more guidance regarding how to take advantage of new tax laws. While information regarding the largest tax breaks, as stated in the findings above, is more widely available, the lesser-known R&D credit, Opportunity Zones and other changes can be a huge opportunity for your company. As always, if you would like to discuss more about these changes, please contact your tax professionals at Berntson Porter.

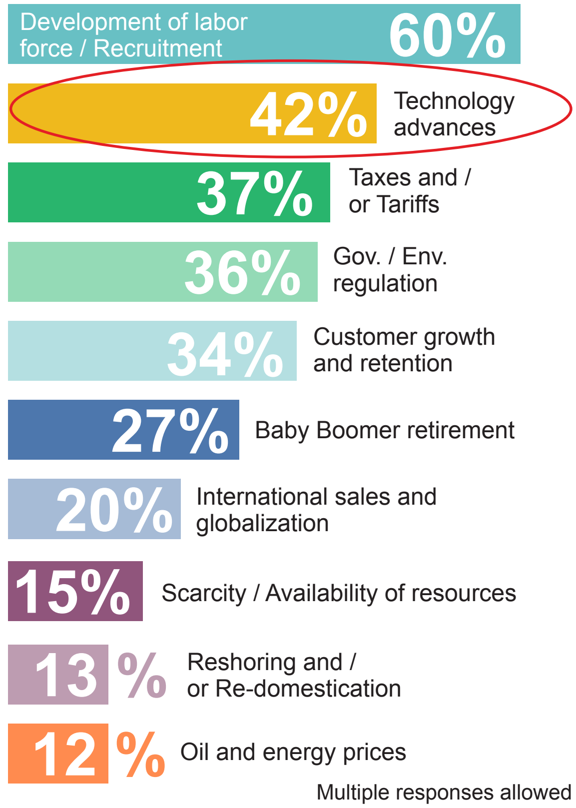
WHAT DO THE EXPERTS SAY?

"With 2018 in the rear view mirror, what started on December 22, 2017 when the Tax Cuts and Jobs Act was passed has forged ahead into a new era where many questions still remain," says **Chris Julien, CPA, Tax Senior Manager at Berntson Porter.** "The biggest change to the tax code since 1986 was created and passed in a matter of weeks and because the law was put together hastily, significant guidance and clarification is still forthcoming and staying on top of the changes is of high priority. Most high income taxpayers should see significant relief, but with a changing landscape, proper planning is needed now more than ever."

FINDINGS

While companies residing in the Pacific Northwest indicated that technology is integral to the distribution and manufacturing industries, over forty percent (42%) of survey respondents have done little to no implementation of new technology in their businesses. The remaining companies responded that they are attempting to or have initiated technology advancements to aid their day-to-day operations. Although many survey participants are not currently incorporating new technology, about 15% of respondents indicated they view technology as one of their biggest opportunities. Additionally, in the next five years about 42% of respondents stated that technology will most impact in the distribution and manufacturing industries.

WHAT WILL MOST IMPACT THE U.S. MANUFACTURING AND DISTRIBUTING INDUSTRIES OVER THE NEXT FIVE YEARS?



BP INSIGHT FROM NATALYA

Technology is one of the most essential components for businesses in distribution and manufacturing. One example of technology used in the workplace is an online platform used in advertising for job openings, relevant for three-quarters (75%) of our respondents who utilize online job postings. Businesses using robots, production lines, and additional automation are improving efficiency throughout their business processes.

Although initially costly, there are many economic benefits to introducing new technology. Benefits can range from reducing labor expense, to expediting production, to improving customer experience. Despite the challenges faced in onboarding new technology, many respondents acknowledged the opportunities it will present in the future.

Two types of technology were most frequently cited by our participants: Internet of Things and Blockchain. In addition to these two types of technology, many respondents stated they are utilizing cloud technology. As technology advances, there will be more opportunities for businesses to use it to help improve their business.

WHAT DO THE EXPERTS SAY?

"Taking into account the number of respondents that skipped this question and those who indicated interest in existing (not new/next generation) technology, I find that the overwhelming majority (~90%) of respondents reported little or no current activities for incorporating new/next generation technology," states **Doug Creeley of NextLevel**, experts in enterprise value consulting. "This indicates that new technologies have not yet demonstrated sufficient value to the manufacturing business leaders who participated in the survey.

Small to Medium Business manufacturing business leaders and owners will wait until such value can be demonstrated. The risk to the SMB business leader is that the opportunity to capture a reasoned return for investment will very likely deteriorate rapidly into a need to implement that same technology to survive. With new technologies maturing rapidly, SMB business leaders would benefit from a specific and reasoned decision to consider new technologies as 'not ready', 'likely ready in 18-24 months', or 'ready now' for favorable change impact to their business. This can be accomplished with a 3-year business initiative planning cycle, and will give the SMB business leader confidence in investing at the right time in a new technology."

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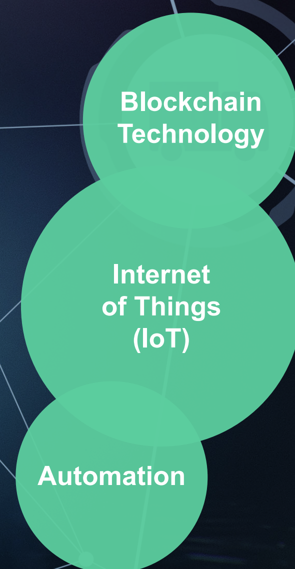

ACKNOWLEDGEMENTS

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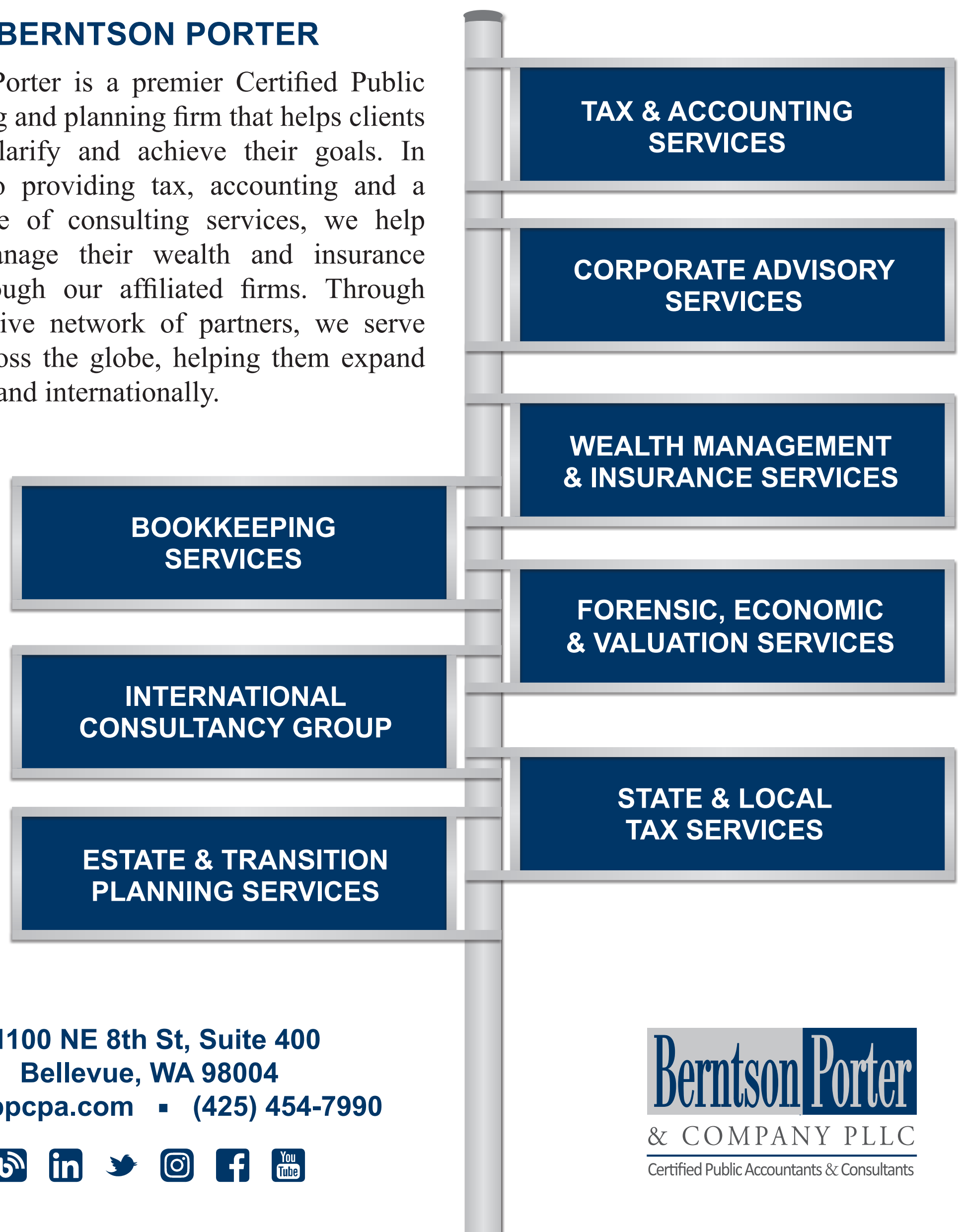

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