Forefront

ISSUE 3 | 2018

Inside:

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This publication of Forefront deals with the impact of tariffs. Many companies are uncertain how the U.S. Government's policy will impact their business. There are positives and negatives with an aggressive policy. My personal belief is this strategy will be short lived. President Trump is certainly getting the attention of foreign leaders. I remember the adage of an old friend who once said, "the key to my success is I tell people what I am going to do and I do it and sometimes that surprises people." I think President Trump also subscribes to that adage. As his agenda was very clear, he is swiftly executing it at a speed unaccustomed within the Federal bureaucracies. His efforts are unsettling to all those who don't support him. To those who do, he is like a breath of fresh Northern Michigan air. A certain cleansing to it. My view is that this is a necessary maneuver to level the U.S. trade playing field. We compete against countries who dump goods, manipulate their currency and steal our innovations with no recourse. It is about high time somebody in government address these inequities as our competitive advantage as an economic power erodes. Even though his style is not my own, I cheer the President's efforts because I see the long-term benefits even if in the short run it causes uncertainty. Uncertainty in our world breeds opportunity. It is our hope that our clients and referral sources identify strategies with the information on the trends we see. As I often say, we don't determine the speed or direction of the wind but we do control how we set our sails. Good luck to all in making your businesses even greater. ~ Patrick O'Keefe

BIG TROUBLE IN BIG CHINA

By Matthew Rizzo

All of the rhetoric surrounding the current Trump tariffs has focused directly on how U.S. commerce will be affected. There has been little to no discussion of the effect the tariffs will have on other economies. China, who seems to be the main target of the new tariffs, will be greatly affected.

China's export advantage is at risk

China's 2018 GDP growth is estimated at 6.6% which is slightly down from 6.9% in 2017. This reflects a stricter regulatory environment and softer external demand. A trade war with the U.S. could further hinder global demand for Chinese products due to increased cost in raw material type imports; for instance, steel which affects numerous Chinese industries such as real estate and manufacturing. With China already experiencing greater labor costs leading to decreased profits, these increased costs are causing Chinese exports to be less price competitive. This does not even include provisions for new tariffs.

China's debt reduction policies

China has been amassing a large amount of debt since the 2008 crash at both the government and corporate levels to the tune of 37% and 136% of GDP, respectively. While corporate debt to GDP has stabilized, nonfinancial sector debt increased faster than nominal GDP. Although the Chinese government's debt to GDP seems low, Chinese State-Owned Enterprises or SOEs have turned to shadow banks or Local Government Financing Vehicles ("LGFV") to bridge the gap for funding shortfalls set forth by the central Chinese government. At high interest rates, this funding is all off-balance sheet and this snowball of debt cannot be measured by the Chinese government. The central Chinese government is also being hurt by the continued depreciation of the yuan versus the U.S. dollar as well as other currencies. This makes China's external debt more expensive to service which increases China's default risk. The U.S. tariffs against China further exacerbates the debt situation due to the fact that SOEs and Corporations may need quantitative easing. This will cause the Chinese government to abandon their debt reduction policies and take on more debt, which will create a general uneasiness for countries that hold Chinese paper.

With business defaults happening in China due to crippling amounts of debt, the trade war with the U.S., and the risk of Chinese default due to continued depreciation in value of the yuan, China simply cannot afford to ignore the impacts of the Trump tariffs.

Matthew Rizzo
CPA, CVA, Director, specializes in turnaround and restructuring, litigation support, and business valuation expertise in various types of transactions including, but not limited to mergers and acquisitions, shareholder disputes and gift tax valuations.

Tariffs The First Step Down a Long Road

By Anson Smuts

"China's laws, policies, practices, or actions that may be harming American intellectual property rights."

In August of 2017 the United States Trade Representative initiated an investigation under Section 301 of the of the Trade Act of 1974 into "China's laws, policies, practices, or actions that may be harming American intellectual property rights." Section 301 allows for the use of trade sanctions to protect intellectual property ("IP") rights. Subsequent to the Representatives' report, tariffs were imposed upon China, which for years has been accused of demanding the transfer of IP rights from foreign firms seeking to gain access to the Chinese market. A 2015 paper by the Federal Reserve Bank of Minneapolis found that this quid pro quo policy has resulted in more than half of all technology owned by Chinese firms being obtained from foreign firms.

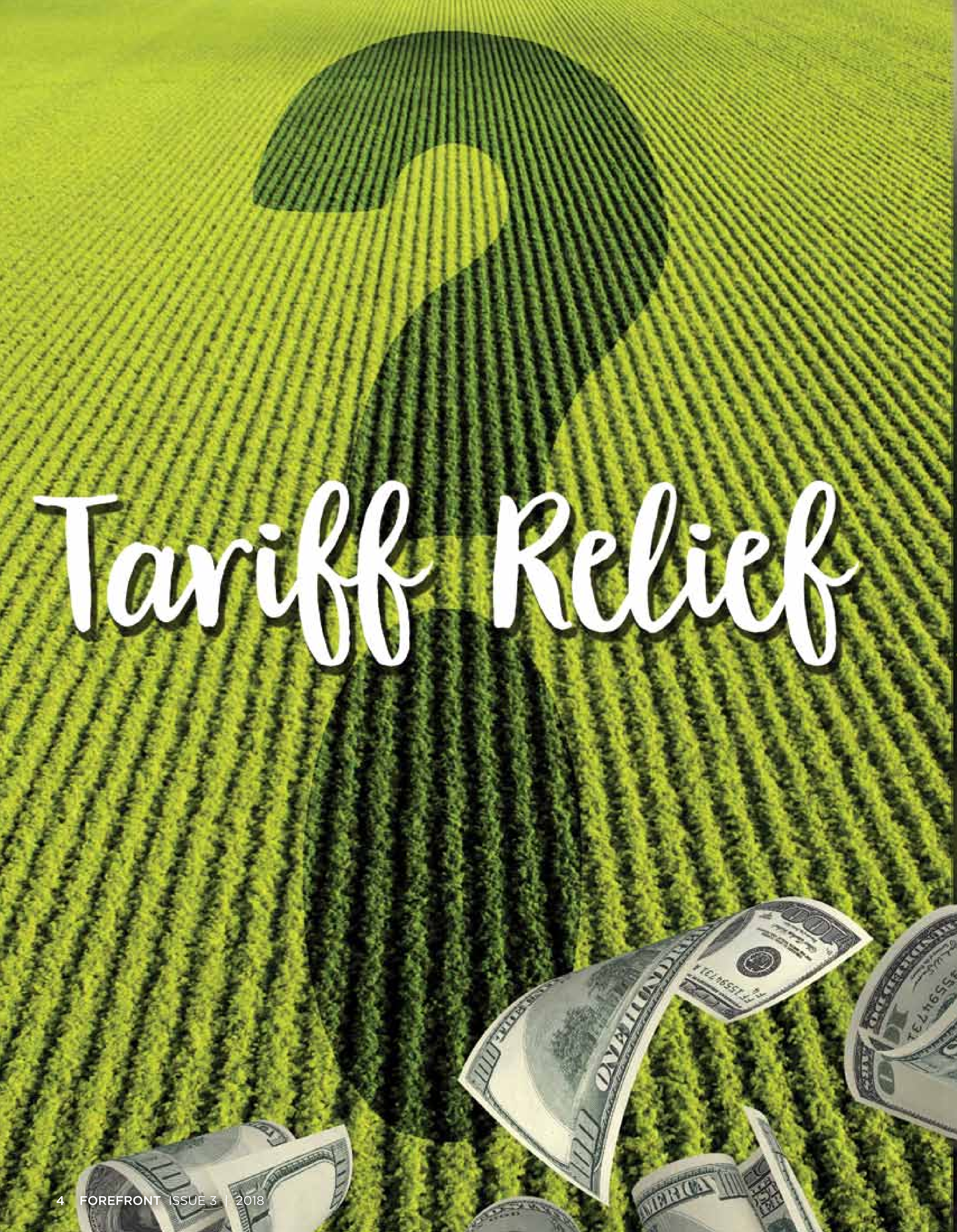
There is a wide range of estimates for losses caused by foreign IP theft. A 2011 report by the U.S. International Trade Commission estimated that total annual losses due to IP infringement in China were $48.2 billion, of which $36.6 billion represented lost sales, $11.6 billion being lost royalty or license payments. The majority of these losses related to either copyright or trademark infringement. A 2013 report by the National Bureau of Asian Research ("NBAR"), a nonprofit based in Washington DC, estimated the losses due to IP theft to be far higher, over $300 billion globally, with China allegedly being responsible for up to 70% of those losses. These two reports agree on the consequences of IP infringement for the U.S. Beyond the direct loss of sales and fees, infringement diminishes the incentives to innovate, creates a drag on U.S. GDP, and denies employment opportunities in the U.S.

What is the solution to this issue? For China, the problem is rooted in the policy of "indigenous innovation" which seeks to turn China into a technological powerhouse by 2020 by "enhancing original innovation through co-innovation and re-innovation based on the assimilation of imported technologies." A focus upon "imported technologies" does not promote IP rights for either domestic or foreign firms. A society that respects IP rights is a self-innovating society. But this does not happen overnight.

In the U.S., Congress passed the Copyright Act in 1790. That same year, George Washington signed the bill that laid the foundation of our modern patent system. Over time, IP rights and self-innovating values have been ingrained within U.S. business culture. This has required the long-term commitment of the business community, the courts, and legislators. In contrast, China only began to form its IP laws in the 1980's. Consequently, while today China has numerous modern economies from which to mold its IP laws and institutions, we should not underestimate the scale of this endeavor.

As discussed in the 2013 report by NBAR, the solutions to IP theft are complex and require long-term commitments from both the U.S. and China. The recommendations for the U.S. government included, but were not limited to, preventing goods derived from stolen IP from entering the U.S. market, increasing accountability and deterrence for foreign firms using stolen IP, and emphasizing IP protections in the priorities of American diplomats. China must commit to encouraging technological development from within while promoting the rule of law surrounding the IP rights of both domestic and foreign firms. Tariffs may bring the two nations to the negotiating table, but the road ahead is long.

Anson Smuts
CMA, CFE, CVA, Senior Associate, utilizes his accounting and finance expertise in mergers and acquisitions, business valuation, intellectual property, and data analysis to identify strategies for business growth and development.



Tariff Relief

By Carolyn Riegler

In Late August, the U.S. Department of Agriculture (USDA) announced the structure of $12 billion in programs designed to assist farmers in response to damages they have suffered due to retaliatory tariffs. The tariffs on U.S. agriculture were implemented by foreign governments this year in response to U.S. steel and aluminum tariffs. The aid programs will be a combination of (a) direct payments to farmers via the Market Facilitation Program (MFP), (b) a food purchase program administered by the USDA's agricultural marketing services, and (c) funding for the development of foreign markets for U.S. agriculture products.

The guidelines for the first round of funding propose limits and include only 50% of the anticipated total funding for the program. There are restrictions placed on applicants such as limiting the average adjusted gross income (AGI) to less than $900,000 for each of the three years 2014, 2015 and 2016. Payments will be capped at $125,000 to each person or legal enterprise. The initial MFP payment will be calculated by multiplying 50 percent of the producer's total 2018 actual production by the applicable MFP rate. In addition, the various commodities have caps on the amount of total payments. Initially the MFP will distribute $4.7 billion to seven commodities as follows:

Product	Funding	Percent
Soybeans	$ 3,629,700,000	77%
Pork	290,300,000	6%
Cotton	276,900,000	6%
Sorghum	156,800,000	3%
Dairy	127,400,000	3%
Wheat	119,200,000	3%
Corn	96,000,000	2%
	$ 4,696,300,000	

In addition, 29 other crops will be purchased from farmers for $1.24 billion based on an economic analysis of the damage caused by the tariffs, bringing the initial aid to a total of $6 billion.

Reaction to the rate of tariff relief was swift—and less than complimentary. Jim Mulhern, CEO and President of the National Milk Producers Federation commented that, "Today's announcement by the USDA on its tariff mitigation plan falls far short of addressing the losses dairy producers are experiencing due to trade retaliation resulting from the Trump Administration's imposition of steel and aluminum tariffs." In addition, the current state of NAFTA renegotiations is very uncertain (as of the writing of this article). As of today, there is a "tentative deal with Mexico," however very few details have been made public. Recently Canada came back to the negotiating table, however, there are many issues on which the U.S. and Canada still do not agree. The uncertainty surrounding steel, aluminum, and automotive import tariffs will continue to impact the agricultural retaliatory export tariffs. Government assistance, while welcomed by some, is also not a favored solution by many. Time will tell. Most importantly, stay up to date and be ready to react when the economic and political environments dictate.

Carolyn Riegler
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DEATH OF THE FAMILY FARM

By Stephen Weber

As the 2018 harvest season continues, we can appreciate the changing face of agriculture. In many places, the family farm is becoming a rarity as generations move away from the family homestead in search of newer opportunities available in cities and larger towns across the United States. Over time, are we witnessing the death of the once sacred family farm?

Agriculture has changed dramatically over the last 200 years. In the 1800's, nearly 90% of the U.S. population lived and worked on family farms. Each family farm was only capable of feeding 3-5 people annually. Additionally, due to a lack of mechanization, farms were much smaller.

In the 1900's, farms continued to grow. By the mid 1990's each farm produced enough to feed an average of nearly 130 people per year. Farms also increased in size. By 1995, the average farm size was 469 acres and 20% of all farms were over 500 acres.

Stephen Weber

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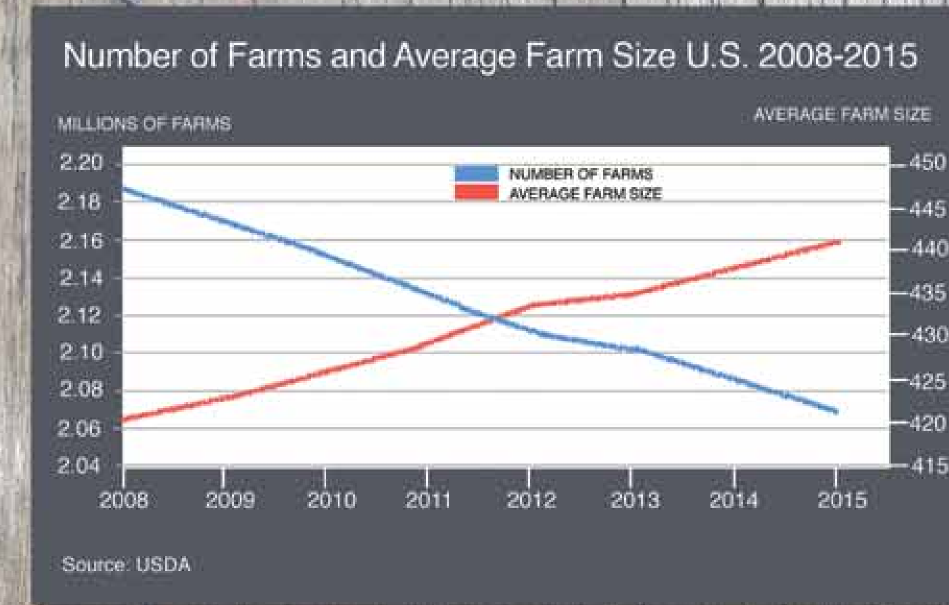
The USDA has reported that the number of U.S. farms has fallen sharply. It peaked at about 6.8 million farms in the mid 1930's. As shown in the chart (right), the number of farms has continued to decrease resulting in only approximately 2.06 million farms by 2015.

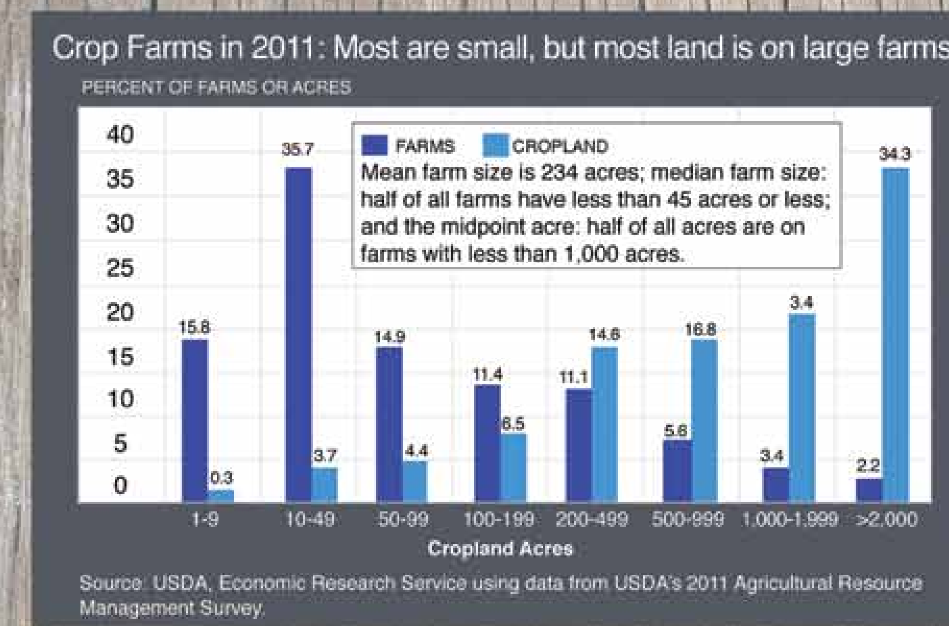
The amount of land devoted to farming has fallen as well. The American Farmland Trust estimated that an acre of farmland goes into development every two minutes. In some metro areas, what used to be a surrounding belt of farmland has now made way for new housing development, shopping centers, and businesses. As reported by the USDA NASS, 2012 Census of Agriculture, farmland decreased by nearly 7.6 million acres between 2007 and 2012.

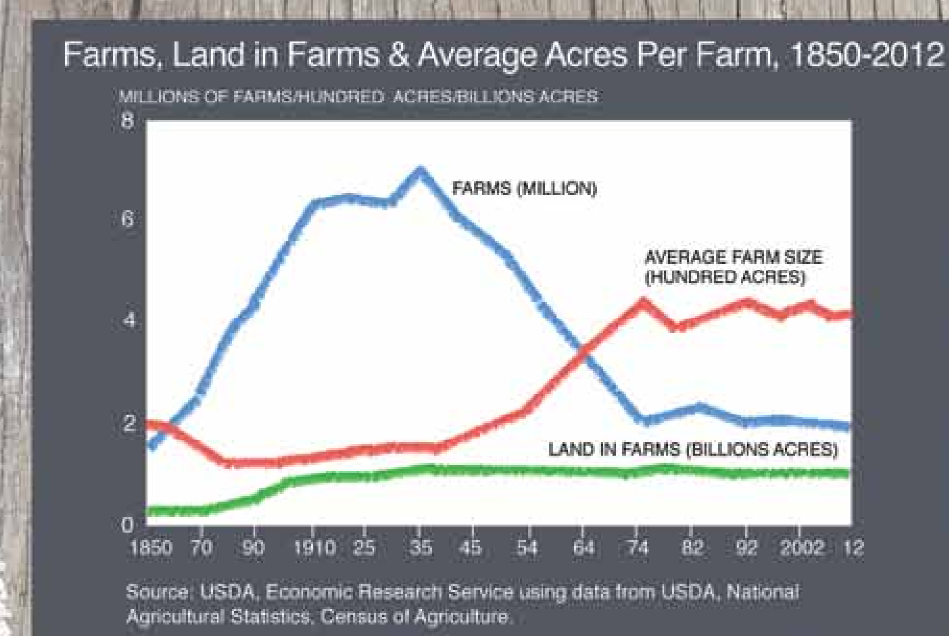
As the cost of machinery, regulation, taxes, and labor continue to increase, farms are continuing to increase in size to benefit from economies of scale. While small farms continue to dominate agriculture numerically, large farms (>2000 acres) make up over 34% of the land in cultivation currently.

Finally, labor laws governing children working on the farm, environmental regulations, and current tax and estate laws all have detrimental effects on farms. These factors restrict who can work on a farm, increase the cost of operating a farm, and increase the cost of transferring a farm onto a next generation, if there is one.

Many pressures impact the family farm in the United States. Will the family farm die out for good? Most likely not. However, the shape and size of ongoing agricultural operations in the United States will likely continue on their current path.







Auto Tariff CONSEQUENCES

By Katie Montague

Perhaps the most obvious group impacted by President Trump's steel and proposed auto parts tariffs, at least in metro-Detroit, is the automotive industry. The most ecstatic group in support of the tariffs on imported steel to the U.S. is, not surprisingly, U.S. steel makers. Nucor, the largest steel company in the U.S., has already seen increased revenue in the second quarter of 2018, which it's at least partly attributing to the tariffs. U.S. Steel restarted operations at a plant in Illinois in response to the tariffs. Steel makers are happy. Steel consumers, like auto suppliers and OEMs, aren't going to see the same positive impact.

The number of steel-consuming companies in the U.S. significantly outweighs the number of steelmaking companies in the U.S. The steel tariff is contributing to a higher demand for domestically-produced steel and thus, lower overall steel supply in the U.S. A simple solution for U.S. auto suppliers would be to make the switch from foreign-supplied steel to U.S.-supplied steel; however, the switch isn't so simple. U.S. auto suppliers aren't able to easily switch to domestic steel because of a variety of factors, such as rising prices, existing contracts with foreign suppliers, and lack of availability due to supply and demand constraints. In addition, new proposed auto parts tariffs are adding to the uncertainty and fear of U.S. auto suppliers. Someone in the supply chain will need to absorb the increased costs from the tariffs, which is going to start with auto suppliers and end with a portion paid by the consumer.

Auto suppliers will have to make some significant decisions on how they will handle the new tariffs – whether they will absorb the cost or try to pass it on to their customers. Some auto suppliers aren't able to pass the costs along to their customers because of long-term contracts already in place. Supply contracts often include provisions for the risk of fluctuating commodity prices, such as steel, but don't necessarily reference fluctuating tariffs. If the contracts do protect the supplier with regard to increasing tariffs, the customers may end up bearing some of the risk. Other suppliers aren't large enough to absorb the substantial increase in costs, even if contractually obligated to do so. Suppliers and their customers will likely have to negotiate a solution. For those suppliers who do survive the tariffs in the short-term, cost-cutting and price increases are necessary to continue operations. Cost-cutting may lead to increased unemployment and more negative impacts. An analysis by the Peterson Institute for International Economics stated that a 25% tariff on foreign cars and auto parts would lead to a 5% decrease in employment in the auto sector. Price increases will be passed along to the consumer. Estimates for the increase in new car prices due to a 25% auto parts tariff range from $1,000 to $5,000 per vehicle.

Although there is much opposition to the President's new tariffs, the full direct impact on the U.S. economy is unknown. The tariffs are expediting global trade discussions, which may result in swift changes in any direction.

Katie Montague
CPA, CFE, Associate, utilizes her financial expertise in many areas including, but not limited to litigation support, business valuation, forensic accounting, and shareholder disputes.

MARIWANNA?

By Matthew Rizzo

By the time you read this article a critical vote will have happened in Michigan as to whether or not recreational marijuana use will be legalized. Aside from polarized personal feelings and stigmas surrounding marijuana, the legalization of recreational marijuana will also impact local economies. The evidence can be found in Colorado, more specifically Denver, which can be referred to as patient zero.

The sale of recreational marijuana in Denver was first allowed in 2014. That year, retail gross sales came relatively close (20% shy) to the already established medicinal marijuana gross sales. In 2015, retail gross sales surpassed those of medicinal gross sales by 15%. The next year retail gross sales were almost 40% higher than that of medicinal gross sales. In four years, the compound annual growth rate of retail gross sales was approximately 36% and is on track to top $379 million in 2018.

So, what does this mean for the State of Colorado and the City of Denver? In 2017 they received $29.6 million in additional tax revenue, a large portion of which is attributed to recreational marijuana sales. This is in part due to retail sales including an additional 3.5% special tax on top of the 3.65% general sales tax whereas medicinal sales are only taxed at the general sales tax rate. The difference between retail and medicinal marijuana tax at the State level is even greater as medicinal is only subject to a 2.9% state sales tax, while retail is subject to the same taxes as medicinal plus a 15% state marijuana sales tax. Colorado's total state sales, use, and excise tax revenue in 2017 was approximately $4.2B of which about 5% is attributed to the marijuana industry. In the city of Denver, 6% of tax revenue comes from the industry.

These numbers may seem like a blip on the radar screen in terms of tax stimulus, however, Denver has benefitted from an increase in tax revenues that are able to be directed to programs that are in need. Although it has not been quantified, one should also consider additional cost savings in enforcement such as jail services and policing.

NHTSA LACKS MONITORING & OVERSIGHT PROCESSES

By Andrew Malec, Ph.D.

In December 2015, Congress passed the Fixing America's Surface Transportation ("FAST") Act. This Act mandated that the Office of Inspector General ("OIG") audit the recall processes of the National Highway Traffic Safety Administration's ("NHTSA") Office of Defects Investigation ("ODI"). This mandate stemmed from congressional concerns over NHTSA's handling of the Takata airbag recall. ODI is responsible for investigating potential safety defects and overseeing safety recall campaigns to assess recall effectiveness and maintains two divisions. The Recall Management Division ("RMD") is responsible for monitoring safety defect and noncompliance recalls. The Vehicle Defects Division ("VDD") is comprised of engineers who investigate potential safety defects and provide technical reviews of engineering issues. The findings of this audit were released on July 18, 2018.

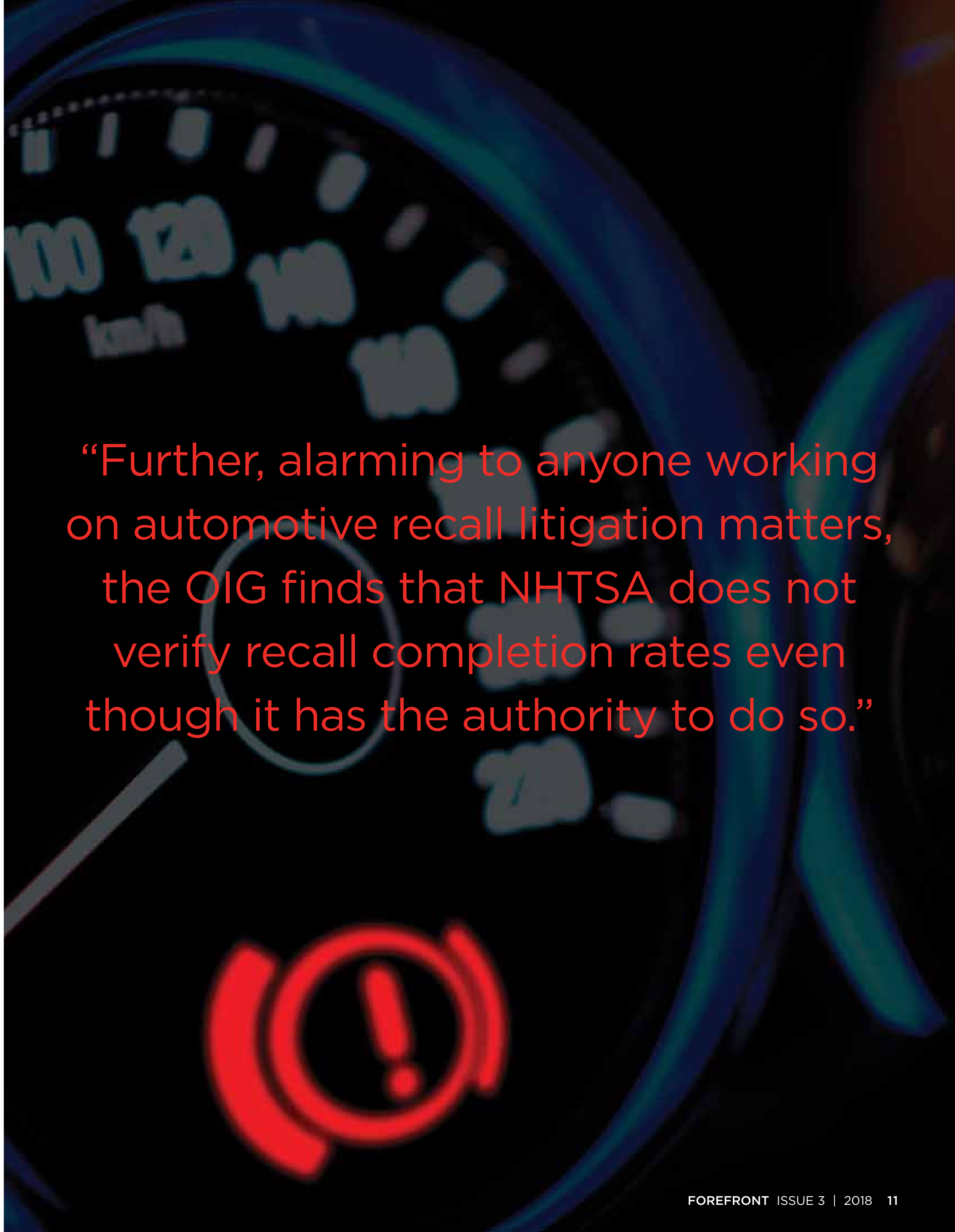
The OIG finds that NHTSA did not adequately manage light passenger vehicle recalls. The recall files lack documentation, do not ensure that remedies are reported in a complete and timely manner, and lack sufficient management controls to ensure staff assess risk when deciding on using oversight tools to improve recall completion rates. This finding may not be that surprising since the RMD only has eight employees (five recall specialists; one program analyst; one program assistant; and one engineer). Based on the sample of recalls analyzed, the OIG projects that manufacturers did not submit 28.1 percent of the required scope information in their initial recall reports, and submitted only 4.1 percent of the missing scope information in their final reports. However, it should be noted that NHTSA failed to notify manufacturers about 96.5 percent of the missing scope information. Further, the online portal that the agency requires manufacturers to use does not identify all the regulatory requirements, and the agency lacks written guidance to show manufacturers how to meet those requirements.

Further, alarming to anyone working on automotive recall litigation matters, the OIG finds that NHTSA does not verify recall completion rates even though it has the authority to do so. The OIG noted that they spoke to officials at several manufacturers who said they obtain completion rate data from their dealerships, then the manufacturers' employees manually input the data into the RMD's online recall reporting tool which has resulted in reporting errors. The RMD manager informed the OIG that their division is not obligated to detect incorrect reporting and that if the RMD is aware of completion rate reports that are incorrect, the division has follow-up processes and enforcement tools that it can utilize against the manufacturer. However, the RMD manager could not provide an example related to light passenger vehicle recalls.

The audit findings prompted the OIG to provide recommendations to NHTSA in order to improve their monitoring and oversight processes. NHTSA concurred with three of the six recommendations.

It is concerning that NHTSA's monitoring and oversight processes on light passenger vehicle safety recalls are lacking. In particular, NHTSA's lack of verification of recall completion rates is troubling since the estimated number of vehicles to be repaired is an important factor to consider in automotive recall litigation claims and may lead to economic damage computations that are out of line with economic reality. When facing an automotive recall litigation, the findings of the audit highlight that it is important to ensure that the completion rates proffered by automotive manufacturers be verified by a dispute resolution professional experienced in automotive recalls and not just take NHTSA's or the OEM's reported numbers as being accurate.

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



Good Record KEEPING

By Susan Koss

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.

Over the years I have worked with many clients with less than perfect record keeping practices. In some situations, this resulted in avoidable (and expensive) professional fees to straighten out the books and records before any analysis could be performed.

However, poor record keeping holds additional risks which can be even more costly. Estate transfers, a company sale, litigation disputes, IRS and sales tax audits, and partnership value disputes are just a few of the many examples that rely on accurate, complete and timely financial records.

Why are accurate records so important? Imagine an IRS audit that cannot justify certain business expenses. This could result in thousands of dollars charged in penalties and interest. In addition, any potential allegations of fraud from the IRS may trigger more dire consequences. From an estate planning perspective, the gifting of shares in a business to children or grandchildren must address the value of the company in order to value the gift. If the value of the gift is disputed by the IRS as a result of inadequate books and records, it could turn out to be a very expensive "gift" indeed. IRS adjustments to the value may also result in unanticipated tax consequences to any heirs. Another serious consequence of inadequate record keeping can occur when trying to sell a company for a fair price but lacking the financial records to support the financial activity of the business and therefore the desired price.

What should a business owner do to improve the accuracy and completeness of the business records? First, the business owner should perform a self-assessment by assigning the controller, bookkeeper or CFO to provide a document inventory of all key records, their location and retention policies.

Basic records will include support for all transactions of the business including, (but not limited to):

- Monthly financial statements including a balance sheet, income statement and cash flow statement supported by a detailed account general ledger and any subsidiary ledgers or journals which are applicable to the business
- Bank statements from all bank accounts reconciled to the general ledger or financial statements on a monthly basis
- Cash records including cash receipts, records of bank deposits, petty cash records, and check copies
- Sales records including invoices, contracts and agreements with customers
- Purchasing records including all purchases made by the company for any goods and services
- Minutes of Shareholder and Board of Directors meetings
- Deeds, mortgages and bills of sale
- Agreements related to any loans or obligations of the company
- Payroll records including time cards, time reports, payroll journals and year-end W2 statements and employment contracts
- Governance documents of the company

Also, the business owner should consult with his/her financial advisor to evaluate the status of the business' record keeping and determine what recommendations they have for improvement. Do the records include the proper detail for the specific industry? Are there additional industry benchmarks that should be tracked? What else would be expected from the IRS, a potential purchaser, or other shareholders? Time spent now to plan for the future will reap tremendous benefits and perhaps even help improve the value of the business in the long run.

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O’Keefe grows team with new hires and a promotion:

Violeta Zdravkovic brings more than 25 years of financial consulting experience specializing in litigation support, forensic accounting, mergers and acquisitions, business valuations, insolvency/bankruptcy and turnaround management in a broad range of industries, including automotive, retail and healthcare, among others. She also has extensive experience in fraud related issues, including detection, investigation and quantification.

Keith Chulumovich is an accomplished finance leader focused on strategic and operations planning, executing against financial goals, business analysis and financial reporting, process improvement, and financial services. Keith’s breadth of industry experience includes leasing, manufacturing, logistics, supply chain, and real estate. He is also experienced in private equity, working capital management, financial analysis, strategic planning, turnaround/profitability improvement initiatives, management of operating budget and forecast planning cycles.

Additionally, O’Keefe’s **Julie Lock** has been promoted from intern to full-time analyst.

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