The Financial Valuation Group

Forensic Accounting, Business Valuation and Consulting

In This Issue:

Overtaxed?

By Todd D. Jones, MBA, MAI, AI-GRS, CRE, FRICS
Principal, RealAdvice

Property tax is a very narrow, very deep practice niche that encompasses valuation, law, accounting, and politics. That said, virtually every type of income-producing commercial property has some degree of intangible value. And, while that component is typically minimized for federal tax purposes, it should be carefully scrutinized for state and local tax opportunities. For many companies, property tax liabilities exceed federal income tax liabilities.

Recognizing that property tax is the largest "above-the-line" operating expense for income-producing commercial real estate, prudent owners and asset managers actively manage the liability by retaining third party experts. These experts typically work reactively to assessment changes, which gives the local government and edge in the process. However, sophisticated proactive strategies that effectively minimize property tax liabilities over the investment's holding period exist that are preferable because they can settle the debate before it ever begins. Understanding why the debate exists will help you make better business decisions.

The Current Fiscal Dilemma

Today, state and local governments across the US are facing serious operating inefficiencies and deficits, as well as unsustainable pension obligations. These problems are compounded by expected declines in tax revenue as the Baby Boomer population begins to retire.

The dilemma is summarized in an article titled "States Expand Lucrative Pensions To More Jobs," in USA Today, reported on December 9, 2011:

> *"Special retirement benefits once reserved for police, firefighters and others with dangerous jobs are now being given to tens of thousands of state workers employed as park rangers, foresters, dispatchers, coroners, even highway laborers, museum guards and lifeguards.*
>
> *The trend will add heavily to the $70 billion that state taxpayers owe state retirement funds each year and is costing states such as Florida and Maryland $15 million to $30 million annually, a USA TODAY analysis shows.*
>
> *Thirty-one states have passed laws since 2000 that expand the range of workers who can retire when they turn 50 or 55 or after working 20 or 25 years, then collect special pensions that will pay some an extra $1 million or more in retirement. The pensions are enhanced because they are usually based on a higher percentage of a worker's salary than pensions for ordinary state workers.*

Continued on page 2

"There's been a massive increase in the scope of who qualifies for (early) retirement benefits," said William Eggers, public-sector research director at Deloitte consultants. "They're supposed to be for people who are getting shot at and running into buildings that are on fire."

Early retirement is usually far more costly to taxpayers because retirees collect a pension for additional years and are not paying into the state pension system as full-time workers.

"You could easily end up spending more on public-safety workers while they're retired than when they're working," said North Carolina State University retirement expert Robert Clark, author of A History of Public Sector Pensions in the United States. "If these folks are starting work in their 20s, they are eligible to retire in their late 40s, early 50s and get a pension and health insurance for the rest of their life."

The growth of early retirement has helped fuel massive deficits in some of the nation's largest public pension plans, including the main California and Florida retirement systems.

The deficits led 36 states in the past two years to take cost-control steps such as requiring workers to pay more toward their pension or delaying when they can retire, said Ron Snell, a pension expert at the National Conference of State Legislatures. "This is unprecedented," he said."

Accounting giants Deloitte, PricewaterhouseCoopers, and Ernst & Young, as well as the Pew Research Center have all documented the problem and realized similar conclusions.

Add to that the impact of governmental bureaucratic delays on business startups alone (recently studied by the Foundation for Government Accountability) and a sense of the economic costs attributable to operational inefficiencies can be grasped. The Foundation reports that hypothetically delaying the creation of all Florida new business start-ups by an additional week in 2009 would have cost $11.34 million in federal unemployment compensation and up to $36.34 million in lost tax revenue, added together to create a combined cost of $47.7 million. This number is likely understated, however, because it does not consider the additional net costs incurred by the federal government for the distribution of other entitlement programs - food stamps, Medicaid, public housing, etc. - to unemployed workers. A hypothetical one week of delay to new business start-ups costs the federal government about $36.3 million in lost tax revenue.[1]

In an ongoing report titled "Bankrupt Cities, Municipalities List and Map," Governing.com reports:

Many local governments across the U.S. face steep budget deficits as they struggle to pay off debts accumulated over a number of years. As a last resort, some filed for bankruptcy.

Governing is tracking the issue, and will update this page as more municipalities seek bankruptcy protection.[2]

Most recently, Detroit became the largest municipality in U.S. history to file for bankruptcy. The state had already appointed an emergency financial manager for the city, saddled with debts totaling an estimated $18 billion.

Overall, though, bankrupt municipalities remain extremely rare. A Governing analysis estimated only one of every 1,668 eligible general-purpose local governments (0.06 percent) filed for bankruptcy protection over the past five years. Excluding filings later dismissed, only one of every 2,710 eligible localities filed since 2008.

The majority of filings have not been submitted by bankrupt cities, but rather lesser-known utility authorities and other narrowly-defined special districts throughout the country. In Omaha, Neb., a dozen sanitary districts have filed for bankruptcy, accounting for nearly a third of all Chapter 9 filings since 2010.

It's also important to note that only about half of states outline laws authorizing municipal bankruptcy.

The report indicates that 38 cities have filed for bankruptcy protection, including Detroit, MI, San Bernardino, CA, Mammoth Lakes, CA (Dismissed), Stockton, CA, Jefferson County, AL, Harrisburg, PA (Dismissed), Central Falls, RI, and Boise County, ID (Dismissed).

Continued on next page

Understandably, significant political pressure will come to bear on elected officials and employees (including appraisers) working for government agencies to find revenue to meet these pressing demands; however, taxation based on over-assessment, or without due process, is theft.

Intangible Property

The foregoing helps explain why the existence of intangible property (when integrated into real or personal property) is resisted by assessors, despite that accountants and business valuers routinely deal with these assets. Intangible property is not assessable in most states and therefore is nontaxable in most jurisdictions. Regardless, the Uniform Standards of Professional Appraisal Practice requires that appraisers separately identify, and, if possible, value, separate real, personal, and intangible components in assignments where such property exists. USPAP Standard 1-4(g) states:

> *When personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items.*

For more information, contact Todd.Jones@RealAdvice.com ~~

Endnotes (Overtaxed?):

1 Foundation for Government Accountability, March 2012, The Cost of Bureaucratic Delays.

2 http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html

Announcements:

Michael Mard is honored and pleased to be recognized as an "Industry Titan, the Financial Consulting Profession's Most Influential" by the National Association of Certified Valuation Analysts (NACVA). Over the past quarter century, NACVA has helped shape and influence the business valuation and financial forensics disciplines with the support of key subject matter experts leading the charge. During 2016 NACVA is celebrating these subject matter experts and acknowledging the impact they have made to the profession. Mike Mard is grateful to have been nominated and chosen as a "Business Valuation and Financial Forensic Masters" expert who has been instrumental in developing methods and models, codifying standards and ethics, and instructing, mentoring, authoring, publishing and providing resources to thousands of business valuation and financial forensic analysts, attorneys, judges, federal and state regulators, business owners, and other financial consultants around the globe.

Donald Wisehart has been awarded the "Master Analyst in Financial Forensics" (MAFF), a credential issued by the National Association of Certified Valuators and Analyst (NACVA). Over the past quarter century, NACVA has helped shape and influence the business valuation and financial forensics disciplines around the globe. NACVA states the "MAFF credential is designed to provide assurance to the legal and business communities—the primary users of financial forensics services—that the designee possesses a level of experience and knowledge deemed acceptable by the Association to provide competent and professional financial forensic support services." To earn the MAFF credential, candidates must attest to having met certain prerequisites and experience requirements plus pass a four-hour proctored exam objectively testing NACVA's Financial Forensics Body of Knowledge. The MAFF credential gives practitioners the foundation needed to deal with the attendant legal or corporate board level support that often enters into business valuation engagements.

Mike Crain The Financial Valuation Group is happy to announce Dr. Michael A. Crain, CPA/ABV, CFA, CFE has become a member of the faculty at Florida Atlantic University and is the Director for FAU's Center of Forensic Accounting. We have been very proud to have benefitted and enjoyed Mike's partnership for twenty years with more to come. He will continue to consult with clients in the areas of forensics, economic damages, and business valuation. Mike's new contact information is listed on page 6 of this newsletter.

Measurement of Brands and Intangible Assets for Ad Valorem Purposes

Michael J. Mard, CPA/ABV, CPCU

A fundamental tenet of economics holds that return requirements increase as risk increases, with many intangible assets being inherently more risky than tangible assets. It is reasonable to conclude that the returns expected on many intangible assets, brands and tradenames particularly, will be at or above the average rate of return (discount rate) for the company as a whole.[1]

The need for and process of measurement of brand value is getting recognized internationally. Specifically, the British Standards Institution (BSI) has published BS ISO 10668 addressing brand value methodology.[2]

Further, The Appraisal Foundation has authored its Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group – Contributory Assets, *The Identification of Contributory Assets and Calculation of Economic Rents*[3] (IPR&D Practice Aid), which states:

The MPEEM (Multi-period Excess Earnings Method) is a method under the income approach. In applying this form of analysis, the starting point is generally Prospective Financial Information ("PFI") for the entity that owns the subject intangible asset. From this, a stream of revenue and expenses are identified as those associated with a particular group of assets. This group of assets includes the subject intangible asset as well as other assets (contributory assets) that are necessary to support the earnings associated with the subject intangible asset. The prospective earnings of the single subject intangible asset are isolated from those of the group of assets by identifying and deducting portions of the total earnings that are attributable to the contributory assets to estimate the remaining or "excess earnings" attributable to the subject intangible asset. The identification of earnings attributable to the contributory assets is accomplished through the application of CACs in the form of returns "on" and, in some cases, "of" the contributory assets. These CACs represent an economic charge for the use of the contributory assets. The "excess" earnings (those that remain after subtraction of the CACs) are attributable to the subject intangible asset. These excess earnings are discounted to present value at an appropriate rate of return to estimate the fair value of the subject intangible asset. Thus, the MPEEM could be described as an attribution model under the income approach.

Expressed in a slightly different manner, when PFI is used to determine the fair value of a subject intangible asset it might include contributions from a number of different assets working together as a group. To arrive at the excess earnings solely attributable to the subject intangible asset, the valuation specialist needs to identify other assets that are contributing to the generation of the asset group's earnings. If the specific revenues and expenses of these other assets cannot be separated from the PFI for the group of assets, the subtraction of CACs is necessary to recognize the economic benefit provided by the contributory assets. If the contribution of these assets is separated from the group's aggregate PFI, then CACs are not necessary.

We apply the Multi-period Excess Earnings Method to the determination of value for intangibles including brands in the next section.

The Multi-period Excess Earnings Method

The MPEEM measures the present value of the future earnings to be generated during the remaining lives of the subject assets. Using the BEA as a starting point, pretax cash flows attributable to the acquired assets as of the valuation date are calculated. As with the BEA, deductions are made for cost of goods sold and operating expenses. Contributory charges on the other identified assets are then taken.

Returns on and of or contributory charges represent charges for the use of contributory assets employed to support the subject assets and help generate revenue. The cash flows from the subject assets must support charges for replacement of assets employed and provide a fair return to the owners of capital. The respective rates of return, while subjective, are directly related to

Continued on next page

the analyst's assessment of the risk inherent in each asset.

The following Exhibit 1 from the IPR&D Practice Aid provides examples of assets typically treated as contributory assets, and suggested bases for determining the fair return. Generally, it is presumed that the return of the asset (reflecting the "using up" of the asset) is reflected in the operating costs when applicable (e.g., depreciation expense). The contributory asset charge is "the product of the asset's fair value and the required rate of return on the asset."[4]

It is important to note that the assumed fair value of the contributory asset is not necessarily static over time. Working capital and tangible assets may fluctuate throughout the forecast period, and returns are typically taken on estimated average balances in each year. Average balances of tangible assets subject to accelerated depreciation (as is the case here) may decline as the depreciation outstrips capital expenditures in the early years of the forecast. While the carrying value of amortizable intangible assets declines over time, there is a presumption that such assets are replenished each year, so the contributory charge usually takes the form of a fixed charge each year. An exception to this rule is a noncompete agreement, which is not replenished and does not function as a supporting asset past its expiration period.

The return requirements used here are after-tax and are shown in the following table.

The discount rates shown here are for illustrative purposes only and represent general relationships among assets. Actual rates must be selected based on consideration of the facts and circumstances related

Continued on page 6

Exhibit 1

Asset	Basis of Charge
Working capital	Short-term lending rates for market participants (e.g., working capital lines or short-term revolver rates)
Fixed assets (e.g., property, plant, and equipment)	Financing rate for similar assets for market participants (e.g., terms offered by vendor financing), or rates implied by operating leases, capital leases, or both, typically segregated between returns of (i.e., recapture of investment) and returns on
Workforce (which is not recognized separately from goodwill), customer lists, trademarks, and trade names	Weighted average cost of capital (WACC) for young, single-product companies (may be lower than discount rate applicable to a particular project)
Patents	WACC for young, single-product companies (may be lower than discount rate applicable to a particular project). In cases where risk of realizing economic value of patent is close to or the same as risk of realizing a project, rates would be equivalent to that of the project.
Other intangibles, including base (or core) technology	Rates appropriate to the risk of the subject intangible. When market evidence is available, it should be used. In other cases, rates should be consistent with the relative risk of other assets in the analysis and should be higher for riskier assets.

Exhibit 2

Contributory Asset Charges	Rate
Net Working Capital	4.0%
Land and Building, net	6.5%
Machinery and Equipment, net	7.5%
Acquired Software	16.0%
Noncompete Agreement	15.0%
Assembled Workforce	15.0%

Tampa, FL

Kingston, RI

Return address:
The Financial Valuation Group
8074 North 56th Street
Tampa, FL 33617

To receive this newsletter in electronic format, please send an email to **l.muraki@FVGFL.com** with the words "mailing list" in the subject line. To download this newsletter, visit us on the web at www.FVGFL.com.

Visit us on the web at www.FVGFL.com.

The Financial Valuation Group newsletter is distributed jointly by:

The Financial Valuation Group of Florida, Inc.
201 N Franklin Street
Suite 3150
Tampa, FL 33602

and

The Financial Valuation Group
of New England, LLC
1767 South Road
Kingston, RI 02881

For more information about our services and experience, visit us online at www.FVGFL.com.

Michael Crain's contact information:
Florida Atlantic University
School of Accounting
3200 College Ave, LA-420
Davie, Florida 33314 USA

E-mail: michael.crain@fau.edu
Voice: (954) 236-1066

Measurement (continued from page 5)

to each category of asset as determined based on market participants. Contributory asset charges (CAC) calculations are shown in Exhibit 2. ~~

Endnotes (Measurement):

1 Note, however, that the returns expected on some intangible assets may be below the company average for a service business that has mostly intangible assets.
2 http://shop.bsigroup.com/ProductDetail/?pid=000000000030187924.
3 The Appraisal Foundation, May 31, 2010 https://appraisalfoundation.sharefile.com/d/s80f9c7da9e744de9
4 Ibid.