Forefront

ISSUE 1 | 2017

Inside:

O'Keefe

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Did you know:

Did you know that O'Keefe provides valuation consulting services?

Highly-credentialed valuation professionals are experts in the valuation of enterprise value, equity, intellectual property, and complex securities for a variety of purposes. In addition to our independent and thorough valuation analysis, we are able to communicate our findings in a clear and easy to understand manner. Should your valuation need be litigious, know that our experts are well versed to assist you with discovery assistance, economic damages, work product rebuttal of other experts, and regularly testify in state and federal courts.

Our independent valuation services include, but are not limited to:

- Shareholder Disputes
- Intellectual Property
- Estate and Gift Taxation
- Bankruptcy Related Valuation Services
- Financial Reporting
- Debt and Complex, Financial Instruments
- Zone of Insolvency

Should you have a valuation need, our valuation professionals would be happy to assist you.

Watch New Video Case Stories

Many times clients are buying our services for the first time with no idea what the criteria should be for picking a consulting firm to engage. We have recently posted to our website four case studies and interviews with clients who had never used our services before. It might be interesting to learn how the process went from their perspective.

O'Keefe expands with Automotive Recall Practice Group

Our team brings many years of financial, operational, economic, and automotive industry experience together in the quantification of economic damages for automotive recall matters.

Closely monitoring developments in the automotive industry, National Highway Traffic Safety Administration (NHTSA), and case law, the Automotive Recall Practice Group adeptly guides and counsels suppliers in automotive recall settlement discussions, including the areas of:

- Economic analysis of completion rates
- Cost data sampling
- Cost analysis of labor, material and overhead charges
- Discovery assistance and expert witness rebuttal reports
- Expert witness testimony

Looking beyond financial statements

By Russell Long

The concept of due diligence is as varied as its applications in the business world. To a business owner looking to expand through acquisition, due diligence will identify whether a target company's financial condition is sound, the management team is competent, the underlying business practices are proven and the disparate cultures will mesh in a way that will achieve the growth desired. To business owners looking to sell, utilizing a professional to perform the due diligence prior to marketing a company will assist in anticipating any matters that may affect the transaction and thus maximize the value of the business.

In last quarter's Forefront, Susan Koss discussed the importance of understanding the "Quality of Earnings," which is a key component of the due diligence process. A business seller can engage a firm to prepare an independent Quality of Earnings report, a much more thorough analysis than revenue and expenses, that can be utilized by management to prepare themselves for the questions that will come during the sale process.

Traditional accountants and auditors are trained to prepare, evaluate and validate financial statements but are restricted by materiality thresholds. Boiler-plate audit programs executed by staff with limited or no business experience can miss critical red flags in financial or operational performance. Due diligence engagements must be performed by seasoned professionals, experienced in multiple industries, who have the ability to look beyond the financial statements and identify potential risks buried in the details. Additionally, due diligence engagements should all be done in a dynamic fashion that will vary significantly by engagement. At O'Keefe, a unique due diligence plan is designed specifically for each engagement and is tailored to the needs of the acquirer or in the case of a sell-side engagement, will focus on the areas management deems the most vulnerable.

In addition to a comprehensive Quality of Earnings analysis, a due diligence plan should include:

- Validation of purchase price – No two deals are structured alike and the due diligence team will want to ensure the client is getting the best deal possible.
- Analysis of Working Capital Requirements – A coordinated analysis of the working capital needs of the consolidated entity during the due diligence is essential to ensure working capital needs increase during the integration period and management needs to be prepared for the new environment.
- Assessment of Management – Assessment of the quality of management is part of the Quality of Earnings review. However, consideration must be given to whether management styles will mesh with the acquiring company's key leaders. Identification of key managers and their roles is essential.

A comprehensive due diligence plan performed by a seasoned professional is essential to ensure the buyer doesn't overpay and the seller does not leave money on the table. Because there is no single approach to a due diligence engagement, hiring the right firm is critical to a successful acquisition or sale.

Russell Long
CPA/ABV/CFF, Partner and Managing Director, specializes in litigation support, business valuation, real estate, turnaround consulting, forensic accounting, and receiverships.

SPECIAL AUTOMOTIVE SECTION:

PEELING BACK THE LAYERS

COST COMPONENTS OF A RECALL DAMAGE CLAIM

By Carolyn Riegler

Recall damage claims can be significantly overstated as the Original Equipment Manufacturer ("OEM") tries to recover in some instances more than the actual out of pocket costs. In many instances recall efforts, in addition to getting unsafe parts off the market, serve as profit opportunities for the OEM. It is critical to peel back the layers of the alleged recall costs being pushed to suppliers to properly assess the accuracy of the program recall costs asked to be reimbursed. Each component must be evaluated for underlying assumptions, relevant historical data, industry trends and relevance to the recall/claim involved. OEMs may use standard costs to estimate labor or material cost in the damage claim. Understanding the standards and comparing them to actual repair costs is a first step. In addition, the evaluation should dig deep into purchase orders, invoices, and the claimant's data systems to ascertain the propriety of such costs. In many cases the OEM's accounting system is not sufficient to properly prove the costs of the recall to be borne by the supplier. It is also important to consider the location of the repair population. Location mix is relevant to many costs as labor rates and allowable profit margins for handling and recall repair vary by region. Many profit margins for dealer services in this area are regulated by the applicable State. Understanding the percentage of vehicles in any one area can significantly impact cost. An additional key component on cost is interdivisional profit, which can be complicated to unwind. Once the layers of the cost build up are unveiled, a complete assessment of the alleged damage claim can be made.

Carolyn Riegler
CPA/CFE, Director, specializes in litigation support, dispute resolution, forensic accounting, real estate, and business valuations.

SPECIAL AUTOMOTIVE SECTION:

AUTOMOTIVE RECALL COMPLETION RATES

By Andrew Malec, Ph.D.

Nowadays, it seems that you cannot listen to the news without hearing about an automotive safety recall. An automotive safety recall is when an automotive manufacturer requests that the vehicle owner bring the car in for service to fix a part defect that is deemed a safety issue.

For automotive suppliers, a safety recall is a very costly event. This is because the Original Equipment Manufacturer ("OEM") pushes down the cost of the recall action to the automotive supplier. The monetary demand asserted by an OEM to the automotive supplier is dependent upon the number of vehicles expected to be repaired. The number of vehicles expected to be repaired is estimated based on forecasts of "the completion rate." The completion rate is simply the percentage of vehicles in the population expected to be repaired. It is important that this number is well supported and substantiated. The estimated completion rate requires an economic analysis of many variables that influence the expected number of vehicles to be repaired.

Economists have hypothesized that several variables affect the completion rate.[1] These variables include (1) age of the vehicle; (2) size of the recall campaign; (3) severity of the failed component; (4) number of automobile dealerships; and (5) news announcements. Owners of older vehicles are expected to respond less to a recall notice than owners of newer vehicles because owners of newer vehicles are more likely to bundle recall repairs with service warranty work and other regularly scheduled maintenance trips to the dealer. Further, the older the vehicle, the less likely that the current owner is the original owner. As such, older vehicles are expected to have lower completion rates than newer vehicles.

Size of the recall campaign is also expected to negatively impact the completion rate. Larger sized campaigns are expected to produce lower completion rates than smaller sized campaigns because smaller campaigns are targeted to vehicle owners who are more likely to have been impacted by the issue. In a larger campaign, there is a greater probability that the vehicle owner may not have been impacted by the issue and therefore sees the repair as less of a priority.

Severity of the failed component is also a factor in having a positive impact on the completion rate. That is, vehicle owners are more likely to get their vehicle fixed when the nature of the recall is severe, as opposed to non-severe, component failures (e.g., seat belts, windshield wipers, etc.). Also, the greater the number of dealerships, the lower the transaction cost for the consumer in responding to a recall notice. As such, in theory, the number of dealerships positively impacts the completion rate.

Finally, manufacturers are required by statute to notify owners of recalled vehicles and make repairs at no charge. However, there is no statutory requirement that the general public be notified. Theoretically, such announcements could reinforce written notification and encourage owner compliance. It is expected that public announcements of recall campaigns positively impact the completion rate.

As described above, it is hypothesized that various variables impact the completion rate on a recall campaign. Since the facts and circumstances of any given recall campaign may produce results different from expected economic impacts, a thoughtful economic analysis must be conducted to determine the demand drivers affecting the completion rate for the specific recall action.

Analyzing the variables that influence the completion rate on a recall action is a very powerful tool in establishing the parameters for settlement, as well as easing the financial burden of settlement.

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1 Hofer, George E., Stephen W. Pruitt, and Robert J. Reilly (1994), "When Recalls Matter: Factors Affecting Owner Response to Automotive Recalls," *The Journal of Consumer Affairs,* volume 28, 96-106.

Rupp, Nicholas G. and Curtis Taylor (2002), "Who Initiates Recalls and Who Cares? Evidence from the Automobile Industry," *The Journal of Industrial Economics,* Vol. L No. 2 (June), 123-149.

Andrew Malec, Ph.D.
Partner and Managing Director, is the head of the firm's Intellectual Property ("IP") Practice Group. He is a recognized expert in providing economic advisory services, litigation support, and valuation opinions.

UNCERTAINTY IN THE ROAD AHEAD

By Susan Koss

SPECIAL AUTOMOTIVE SECTION:

The newly elected Trump administration will undoubtedly influence several aspects of the automotive industry going forward. Recent headlines have focused on the administration's desire for automotive manufacturers to have U.S. based plant locations and possible tariffs for those who manufacture outside the U.S. Also, from the beginning of his election, President Trump has been discussing his controversial measure to either rescind or renegotiate NAFTA (North American Free Trade Act).

The administration's appointment of various leadership posts has created much debate within Washington. One appointment that will have an impact on the automotive industry, but has not been announced yet, is the Administrator of the National Highway Traffic Safety Administration (NHTSA). NHTSA is responsible for writing and enforcing Federal Motor Vehicle Safety Standards as well as regulations for motor vehicle theft resistance and fuel economy. NHTSA requires automotive manufacturers to recall vehicles that have safety-related defects. Manufacturers are required to fix the problem by repairing it, replacing it, offering a refund, or occasionally repurchasing the vehicle. Automotive manufacturers have various reporting requirements to NHTSA regarding defects and recall activity, among others.

There has been a tremendous number of vehicle related recalls during recent years. Under the leadership of the most recent NHTSA Administrator, Mark Rosekind, the agency has been much more aggressive in its enforcement role as compared to previous administrations. Larger fines have been imposed on manufacturers cited with violations and a more proactive methodology has been implemented to detect and remedy defects as early as possible. Depending on President Trump's nomination for the position, the focus of the agency could change significantly. Trump has stated he wants to cut government regulation, which could have far reaching implications for the automotive sector and consumers. It is really too early to tell what, if any, impact there will be on the policies and procedures NHTSA currently has implemented. What is certain is that automobile manufacturers and their suppliers will be carefully watching changes to international trade policies and NHTSA regulatory standards over the next several months.

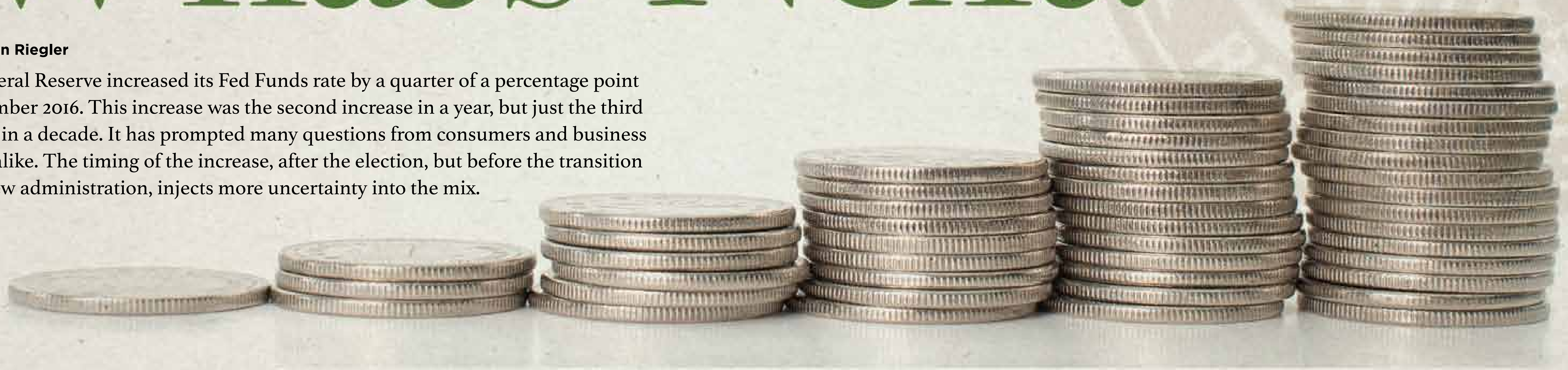
Susan Koss
CPA/ABV/CFF, CVA, Partner and Managing Director, leads the firm's Litigation Support Practice Group. She specializes in litigation support, business valuation, quality of earnings, and forensic accounting.

FED RATE HIKES...

What's Next?

By Carolyn Riegler

The Federal Reserve increased its Fed Funds rate by a quarter of a percentage point in December 2016. This increase was the second increase in a year, but just the third increase in a decade. It has prompted many questions from consumers and business owners alike. The timing of the increase, after the election, but before the transition to the new administration, injects more uncertainty into the mix.



Let's start with the basics - Why did the Fed raise interest rates? What does the rate increase mean to me?
The Fed rate increase was a reaction to a strengthening labor market, a moderately paced expansion in economic activity and modest household spending increases. The move to increase the rates is generally a sign of anticipated good economic conditions. The impact on small business should be slow, but will likely result in borrowing rate increases overall. The impact on the consumer may not be as direct. Mortgage rates are influenced by a number of factors, only one of them is the federal reserve interest rate. Other factors impacting mortgage rates include inflation rates, consumer purchasing power, household saving rates, corporate borrowing supply and demand, as well as availability of government mortgage guarantee programs.

Will the Fed raise rates even more, and why?
The primary reason for further increases would be in response to additional strengthening in labor market conditions. This is a good indicator of a strong economy in general; however, it is too early to know what impact the new Trump administration policies will have on overall market conditions. Expect another increase primarily based on long term economic trends, and overall market stability. The immigration policies of the new President may have the impact of tightening the labor market even further. There is a growing mismatch for skilled workers – particularly in the technology market – in the U.S. workforce.

The Fed has already telegraphed at least two more anticipated increases in 2017, however, other economic changes could also influence these decisions. President Trump's plan promises huge government stimulus projects in the area of infrastructure, as well as plans to cut taxes – these moves will also alter short and long term borrowing rates for consumers and small business.

What does the Fed recently raising rates mean to business owners and home owners?
The Fed rate increase impacts all aspects of the economy in one way or another, for homeowners, buyers and sellers, many other factors will influence their personal mortgage rate. Rates are still at historical unimaginable lows however, even with slight mortgage rate increases, home ownership is still an attainable American Dream. We are still experiencing unprecedented historical lows which bodes well for the consumer and small business. Business owners should find more available credit given the slightly higher borrowing rates lenders are able to demand. Any expansion should be done cautiously as new market trends appear. Expect the biggest impacts of Trump's new policies to come into play in 2018. It will likely take that long for them to take effect.

Carolyn Riegler
CPA/CFE, Director, specializes in litigation support, dispute resolution, forensic accounting, real estate, and business valuations.

Gifting Made Easy

By Susan Koss and Matthew Rizzo

Hiring a certified expert to value your business prior to a gift of stock is a smart move that could save you a significant amount of money. A certified expert is a professional that carries an accreditation in business valuation. Two nationally recognized certifications are Accredited in Business Valuation (ABV) and Certified Valuation Analyst (CVA). Hiring an ABV or CVA ensures the professional understands all valuation methods intimately and is aware of the accounting, finance and economic implications of each method. Unlike brokers or CPAs who are not certified, ABVs and CVAs have the appropriate training and experience in valuation methodology and technique.

Having a certified valuation expert on your side is critically important for IRS representation and approval. Many CVAs and ABVs have experience dealing with the IRS on gift tax matters to ensure their valuation is upheld. Using a valuator without the appropriate experience and training is dangerous because if the IRS doesn't agree with your valuation due to poor methodology or aggressive assumptions, you could be subject to steep penalties and interest. If your valuation is disregarded by the IRS, they will prepare their own valuation as a basis for you to pay additional taxes.

While business valuations are not an exact science, there is an inherent right and wrong way to value a company. CVAs and ABVs are highly experienced at analyzing and calculating different types of earnings multipliers and divisors and valuation discounts based upon certain assumptions. These assumptions are critical to the value calculation and must be carefully analyzed. A small error in economic assumptions can multiply into a much larger impact on the value. If your business is undervalued by such a mistake, you could be subject to accrued underpayment penalties and interest.

Hiring a certified valuation expert is not cheap, however, the amount spent may likely save a significant amount of taxes. Hiring someone that is not qualified could do just the opposite. To sum it up, there is a saying, "if you think it's expensive hiring a professional, just wait until you hire an amateur." Don't wait to find out the hard way.

Susan Koss
CPA/ABV/CFF, CVA, Partner and Managing Director, leads the firm's Litigation Support Practice Group. She specializes in litigation support, business valuation, quality of earnings, and forensic accounting.

Matthew Rizzo
CPA, CVA, Senior Associate, has business valuation expertise in various types of transactions including, but not limited to mergers and acquisitions, shareholder disputes and gift tax valuations.

O'Keefe hires Anson Smuts as Senior Associate

Bloomfield Hills, Mich. – Financial and strategic advisory firm, O'Keefe, announced Anson Smuts has joined the organization as a Senior Associate. Mr. Smuts has strong knowledge of accounting and finance principles, mergers and acquisitions, business valuation, intellectual property, and data analysis to identify strategies for business growth and development.

Prior to joining O'Keefe, Mr. Smuts worked for Floyd Advisory, a consulting firm with offices in New York and Boston where he assisted clients with post-acquisition disputes involving earn outs and working capital adjustments, business valuations, financial budgeting and projections, damages in intellectual property matters, damages in fiduciary duty and employment matters, and fraud investigations.

Mr. Smuts holds a Bachelor of Social Science with a concentration in Economics, Politics and Economic History from the University of Cape Town, South Africa as well as a Master of Arts in International Political Economy and Development from Fordham University. Mr. Smuts holds advanced certificates in Financial Econometrics and Data Analysis, and Emerging Markets and Risk Analysis from Fordham University. He is a member of the Institute of Management Accountants (IMA) and the National Association of Certified Valuators and Analysts (NACVA). Mr. Smuts is a Certified Management Accountant (CMA) and a Certified Valuation Analyst (CVA).

2017: More questions than answers

By Patrick O'Keefe

With the historic come-from-behind political victory of Trump and the overreaction of the liberal media to every move our president makes, 2017 should be quite a year. I am hopeful with our 3 branches of government, change will be slow, but necessary. It will be interesting to see if the Keystone Pipeline moves forward and what that does to our energy dependence on foreign oil. What happens if Trump cuts back regulation? Will we see fewer automotive recalls? What impact will that have on consumer protection? What is the balance? With proposed changes in FDA will we see new experimental drugs faster into the market? If Dodd Frank gets repealed what does that mean for the banking industry? Will we see credit rules loosening? Will tighter immigration laws really impact the labor market or is this an overreaction? What about the Affordable Care Act? It's not so important that it may be repealed, but what will its replacement look like and will it really be better? Lots of questions in 2017, but uncertainty breeds opportunity. 2017 should be a very interesting year. Buckle up.

O'Keefe
2 Lone Pine Road
Bloomfield Hills, MI 48304

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