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Are your prices too high, too low or just right?

Manufacturers tend to base product prices on direct production costs. Then they occasionally adjust prices for inflation or when the costs of raw materials or labor rates spike. Here's why this simplified pricing model may compromise market share over the long run — and how market leaders factor *market-based* considerations into their pricing strategies.

Production-based pricing

Direct production costs are a logical starting point for pricing new and existing products. For example, suppose Company A spends $2 in raw materials and $3 in labor to manufacture a widget. The owner adds up these costs ($5) and applies a 10% markup to arrive at the selling price ($5.50) for each widget. The problem is that markups are often based on historic performance or gut instinct.

What happens when competitors sell their widgets for $5.15? This often happens to smaller manufacturers that compete with larger companies that can negotiate lower supply costs or companies located in areas with lower labor rates. Unless Company A can provide a compelling reason for customers to pay a premium, such as superior quality or more responsive customer service, its market share will likely diminish — and overhead costs will eventually consume profits.

> Market research helps management decide how to position the company's offerings relative to those of competitors — and whether future sales volume will be similar to past performance.

Conversely, what if the $5.50 price point is significantly below competitors' prices? Below-market pricing may cause demand to skyrocket — and the factory may not be able to produce enough widgets to keep up with demand. As a result, quality may suffer, or customers may become frustrated by production delays.

When demand outpaces production capacity, cash flow shortages also may occur due to lags in the cash conversion cycle. That is, Company A will need to front production costs (cash *outflows*), but it will take awhile to bill and collect payments from its customers

(cash *inflows*). A slight price increase can help reduce demand and the pressure that's putting on plant workers.

Demand forecasts

Market leaders factor more than direct costs into their pricing strategies. They also conduct market research, which improves the accuracy of their sales forecasts. For example, salespeople can informally survey customers about which features they value most, how the company can improve the customer experience and how much customers would be willing to pay for new products or improvements to existing products. To entice customers to participate in these surveys, consider offering free trials of new products or discounts on future orders.

It's also important to research competitors. Pay attention to the products they offer, the prices they charge and how they position their products in the marketplace. (See "Low cost vs. differentiation strategies" at right.)

Any research aimed at competitors should be ethical, however. For example, you shouldn't hire a competitor's R&D director and solicit proprietary information. But you can legitimately visit a competitor's website and review copies of print marketing materials that are available to the general public.

Market research helps management decide how to position the company's offerings relative to those of competitors — and whether future sales volume will be similar to past performance. Forecasts are often based on historical sales volume. But changes in market conditions, such as the introduction of a new competitor, changes in technology and evolving customer needs, may require adjustments to historical results.

Low cost vs. differentiation strategies

Market positioning affects pricing decisions. Companies that compete on price typically earn a modest gross margin on each unit sold, but they make up for it with high sales volume. Low-cost producers tend to be large and efficient and offer no-frills service.

Not every manufacturer should be a low-cost producer, however. Some customers make purchasing decisions on more than just price. Smaller "boutique" manufacturers may differentiate themselves from the pack by offering superior features and service or offering product customization. Differentiation strategies generally allow companies to charge high margins, but they compromise market share.

To complicate matters, some manufacturers select one base product to serve as the "hook." This base product is priced below similar products in the marketplace. Once the customer has invested in the base unit, the manufacturer charges premium prices for its complementary products, parts and accessories, and postsale service.

Overhead cost allocations

Overhead costs also need to be forecast and allocated to products to help make better informed pricing decisions. As with sales, future overhead costs may not mirror what's been paid in the past.

Materials and labor costs are just a few of the expenses manufacturers incur. Overhead items may be variable (such as sales commissions, packaging and shipping costs) or fixed (such as depreciation on equipment, managerial salaries and rent). As a company grows, it may need a larger factory or additional salespeople, leading to incremental fixed costs.

Need help?

Accurate forecasts of sales and overhead costs can be used to calculate a markup that's based on more than guesswork, leading to more methodical and responsive pricing decisions. Your CPA can help implement pricing models based on market research and comprehensive costs — and teach you how to monitor prices going forward. ■

What are the limits on fringe benefits for pass-through entity owners?

S corporations, partnerships and limited liability companies (LLCs) that are treated as partnerships for tax purposes qualify for "pass-through" taxation. In other words, these businesses aren't subject to entity-level tax; instead, income, gains and losses pass through to the owners' individual tax returns. This tax treatment generally offers an advantage over businesses operated as C corporations.

But there's a catch: The tax rules for fringe benefits provided to owners of pass-through entities are generally unfavorable compared to the rules for C corporation shareholder-employees.

Tax treatment of common fringe benefits

Most fringe benefits provided to regular employees are "tax-favored." That is, they're tax-free to the recipient and deductible by the employer. Examples of tax-favored benefits for the 2017 tax year include:

- Health insurance coverage,
- Contributions to Health Savings Accounts (HSAs),
- Disability insurance coverage,
- Up to $50,000 of group term life insurance coverage,
- Qualified moving expense reimbursements,
- Qualified adoption assistance programs, and
- Qualified transportation fringe benefits (such as public transit passes, van-pooling and parking allowances).

Unfortunately, none of these fringe benefits are tax-favored when they're provided for S corporation shareholder-employees who own more than 2% of the company's stock, partners, or LLC members treated as partners for tax purposes. For these individuals, these fringe benefits are *taxable*. For S corporation owner-employees, the value (normally the cost) of the fringe benefit is added to the owner's *wages*.

However, S corporation shareholder-employees who own more than 2% of the company's stock, partners, and LLC members treated as partners for tax purposes can generally deduct health insurance premiums paid by the pass-through entity and HSA contributions made by the pass-through entity on their personal returns.

Universally tax-favored fringe benefits

Some fringe benefits are tax-favored for the 2017 tax year, regardless of whether they're provided for regular employees or for S corporation shareholder-employees who own more than 2% of the company's stock, partners, or LLC members treated as partners for tax purposes. That means the pass-through entity can deduct the cost of providing the benefits, and the recipients don't owe federal income tax on the benefits, assuming the basic qualification rules for tax-favored treatment are met. For 2017, these universally tax-favored fringe benefits include:

Qualified educational assistance. Up to $5,250 annually of qualified educational assistance can generally be provided tax-free to employees and pass-through entity owners. However, tax-favored treatment isn't allowed if more than 5% of benefits are provided to owners (including their spouses and dependents) who own more than 5%.

Qualified dependent care assistance. Up to $5,000 annually of qualified dependent care assistance can

generally be provided tax-free to employees and pass-through entity owners. However, tax-favored treatment isn't allowed if more than 25% of benefits are provided to owners (including their spouses and dependents) who own more than 5%.

Working condition fringe benefits. Examples include reimbursements for job-related education and cell phones given out primarily for noncompensatory business reasons.

De minimis fringe benefits. These benefits are so small that accounting for them would be unreasonable or impractical. A common example is occasional meal reimbursements when working outside normal business hours.

Fringe benefits that aren't listed in this article — such as free airfare for a personal vacation or season tickets to sporting events — are generally taxable whether provided to an employee or an owner of a pass-through entity. The pass-through entity can generally deduct the cost.

Moving target

When your business is set up as a pass-through entity, the tax code limits tax-favored fringe benefits for owners. The rules are complicated — and they could change for tax years starting in 2018 under congressional tax reform efforts. Your tax advisor is atop the latest developments and can help you navigate the rules. ■

Smart factories and blockchain: How to stay on the cutting edge of technology

Most manufacturers have already applied classic business management concepts, such as just-in-time production and continuous improvement initiatives, to enhance cash flow and efficiency. But those efforts might not be enough to stay competitive in a technology-driven marketplace. Here's how smart factories and blockchain technologies are expected to revolutionize the manufacturing industry in the 21st century.

Creating "smarter" factories

The Manufacturing Leadership Council (MLC) has identified several important issues facing manufacturers over the next year. Smart factories are a pivotal part of the MLC's agenda in a data-driven future.

The MLC envisions that factories of the future will embrace the potential of new and evolving production models, materials and technologies. This requires digitization — from start to finish — of procurement, production and engineering processes. As a result, smart factories will be more cost efficient, responsive, automated and sustainable than factories today. In addition, management will be able to analyze the manufacturing process using real-time, cross-functional data, enabling management to adapt quickly and seize new business opportunities.

For example, a smart warehouse might be equipped with sensors that automatically detect when materials, parts and accessories are at the reorder point.

Then the system would send an alert to the procurement department to order more materials — or it would communicate directly with a supplier about reordering the item. If the company owns more than one warehouse, the system might also identify other warehouses that have the items in stock.

Defining "blockchain"

On the other hand, blockchain is most commonly associated with Bitcoin transactions. But its potential uses extend far beyond digital currencies. Blockchain is essentially a distributed ledger that's shared among thousands, or even millions, of computers (or "nodes") rather than being housed on one central server.

Blockchain provides safeguards against errors, fraud or tampering, which helps to engender trust with supply chain partners. The technology is encrypted and requires digital signatures to protect participants' identities. Moreover, it's not controlled by any single party.

Widespread implementation of blockchain is several years away. In the meantime, it's important for manufacturers to learn about the technology and brainstorm ways it can simplify and add value to supply chain transactions. Over the long run, blockchain may eliminate the need for third-party payment processors.

Taking the plunge

Technological change is a moving target that will require ongoing financial investment. Before upgrading your processes and systems to take advantage of emerging smart-factory or blockchain technology, it's important to crunch the numbers and evaluate your options. Your CPA can help address the financial side of the equation. ■

Understanding "nexus"

Know the risks and rewards of operating across state lines

Estimating state-level taxes is generally easier when you operate in only one state. But manufacturers and distributors that cross state lines may be subject to tax in more than one state. Although this may complicate matters during tax filing season, it also offers opportunities to lower your company's state tax liability, if you know the relevant state tax laws and plan ahead.

The concept of "nexus"

An important question to ask when it comes to facing taxation in another state is: Do we have "nexus"? Essentially, this term indicates a business presence in a given state that's substantial enough to trigger that state's tax rules and obligations.

Precisely what activates nexus in a given state depends on that state's chosen criteria. Common

triggers include employing workers, using a local telephone number, owning property, and marketing products or services in the state. Depending on state tax laws, nexus could also result from installing equipment, performing services, and providing training or warranty work in a state, either with your own workforce or by hiring others to perform the work on your behalf.

A minimal amount of business activity in a given state probably won't create tax liability there. For example, an OEM that makes two tech calls a year across state lines probably wouldn't be taxed in that state.

As with many tax issues, the totality of facts and circumstances will determine whether you have nexus in a state.

Market-based sourcing

If your company licenses intangibles or provides after-market services to customers, you may need to consider "market-based sourcing" in order to determine state tax liabilities. Not all states have adopted market-based sourcing, and states that have adopted this model may have subtly different rules.

Here's how it generally works: If the benefits of a service occur and will be used in another state, that state will tax the revenue gained from said service. "Service revenue" generally is defined as revenue from intangible assets — not the sales of tangible personal property. Thus, in market-based sourcing states, the destination of a service is the relevant taxation factor rather than the state in which the income-producing activity is performed (also known as the "cost of performance" method).

Essentially, these states are looking to claim a percentage of any service revenue arising from residents (customers) within their borders. But there's a trade-off: Market-based sourcing states sacrifice some in-state tax revenue because of lower apportionment figures. (Apportionment is a formula-based approach to allocating companies'

taxable revenue.) But these states feel that, even with the loss of some in-state tax revenue, they'll see a net gain as their pool of taxable sales increases.

Strategic moves

If your company is considering operating in another state, you'll need to consider more than logistics and market viability. A nexus study can provide insight into potential out-of-state taxes to which your business activities may expose you. Once all applicable income, sales and use, franchise and property taxes are factored into your analysis, the effect on profits could be significant.

Bear in mind that the results of a nexus study may not be negative. If you operate primarily in a state with higher taxes, you may find that your company's overall tax liability is lower in a neighboring state. In such cases, it may be advantageous to create nexus in that state by, say, setting up a small office there. If all goes well, you may be able to allocate some income to that state and lower your tax bill.

Naturally, if your company licenses intangibles or performs after-market services for customers, you'll also need to identify whether the state in question uses market-based sourcing. Your tax advisor can help you understand state tax issues and provide a clearer picture of the potential tax impact of crossing state lines. ■

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We Know Manufacturing

With increasing regulations, technological changes and heightened competition, manufacturing companies are faced with a myriad of challenges in getting their products to clients in a fast and cost-effective manner. Staying abreast of the constantly changing rules in the industry makes it difficult to remain profitable. The Hoffman Group is experienced in helping manufacturers develop profit enhancing solutions to improve the bottom line and anticipate marketplace changes. We become a part of your management team to help develop and implement strategic decisions.

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