2014 BDO MANUFACTURING RISKFACTOR REPORT

RESURGENCE IN MANUFACTURING BRINGS NEW RISKS

The ***2014 BDO Manufacturing RiskFactor Report*** examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. manufacturers across five sectors including fabricated metal, food processing, machinery, plastics and rubbers, and transportation equipment. The factors were analyzed and ranked by order of frequency cited.

At the beginning of Q2, the Commerce Department reported that the manufacturing sector had recovered all the value lost during the recession. There's also good news from the Institute for Supply Management who reported that manufacturing growth accelerated in May and forecasted capital expenditure increases in 2014, including a 10.3 percent increase in manufacturing spending. Moreover, reshoring is on the agenda as many companies look to move production closer to customers and increase speed to market. But with growth on the horizon, manufacturers are shifting focus from securing demand to meeting demand, and new challenges are on the rise.

Chief among them are supply chain, regulation and labor related risks, according to BDO's second annual ***Manufacturing RiskFactor Report***, which analyzes risk factors listed in the most recent 10-K filings of the largest 100 public U.S. manufacturers to determine the top 20 risks impacting the industry.

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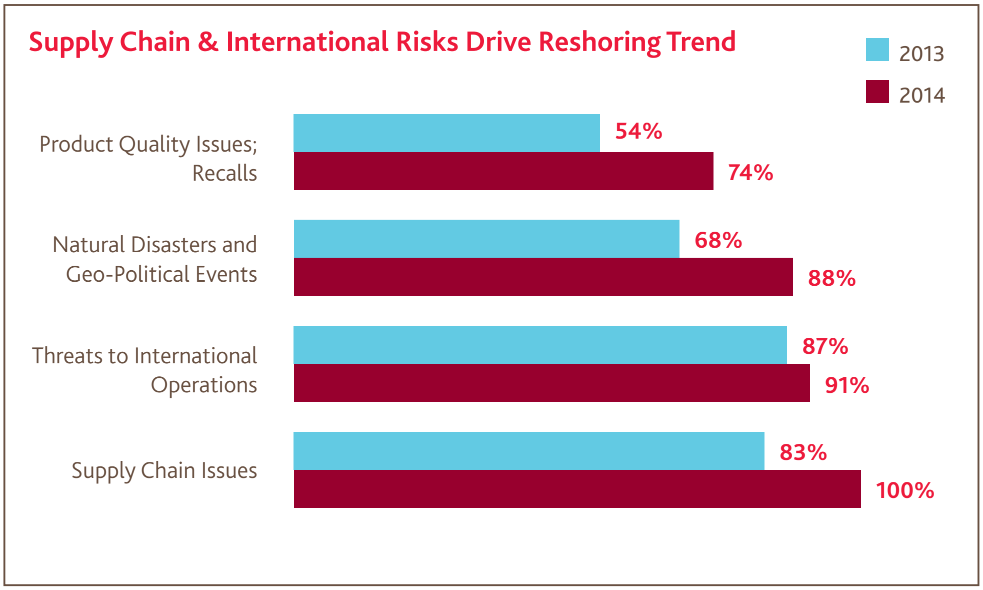
"Growth in the economy and an increase in capital spending is excellent news for the manufacturing industry," said **Howard Sosoff, Manufacturing & Distribution practice leader at BDO USA, LLP**. "But with greater opportunity comes greater challenges. Manufacturers will face intense competition this year as they work to attract new orders and workers and expand their capabilities."

All manufacturers in the study cite concerns related to their supply chain this year, up notably from 83 percent in 2013. Security and efficiency are top priorities as manufacturers work to meet demand. In addition, manufacturers are increasingly concerned about forecasting errors that could lead to costly backlogs or shortages, as well as potential interruptions. As manufacturers' supply chains often have several international touch points, 91 percent cite international operations risks and 88 percent cite concerns over political incidents or natural disasters, which could cause transportation breakdowns, and significant delays.

In addition, a growing number of manufacturers are noting concern over product or component quality issues with vendors. This year, risks related to recalls or product defects are cited by 74 percent of manufacturers, up significantly from 54 percent in 2013. Quality concerns, coupled with significant exposures caused by the global nature of supply chains, continue to fuel a reshoring trend in the industry.



▶RESHORING & U.S. GROWTH HEIGHTEN LABOR ISSUES

In addition to foreign vendor concerns, U.S. economic improvement and the reduction of the wage and cost advantages in China are also leading manufacturers to move operations and add jobs in the United States. According to a June Wall Street Journal article, the number of U.S. factory jobs is up by about 650,000 over the past four years, after declining for decades. These numbers are likely to continue to climb. A Boston Consulting Group survey found that 21 percent of large U.S. manufacturers said they were already returning production to the United States, or planned to do so in the next two years.

As a result, workforce risks are intensifying. This year, 97 percent of manufacturers cite labor issues as a risk, up notably from 2013 (75 percent). The manufacturing workforce is being squeezed on both sides. Growth and reshored operations are fueling more demand for workers, while at the same time, baby boomers are retiring in droves. Although educators and the National Association for Manufacturers are working to demonstrate the opportunity for young professionals, there is still a significant skills gap among perspective workers that is leaving available jobs unfilled.

▶CONFLICT MINERALS & ACCOUNTING STANDARDS DRIVE REGULATORY RISKS.

Manufacturers also report significant challenges when it comes to regulation. OSHA continues to monitor manufacturers closely for any violations of federal safety regulation, while at the same time, manufacturers are facing several new regulations this year. As a result, nearly all (99 percent) cite federal state or local regulations as a risk factor and 87 percent note concern over accounting standards and regulations, up from 66 percent in 2013. Several new rules and regulations are likely contributing to the increase.

Manufacturers point to the SEC requirement to file disclosures about the use of conflict minerals as one key compliance challenge, which could prove costly to their business. The SEC estimated that it would cost all companies up to $4 billion for implementation and up to $609 million annually to comply. An increased focus on internal controls by auditors and regulators is also putting added pressure on manufacturers. In addition, manufacturers have been closely watching the FASB for new guidance on revenue recognition, which was issued on May 28th after over a decade of work. FASB member Mark Siegel told Accounting Today that during the process they heard from automobile manufacturers that they "might look at the customer incentives that they offer a little differently under the new standard than they do today."

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"The most common theme I hear everywhere I go is a workforce shortage," Sosoff told Modern Materials Handling. "The challenge is two-fold. As manufacturing expands and evolves, it's hard to find employees with the right skills. Part two is Baby Boomers retiring. If they can't find skills for expansion, how will they find skills for replacement?"

Adhering to regulations can be extremely costly, particularly for manufacturers. A recent NAM article estimated it can cost $14,000 per year, per employee for regulatory compliance, compared to $8,000 per employee for non-manufacturing businesses.

▶M&A RISKS RISE AMID INCREASED COMPETITION

Growth in the manufacturing industry is also leading to fierce competition for resources, workers and speed to market. As a result, 94 percent of manufacturers cite competition and consolidation as a risk this year. At the same time more manufacturers (89 percent, up from 80 percent in 2013) cite risks related to mergers and acquisitions, a sign that many are looking outside their company to gain access to new technologies, IP, products and distribution channels to improve their market position. Recent deal activity in the food sector among Hillshire Farms, Tyson's Foods, Pinnacle Foods and Pilgrim's Pride is a clear example of this trend. Both Tyson's and Pilgrim's Pride have said that they moved to acquire Hillshire in order to stop them from nearly doubling in size with the purchase of Pinnacle.

There's also growing interest in deal flow among private manufacturers. According to our fifth annual PErspective Private Equity Study, 32 percent of fund managers identified manufacturing as the industry most likely to see the greatest opportunity for new investment in the coming year, up from 25 percent in 2013.

▶IP PROTECTION HEIGHTENS DATA SECURITY RISKS

High profile data breaches have businesses in all industries on edge. According to Verizon, the manufacturing industry accounted for less than one percent of security incidents in 2013, but nearly one-in-four of those incidents involved data loss. While manufacturers store less consumer data than their customers in the retail industry, the protection of intellectual property is crucial, and any loss could threaten manufacturers' ability to compete effectively. As a result, more manufacturers this year are citing concerns over IT systems, data security and IP protection. These risks are of particular concern in the transportation equipment and machinery sectors where data security risks were cited by 90 percent and 95 percent of companies, respectively. Moreover, the protection of intellectual property and rising concerns over security are also likely contributing to the increase in manufacturers citing litigation risks (79 percent, up from 57 percent in 2013).

▶FABRICATED METALS

The top risks in the fabricated metals sector align with the overall sample; there was an 18 percent increase in the number of companies citing supply chain risks and a 43 percent increase in those citing labor risks this year. Supply chain efficiency and accurate forecasting is imperative to fabricated metals manufacturers who operate in a capital intensive business and often have large inventories. Fabricated metals manufacturers are also increasingly concerned over their workforce as they work to comply with OSHA regulations for workplace safety. Fabricated metals manufacturers are also contending with intense competition from importers with access to lower cost raw materials. As a result, 100 percent of fabricated metals companies cite competition as a risk, and 95 percent note concern over raw materials. Still, fabricated metals orders contributed to the growth in durable goods orders in April, as reported by Reuters, which is a positive sign for the economy and manufacturing sector.

SPOTLIGHT ON DREAM IT. DO IT.

Dream It. Do it. (DIDI) is an initiative managed by The Manufacturing Institute, an affiliate of the National Association of Manufacturers (NAM). The goal is to improve workforce challenges and the skills gap in the manufacturing industry through education. Young people and educators often have an outdated perception of manufacturing as a career option, and DIDI is committed to shedding light on the realities of modern manufacturing values and opportunities: innovation, high-tech, high-skilled and central to economic growth and national security. With wage rates on the rise and positions open, manufacturing should be a preferred career path, and DIDI works with local companies to improve awareness, provide referrals and ultimately help fill workforce needs.

Recognizing the importance of growing the future generation of manufacturing leaders and skilled workers, BDO is proud to support this initiative at the national and local level. Rick Schreiber, partner in BDO's Manufacturing & Distribution practice serves on the Board of the Tennessee Chamber of Commerce & Industry who recently partnered with NAM to launch DIDI statewide in Tennessee.

For questions, or to learn more about DIDI, please contact Rick at rschreiber@bdo.com, or visit www.dreamit-doit.com.

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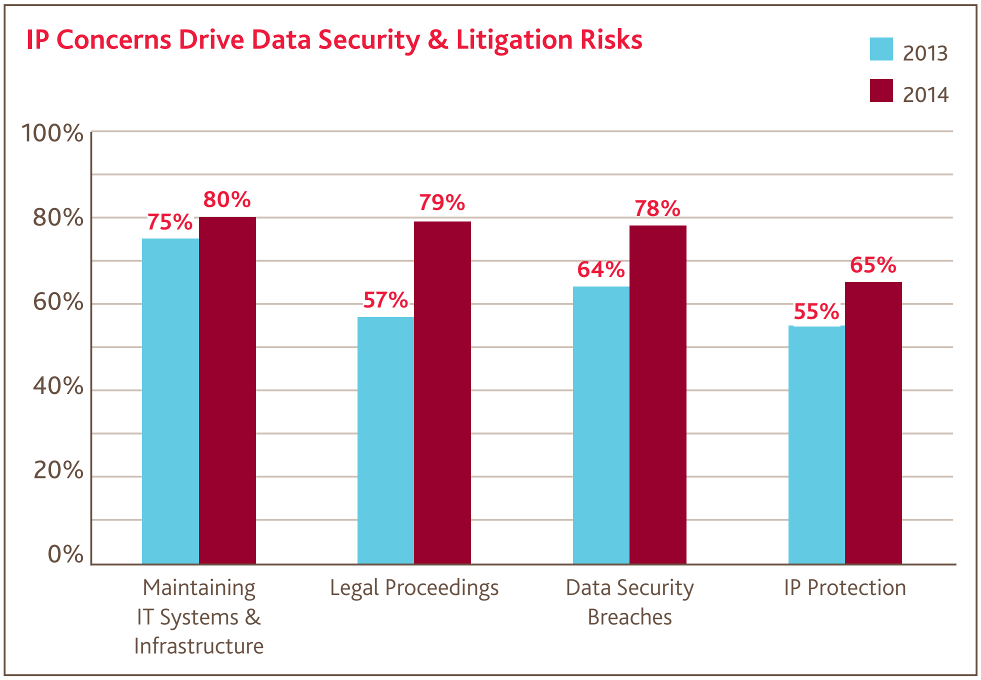
"Mishandling of critical corporate assets by personnel is often the most prevalent data security risk for manufacturers," said **Karen Schuler, Managing Director at BDO Consulting, leading the firm's Forensic Technology Services Practice in Washington, D.C.** "Whether deliberate or unintentional, data leakage caused by employees increases organizations' vulnerability to large-scale security breaches and can facilitate IP theft by external entities. To help protect themselves from these threats, as well as consequent legal proceedings, it's important for manufacturers to pay special attention to employment agreements to ensure that ownership of company data is explicitly stated and that policies are in place to protect IP in the event of a departure."

▶FOOD PROCESSING

Among food manufacturers, five risks tied for the top spot and were cited by all companies studied: supply chain, regulatory, economic, commodity cost and product quality issues. Product quality is paramount for success; in a competitive market with fickle customers, any recall or issue could be detrimental to brand reputation (cited by 85 percent). And given their dependency on the retail industry and consumers, food processors are particularly mindful of the economy (cited by 100 percent) and their dependency on a few major customers (cited by 80 percent) when compared to their peers in other sectors. Food processors are also markedly more concerned about interest rates this year. Eighty percent of the companies studied cite interest rate changes as a concern, up from 40 percent in 2013. This rising concern was echoed in our Retail RiskFactor Report, which found that interest rates were the most cited economic concern among the nation's largest retailers. Companies are likely concerned that slowly improving job market may encourage the Federal Reserve to increase interest rates after five years of historic lows. In addition to the potential impact on consumer spending and sales, changes in interest rates could impact debt financing and pension plan assets.



▶MACHINERY

While the top risks for machinery manufacturers mirror those of the overall study, international is a key focus. International trade is a critical component of the machinery sector, particularly as growth in emerging markets escalates demand. Machinery companies are dependent on favorable international economic conditions and regulations; as a result, 100 percent of companies in this sector note concerns related to international operations, compared to 91 percent of companies overall. Moreover, greater international activities and a competitive market is likely contributing to the increase seen in risks related to compliance with the Foreign Corrupt Practices Act. This year 90 percent of machinery manufacturers cited FCPA risks, up from 65 percent in 2013. Commodity costs are also a rising concern, cited by 95 percent of machinery manufacturers, up from 80 percent in 2013. Prices for raw materials including aluminum, copper and plastics can fluctuate sharply, with steel varying by as much as 30 percent over the course of a year. This fluctuation, coupled with rising international demand, is leading to growth and greater competition in the export market.

▶PLASTIC AND RUBBER

Opportunities abound for plastic and rubber manufacturers. Additive manufacturing, or 3D printing, which is poised to have a major impact on the manufacturing industry, could provide a boost to plastic and rubber manufacturers by decreasing costs and reducing the need for large product inventories since products can be easily made on demand. Moreover, the U.S. shale boom is contributing to lower raw materials costs for plastic manufacturers, and auto sales continue to be positive despite major recalls. Still, supply chain risks are top of mind for companies in the sector, jumping from the fifth most cited risk factor to #1. Moreover, 80 percent of plastic and rubber manufacturers cite concern over product quality issues and recalls, up notably from 45 percent in 2013.

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Labor risks also increased from #19 to #5 this year, as plastic and rubber manufacturers work to improve factory safety and attract workers.

▶TRANSPORTATION EQUIPMENT

The beginning of 2014 has been fairly robust for transportation equipment manufacturers. Durable goods orders have been on the rise, and orders for defense aircrafts and parts have been a major contributor to growth, according to Industry Week. Looking at the key business challenges for the year, top risks in the transportation equipment sector align with the overall findings, with supply chain, regulation and labor risks tying for the #1 spot. However, environmental concerns are also top of mind for transportation equipment manufacturers, a risk cited by 95 percent, compared to 87 percent of the overall findings. Consumers are demanding products that have less of an impact on the environment, while, at the same time, companies are working to comply with environmental regulations to reduce emissions. With emerging markets presenting a major opportunity for growth in the transportation equipment sector, international risks are on the rise: 95 percent cite concerns over international operations and 90 percent cite risks related to international trade restrictions, up from 75 percent in 2013.

2014 Rank	Top 20 Risks for Manufacturers	2014	2013
#1	U.S. and Foreign Supplier/Vendor Concerns and Distribution Disruptions	100%	83%
#2	Federal, State and/or Local Regulations	99%	96%
#3	Labor Concerns; Underfunded Pensions	97%	75%
#4	General Economic Conditions	96%	98%
#4t	Commodity/Raw Material Prices	96%	86%
#6	Competition & Consolidation in Manufacturing	94%	92%
#7	Threats to International Operations	91%	87%
#8	Management of Mergers & Acquisitions	89%	80%
#8t	Access to Capital	89%	78%
#10	Currency/Foreign Exchange Fluctuation	88%	73%
#10t	Natural Disasters, Terrorism and Geo-Political Events	88%	68%
#12	Environmental Laws, Regulations & Liability	87%	86%
#12t	Changes to Accounting Standards and Regulations	87%	66%
#14	Less Demand for Products	86%	91%
#15	Failure to Properly Execute Business Strategy	82%	74%
#16	Maintaining IT Systems & Operational Infrastructure	80%	75%
#17	Legal Proceedings	79%	57%
#18	Ability to Innovate to Meet Changing Customer Needs	78%	69%
#18t	Privacy Concerns Related to Security Breach	78%	64%
#20	Restrictive International Trade Policies	77%	66%

*t indicates a tie in the risk factor ranking

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BDO has been a valued business advisor to manufacturing and distribution companies for more than 100 years. We work with a variety companies from all industrial sectors, ranging from global distributors to startup and niche manufacturing corporations, on a myriad of accounting, consulting, tax and other financial issues.

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