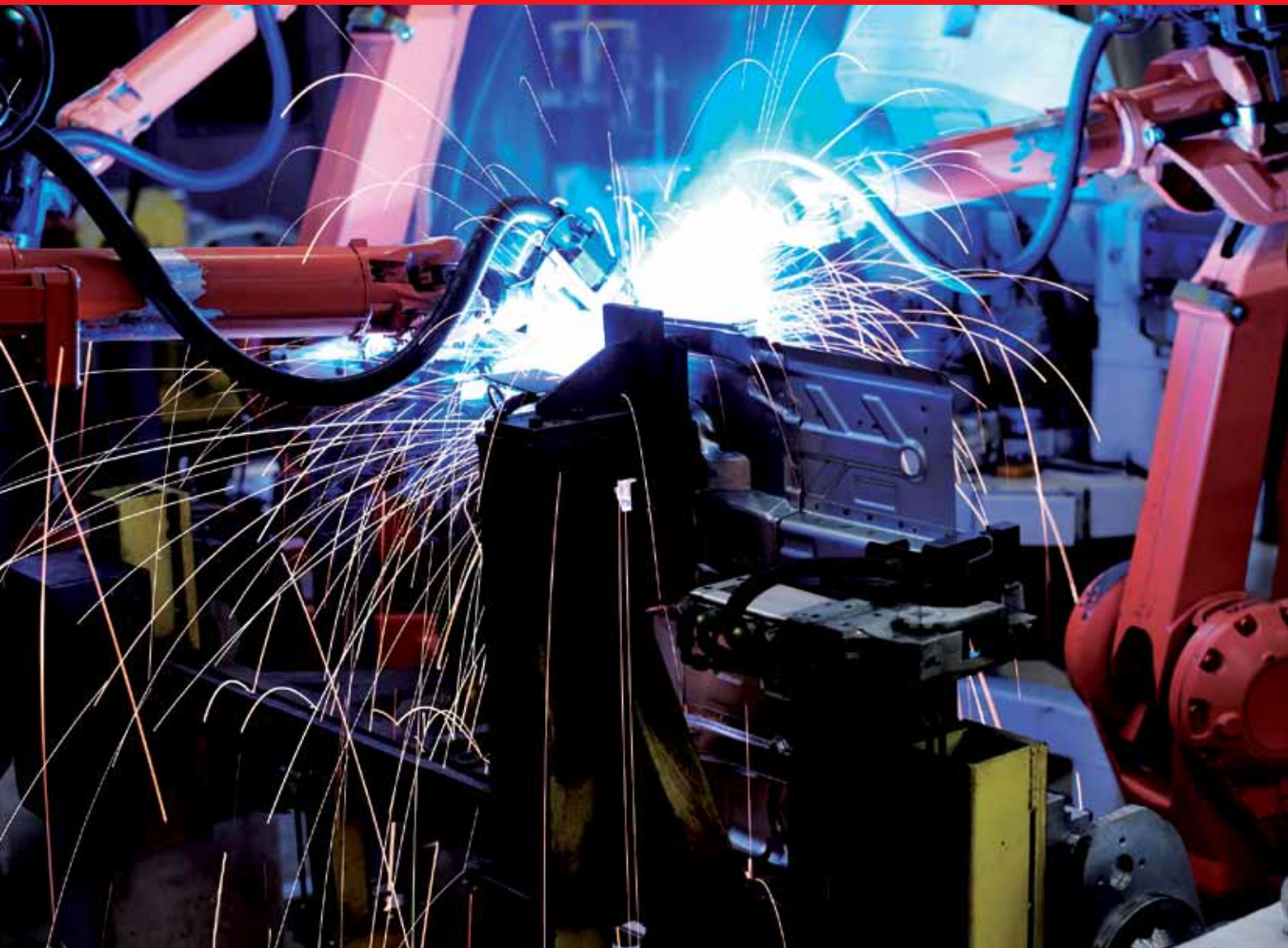




AUDIT &  
ASSURANCE  
FACULTY

# AUDIT INSIGHTS MANUFACTURING



BUSINESS WITH CONFIDENCE

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## ABOUT THE AUDIT AND ASSURANCE FACULTY

The ICAEW Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance. *Audit Insights* is one of several initiatives from the faculty.

Through *Audit Futures*, the faculty is asking big questions about the future of the external audit profession. It convenes stakeholders who normally do not talk to one another and aims to create opportunities for dialogue and for collaborative and creative solutions to emerge. In partnership with the Finance Innovation Lab, we are building a movement for wider behavioural change and we are developing innovation projects for systemic effect.

Through the *re:Assurance* initiative, the faculty is finding out where assurance services over business information, such as key performance indicators, could strengthen markets and enhance confidence and also asking how the International Framework for Assurance Engagements can be applied and developed. The faculty answers demands for practical guidance with publications such as *The Assurance Sourcebook*.

The faculty also hosts the *Audit Quality Forum* (AQF) to bring together external auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in external audit. The AQF is now developing a broader theme; that audit quality should be judged by how reliable the audited financial statements are. This broader theme recognises the commitment that all stakeholders, not just auditors, have to support the statement that 'audited financial statements should be reliable'.

For more information on the Audit and Assurance Faculty, the current work programmes and how to get involved, please visit [icaew.com/audit](http://icaew.com/audit). To learn more about *Audit Insights* please contact Henry Irving at [Henry.Irving@icaew.com](mailto:Henry.Irving@icaew.com), or on +44 (0)20 7920 8450.

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**AUDIT INSIGHTS**  
**MANUFACTURING**

# FOREWORD

Audit is a public interest activity. Reports from external auditors build confidence in financial statements and give credibility to companies and comfort to their stakeholders. External auditors see many issues during their work in auditing the financial statements of a company including issues related to its assets, people and markets.

*Audit Insights* is an opportunity for external auditors to bring some of their knowledge of a market sector to the public, capturing more of the audit value for the public benefit. Shared insights and observations have been brought together, in an environment that protects client confidentiality, to produce this document.

*Audit Insights: Manufacturing* is the work of a group of external audit experts from large and medium-sized audit firms with many years' combined experience of auditing companies in the manufacturing sector. Representatives of the following firms formed the working group of external audit experts: Baker Tilly, BDO, Crowe Clark Whitehill, Deloitte, Ernst & Young, Grant Thornton, Kingston Smith, KPMG, Mazars and PricewaterhouseCoopers.

We hope that this document is of interest to a wide audience, particularly those involved with the management of companies in the manufacturing sector. We also hope that it will help other readers understand how challenging it is to be successful in the manufacturing sector.

The Office of National Statistics (ONS) reports that, as at March 2013, there were 2.6m people employed in the manufacturing sector representing some 8.1% of the UK workforce. This is the same percentage as in March 2011 when some 5.1% were employed in low-tech manufacturing such as food and beverages, and metal and plastic products. The other 3% was employed in medium to high-tech sectors including precision instruments and machines, automotive, aerospace and electrical equipment.

The manufacturing sector has higher productivity than some other sectors. The 8.1% of the UK workforce in the manufacturing sector contributed some 10.7% of UK output in 2011.

The ONS also reports that average weekly wages in the manufacturing sector in March 2013 were £545 compared to £466 for the economy as a whole, being some 17% higher.

As of 27 June 2013, the ONS's provisional results for 2012 in respect of UK Manufacturers' Sales by Product highlighted the following:

- The provisional estimate of UK manufacturers' sales for 2012, at current prices, is £342bn (£4.2bn higher than in 2011).
- The value of UK manufacturers' sales in 2012 was 3.2% (£10.5bn) above the level seen in 2008, at the start of the recession.
- Of the top 10 products by sales value, six related to the motor vehicle and aircraft industries, while three were from the drinks industries (water, beer, and whisky).
- The largest sales in manufactured products in 2012 were from: food (£62.2bn); motor vehicles, trailers and semi-trailers (£39.2bn); and machinery and equipment (£26.1bn).

# EXECUTIVE SUMMARY: FOUR FLAGS FOR THE MANUFACTURING SECTOR

**The manufacturing sector is back in fashion and is seen by Government as playing a vital role in rebalancing the economy in the wake of the financial crisis.** The sector is a broad church covering a wide range of industries with companies of all sizes from large multinational groups to owner-managed businesses. It is also very important to the UK economy both nationally and at regional level, not least because it plays a significant role in generating employment.

This document highlights four areas that external auditors, who specialise in the manufacturing sector, believe will be of interest to companies, investors, policy-makers, and other stakeholders.



## FLAG 1: MANUFACTURING: A ROLLER-COASTER SECTOR

Successful manufacturing businesses need to take risks and hold their nerve in good and bad times. For many manufacturing businesses it can often seem like riding a perpetual roller coaster as they face the following challenges:

- competition and keeping pace with the changing demands of international markets through innovation and research to maintain the business's competitive edge;
- productivity driven by the need for highly efficient manufacturing processes;
- managing their supply chains for production materials and energy by continually testing their understanding of the complexities of the supply chain and whether their contingency plans are adequate and up to date to deal with problems that can suddenly arise;
- issues related to access to finance and the large amounts of capital investment required in plant and equipment particularly, as the fast pace of technological change can easily result in high-tech, expensive machines soon becoming obsolete;
- having the right people with the right business and manufacturing skills to produce up-to-date products; and
- developing good, reliable management information and IT systems that are fit for purpose and match the requirements of the company.

In this context it is particularly unfair and unhelpful for commentators to categorise large numbers of manufacturing companies as 'zombie companies', especially as the economy comes out of recession, which will lead to prejudicial and demoralising behaviour and wasted opportunities.

# EXECUTIVE SUMMARY: FOUR FLAGS FOR THE MANUFACTURING SECTOR



## FLAG 2: FUNDING FOR GROWTH

The difference between manufacturing and other sectors is that the amounts of money involved are often much greater. It needs a great deal of faith, commitment and good communication from management and providers of finance to ride out the less good times in the economic cycle by constantly thinking ahead on liquidity, solvency and financial control. For smaller companies issues around finance are very often their top priority especially as finance has become more difficult to obtain. When it is available it is often at higher margins and with tighter covenants. To reduce dependence on financing options such as leasing, awareness of the range of funds and grants that are available from the UK Government and EU sources is essential. Government should also continue to provide tax incentives as a lever to help manufacturing companies invest and create employment.



## FLAG 3: ATTRACTING, RETAINING AND REWARDING PEOPLE

Manufacturing businesses must to be driven by people who, collectively, have business as well as manufacturing skills. In some smaller companies finding the right combination of these skills can be a challenge; as is succession planning to ensure that knowledge and skills are passed on as experienced people retire. Countries such as Germany often place great importance on skills so the UK really needs more training and apprenticeships to attract younger people into high-value manufacturing. Non-degree entry routes should be promoted further with hands-on training, technical qualifications and growth in the number of apprenticeships where young people with practical aptitude are encouraged to develop

skills. It is essential that manufacturing companies engage with schools and universities proactively to inspire the next generation to consider a career in manufacturing.



## FLAG 4: MANAGEMENT INFORMATION AND IT SYSTEMS

New IT systems that have not been properly designed or implemented cause potentially costly problems and disruption for production as well as for the accounting, billing and costing systems. Costing of discrete products and long-term contracts is key to success in the manufacturing sector and clarity on actual and projected costs is needed to avoid incorrect pricing. On larger and long-term contracts, where there can be huge uncertainty and risks, companies really do need to ensure they know what the extras are, split between those that the company can, and cannot, subsequently invoice. In some small to medium-sized enterprises (SMEs), the tracking or recording of costs is often not particularly sophisticated possibly caused by old IT systems which have been expanded by bolting on sub-systems. On the other hand, some companies wastefully invest in new systems that are more sophisticated and complex than necessary to do the job efficiently with the result that they only use a small percentage of the system.

# MANUFACTURING IS BACK IN FASHION

**An economy with relatively limited natural resources in terms of minerals and energy has to add value to sustain long-term growth.** The Government's desire to rebalance the economy and grow exports in the wake of the financial crisis has prompted it to champion a 'march of the makers'.

The manufacturing sector is very important to the UK economy and its economic well-being both nationally and regionally. It plays a significant role in employment, not only directly in manufacturing businesses as noted in the Foreword, but also in generating jobs in other sectors.

The ICAEW Grant Thornton Business Confidence Monitor, based on extensive soundings from ICAEW members in the three months to the end of April 2013, reveals that although in recent years the manufacturing sector has struggled, the good news is that there is a recovery of confidence albeit one that is fragile.

**As markets in Europe are generally not growing, UK manufacturing companies need to grow in other parts of the world.** Government needs to continue to help them by, for example, promoting sources of advice on setting up a presence in high-growth countries and on growing in emerging markets. SMEs in particular may not only face financial barriers to entering foreign markets; they can also have a knowledge and confidence shortfall.

The manufacturing sector is a broad church. It contains companies of all sizes from large multinational groups to owner-managed businesses (OMBs) and covers a wide range of industries. It is increasingly providing a good number of entrepreneurial and other success stories. While the recent success of car manufacturing is one example, there is an ongoing need to:

- reverse the trend of poor levels of investment that persisted for many years;
- keep increasing productivity and driving efficiencies;
- attract and retain skilled people; and
- innovate to meet customer demands and export more.

For production industries, primarily manufacturing companies, the Business Confidence Monitor noted that respondents believe that, compared to a year ago, issues that are most likely to be seen as a greater challenge today include customer demand, regulatory requirements and market competition. The availability of management and other skills was also noted by respondents as a greater challenge for a larger share of production businesses than for UK business as a whole.

**The manufacturing sector is once again seen as having a key strategic role to play in the future of the UK economy.** To succeed in this it needs sustained interest from Government and broad commitment from across the community and the financial sector. Manufacturing might be back in fashion but it should not be seen as a short-term fad.



# FLAG 1: MANUFACTURING A ROLLER-COASTER SECTOR

**In any sector, successful businesses need to take risks and hold their nerve in good and bad times.**

Yet for UK manufacturing businesses in particular, be they large listed groups or small OMBs, it can often seem like they are riding a perpetual roller coaster with constant surprises as to what will happen next. Just as you think your efforts are being rewarded, things are going well and you have built up momentum, a new set of challenges suddenly appear. Challenges arise from the variability and nature of the many risks that manufacturing companies face such as in innovation, change, research, finance, people and competition. The importance of holding your nerve in this sector cannot be overemphasised.

**Businesses need the flexibility to adapt to circumstances, but above all the nerve to stick to the course through the ups and downs of the business cycle, especially as there is a need for continuous investment. Running a successful company in the manufacturing sector involves:**

- accepting the sheer competitiveness of the sector and the ongoing need for innovation;
- understanding and managing supply chains;
- managing issues related to access to finance and the large amounts of capital investment required in plant and equipment;
- having the right people with the right skills; and
- developing good, reliable management information and IT systems that are fit for purpose and match the requirements of the company.

**Competitiveness is a fundamental issue. Providing competitively priced, quality products to new and existing customers in markets around the globe is a key to the survival and growth of companies in this sector.** As UK companies face strong competition from each other and from overseas, it is vitally important to innovate continually and develop existing products and manufacturing processes, as well as to invest in assets and skilled people, in order to keep pace with the changing demands of the international markets.

Innovation can mean many things: new products, new processes, new countries and markets in which to do business, even a new business model. A lack of innovation in manufacturing processes can adversely impact efficiency, quality, effectiveness and competitiveness as well as having the potential for reputational risk. For example, the use of robotics in the manufacturing process is often quoted as an area where the UK has fallen behind other major European economies.

The pace of technological change can be extremely fast. Ongoing research and development are vital, especially investment in new machinery and skilled people to keep the business's competitive edge. Many UK manufacturing companies now use expensive, high-tech machines that can soon easily become obsolete as new versions of the machine are produced. Leading edge companies try to use up-to-date machinery to help them compete effectively and ensure that manufacturing processes are as efficient as possible. This could be the difference between making profits or losses and between survival or failure.

**Based in a country with relatively limited supplies of the minerals and other natural resources used in manufacturing processes, the supply chains of UK companies can be geographically stretched and also involve foreign currency risk.**

While large companies may have specialist treasury departments, smaller companies can often have difficulties coping with foreign exchange problems.

Companies need to manage all these issues to help ensure a reasonable degree of certainty about the cost of inputs to the manufacturing processes, particularly metals and rare minerals. They also need the logistics to ensure that raw materials and other inputs can get into the UK from suppliers based in riskier countries. For the manufacturing process itself, the company also needs security of energy supplies at a reasonable cost.

Companies thus need to be very careful when managing their supply chains; continually asking themselves whether they really understand their complexities and whether their contingency plans are adequate and up to date to deal with problems. For example, companies can suddenly be exposed to risks arising from their main suppliers as was the case following the recent horsemeat scandal.





In some instances it may be good to partner with organisations in the chain to ensure continued supplies. However, there is a need to understand carefully any partners' needs and risks.

**Overall, despite the risks and challenges and the potentially large sums of money involved, manufacturing is a fascinating and rewarding business to be involved with and a good image of the sector is essential for its growth.** It needs to be understood by stakeholders that manufacturing businesses go through economic cycles with different phases and, for large companies different parts of the business may be in different phases of different cycles.

In this context it is particularly unfair and unhelpful for commentators to categorise large numbers of manufacturing companies as 'zombie companies'. Articles in the press in the last couple of years have suggested that there are a lot of zombie companies

that are treading water, unable to generate cash or attract capital. While they are covering the interest payments on their debts, they are not achieving much more. An alternative and less short-termist view is that in a highly-competitive world and in a low-demand economy, survival might be quite an achievement and survivors do have a future. They may be full of ideas and investment potential.

Branding some manufacturing companies as zombies, especially as the economy comes out of recession, will lead to prejudicial and demoralising behaviour and wasted opportunities. It does not help them secure funding for growth, it discourages turnaround activity and investment and it makes it more difficult to attract good staff. Manufacturing companies, individually and collectively, employ large numbers of people whose skills should not be lost to the UK economy.



# FLAG 2: FUNDING FOR GROWTH

**Manufacturing is like any other dynamic business sector with a basic need for financing and investment for growth.** The difference between manufacturing and other sectors is that the amounts of money involved are often much greater. It also needs a great deal of faith and commitment from boards and management as well as providers of finance to ride out less good times in the economic cycle so that a company can stay on the roller coaster and enable the company and its backers to reap rewards from their investment as well as continuing to provide employment.

Changes in technology, the need for innovation and changes in geographical demand all put pressure on investment decisions and working capital needs. Innovation, research and development, and gearing up for a big project, new product, or further development of an existing product are usually expensive given constant evolution in technology. Adequate funding is essential and while some companies may be able to fund innovation and development from day-to-day working capital, big projects or expansion are likely to require access to new finance for capital investment.

**Access to finance for manufacturing companies often reflects trends in the wider economy, with differences between larger and smaller companies and in different European economies.**

In general terms, unless they have a funding shortage, it is usually far easier for FTSE 350 companies to raise finance than it is for smaller entities. Large companies are currently able to borrow at record low rates. For well-run FTSE 350 companies, some of which appear to have substantial cash reserves waiting for investment opportunities, the problems are often more likely to include how to manage the resources they are holding and best utilise their working capital.

However, for smaller manufacturing companies, especially OMBs, issues around finance are very often their top priority. For some, the position has become noticeably worse as banks appear to have become less willing to provide funding. As finance has become more difficult to obtain, it has

also become more expensive with funds provided at higher margins and with tighter covenants. For example, companies in the £5m to £20m turnover range can find it particularly difficult to raise £0.5m for capital investment in a new or updated production line.

**As a result, smaller companies increasingly look to options such as leasing to provide suitable funds.** As plant and equipment, which is increasingly likely to be hi-tech, will often be expensive, many companies simply have no choice but to enter into finance or operating lease arrangements and will therefore need to spend considerable time sourcing a suitable lessor that is able and willing to deal with them. If finance leases are used, the result can be that the company will become more heavily geared and the directors of OMBs are frequently requested to back their finance agreements with personal guarantees.

Funding for growth can also come from public sources. Some companies appear not to be fully aware of the range of funds that are available from the UK Government and from EU sources, or they are unsure about the criteria for qualification. Local Enterprise Partnerships have noticed that there is difficulty in identifying grants and soft lending incentives available from various agencies, and are actively taking steps to help others improve awareness. It is essential that Government continues to raise awareness of the availability of capital grants to help companies. Such grants could reduce the need for companies to rely on lease finance or invoice discounting to raise money for capital investment.

A point to note for companies that do avail themselves of grants or debt financing is that a poorly worded covenant, be it a bank or other covenant, in the UK or in the EU can lead to misunderstandings and difficulties in signing off on compliance with the covenant. In addition, where EU grant-related covenants are poorly worded, the European Commission can take a very strict view of what the grant is for; with the result that money can be reclaimed.

If UK manufacturing is to prosper, Government should also continue to provide tax incentives as a lever to help manufacturing companies invest and create employment. Examples of such incentives are the Patent Box tax relief and Research and





Development tax credits. In this context, public criticism of companies with low corporation tax bills, but which contribute much to the UK economy and which pay very substantial amounts by way of other types of tax, is unfair and unhelpful.

One major issue that faces boards and management of many companies is reporting ongoing concern. For a significant number of companies, particularly smaller companies, this can be a real issue as banks often insist on an annual, or even a six-monthly, review of facilities rather than committing to any longer period. This makes it difficult to look forward to the required 12 months. Companies need to consider how best to inform providers of finance about roller-coaster issues, such as short lead times and short order books, that impact the sector and which thus make it difficult to project too far into the future.

**Forecasting future cash flows reliably is challenging due to fluctuations in demand experienced by companies in this roller-coaster sector and even larger companies are sometimes only able to look two or three months out.**

This, and covenant breaches, can give providers of finance the opportunity to make short-term decisions in the provider's favour. Disclosure of going concern uncertainties in financial statements, without sufficient emphasis on the positive steps being taken to remedy the situation, can cause immediate adverse responses from banks, business partners, employees, credit rating agencies and also trade indemnity insurers when the financial statements are filed, thereby potentially reducing credit ratings and raising the possibility of a downwards spiral and a self-fulfilling prophecy.

The importance for everyone involved in this sector to hold their nerve, as well as the need for good management information, cannot be overemphasised. Company management need to communicate the nature of the roller coaster they are riding and constantly think ahead on liquidity, solvency and financial control.

# FLAG 3: ATTRACTING, RETAINING AND REWARDING PEOPLE

A major success factor for any business is its people and the quality of their skills. Manufacturing businesses must be driven by people who, collectively, have business as well as manufacturing skills, such as in engineering. While generally in FTSE 350 companies, management skills are not an issue, in some smaller companies finding the right combination of skills can be more of a challenge.

Engineers, for instance, have to be able to understand business and also be able to give their customers what they want. They also need to be able to focus on income and profit streams as well as the quality of the product. For example, with aero engines it is usually the after sales service, with its income stream, where the most profit is made. For all the fantastic engineering that is involved, the production of the engine itself is not enough.

**While the UK has produced many entrepreneurs, such people are often more attracted to the high-tech businesses where they may be more competitively rewarded by the use of share options.** This can be to the detriment of, say, engineering companies of which the success stories may be less well-known. By way of comparison, other countries such as Germany often place greater emphasis on skills in the engineering sector. If the UK is to remain competitive, it really needs more training and apprenticeships to attract younger people into high-value engineering as there can be skill shortages on the shop floor.

As an example, take a high-technology company that produces large electrical equipment. It has to innovate constantly to make its products smaller, more powerful and at the same time more energy efficient. To achieve this innovation requires ongoing investment in high-level engineering skills to meet customer demands. Staff are required to innovate constantly to ensure the products remain at the leading edge of technology in their field. However, the average age of their engineers is the late fifties and, due to a shortage of suitably qualified engineers in their thirties, succession is a significant and challenging issue.

Companies in the manufacturing sector need to attract a range of staff, from highly-experienced, skilled staff to younger employees. Succession planning is thus vitally important to ensure that knowledge and skills are passed on as experienced



people retire. High-calibre, potential candidates with appropriate academic or vocational qualifications may decide that working in manufacturing is not for them due to concerns over the roller-coaster nature of the sector and whether their jobs may be at risk. As a result they may decide to seek alternative careers. These issues affect OMBs just as much as the larger businesses in the sector.

**The manufacturing sector should be presented as a vibrant contributor to UK plc that supports long-term careers and promotes itself as a challenging and exciting sector to work in.** Non-degree entry routes should be promoted further with hands-on training, technical qualifications and growth in the number of apprenticeships where young people with practical aptitude are encouraged to develop manufacturing and engineering skills from an early age. This could help address the skills shortage and local businesses should make direct links with schools. For example, it is essential that motivated individuals from manufacturing companies engage with schools and universities proactively to inspire the next generation to consider a career in manufacturing.

Companies also need to consider helping existing employees who have potential to improve their skills by providing appropriate training, potentially through an apprenticeship route or access to funding for technical qualifications.

# FLAG 4: MANAGEMENT INFORMATION AND IT SYSTEMS

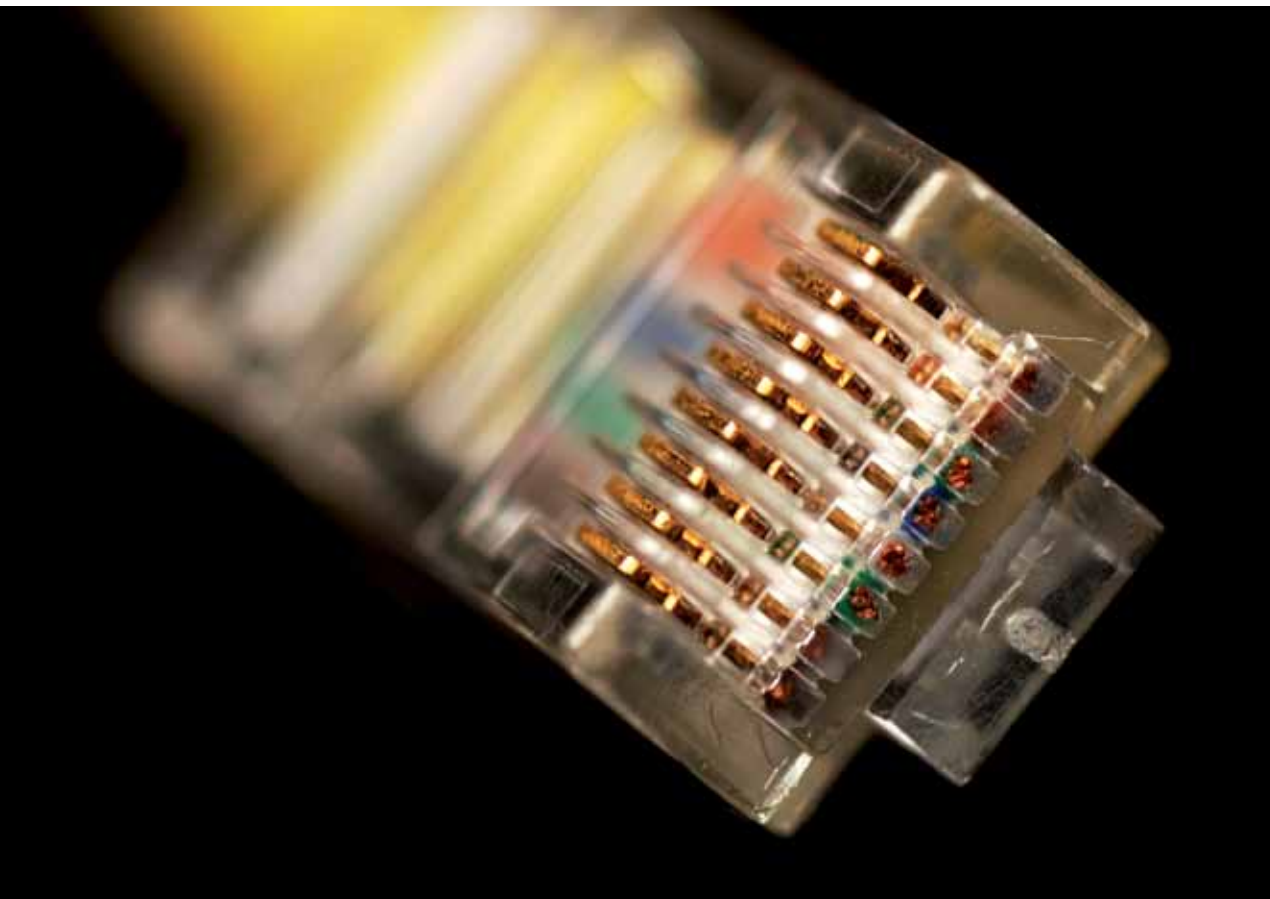
Management information is the lifeblood of any business and essential to decision making. Given the competition, funding and people challenges of the sector, manufacturing companies need good, reliable information and consequently many are installing new IT systems. In the manufacturing sector, information about product and contract costing is an essential component of managing the business.

**Management needs to understand the costing of its products to ensure that the company is making a profit or is taking a fully informed decision to manufacture a product as a loss leader.**

Unique aspects of the manufacturing sector are the challenges around costing of any discrete product and long-term contracts. It will not be possible to know whether a product or contract is profitable, or indeed how to price it, unless there is clarity on actual and projected costs. For new products, particularly innovative products, or long-term bespoke contracts, profitability may be difficult to

achieve if the initial price is set too low or it is a fixed price contract. As products become more reliable, to gain or retain market share, an increasing concern is the issuing of long-term warranties. As there can be no track record for such warranty provisions, management need effective IT systems to know how much these warranties are costing.

Due to the roller-coaster nature of many manufacturing businesses, calculations to track overheads to be absorbed into costings are not easy. Overheads to be absorbed on a specific product manufactured in a period where the business is working at full capacity will be less than when the product is being manufactured during low productivity periods. Even a small change in overhead absorption rate can make a big difference to the cost of products and therefore to gross profit.



# FLAG 4: MANAGEMENT INFORMATION AND IT SYSTEMS CONTINUED

In smaller SMEs, the tracking of actual costs through the production process is often not particularly sophisticated and in some companies may not be properly recorded due to inefficiencies. These can be caused by old IT systems which have been expanded by bolting on sub-systems.

**Equally frustrating are the major problems that can arise with new IT systems.** These can cause potentially costly problems and disruption for production as well as for the accounting, billing and costing systems. For example, some companies, be they large or small, may be tempted to invest wastefully in new systems that are more sophisticated and complex than is really necessary to do the job efficiently with the result that, in some cases, only a small percentage of the new system is actually used or understood. It is essential to get the design phase of IT systems projects right. For example, smaller companies that do not produce a substantial range of products do not necessarily need to acquire complicated IT systems to measure profitability by product.

On the specific issue of larger contracts, companies really do need to ensure they know what the extras to the contract are, split between those that the company can, and cannot, subsequently invoice. Agreement of variations to the original contract need to be clearly documented if costs are to be recovered and risks managed as long-term contracts can bring huge uncertainty. This is particularly the case for 'develop and deliver' contracts because the development phase can be fraught with danger as it is often related to unknown engineering challenges.

**'Cost plus' contracts are generally no longer available and fixed price contracts are now commonplace.** Here it is vitally important to get the pricing right. It may be difficult to change market practice in long-term contracting companies where they may tend to bid on a low price to get the contract thereby keeping the production lines going. Such companies do need to know what their costs will be so as not to get the fixed price wrong and also not to let costs run out of control especially if the production line and/or the product are technically difficult to develop and it is something the company has not done before. Thus a key decision is whether or not to bid for a contract. This reinforces the need for good management information.

To sum up, good quality management information and IT systems, combined with management skills within the company, can help to make it less likely that the company will fall off the manufacturing roller coaster.



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