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Firm Values

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We offer this newsletter to provide insight into current information and trends in business and the appraisal industry. We hope you find it enriching and welcome any questions or comments you may have. For more information about our practice please visit our website at GRWAppraisalServices.com or call us at 512-574-3444. Enjoy!

Lost Profits Analysis Satisfies Both Panduit & Daubert

Roll-Rite, LLC v Shur-Co, LLC, 2014 U.S. Dist. LEXIS 73026 (May 29, 2014)

A recent Daubert case offers an excellent review of how to establish lost profits by using the four-factor Panduit test. The plaintiff owned a patent for the use of a spur gear motor in an electric tarp spool system. That system features in open top vehicles, including dump trucks.

In 2006, the company began selling two types of motors to the defendant, which, in turn, built the devices into its Series 3500 tarp systems. When the defendant kept experiencing problems with the plaintiff's motors, it hired a company to design and build a similar motor that it then used with its new Series 4500 tarp systems. The defendant began selling the 4500 Series in late 2011 and subsequently applied for a patent for the newly designed gear motor. Meanwhile, the plaintiff lost the defendant's business and, in March 2012, sued in federal court (D. Mich.), claiming patent infringement and demanding lost profits.

Incremental profit determination. To establish damages, the plaintiff retained an expert, who was a CPA and certified in financial forensics. He used the four-factor Panduit test to reconstruct the market as it would have developed absent the defendant's 4500 Series system.

He found that in 2012 lost profits per unit for one type of motor were $167 and for the other type were $164. In 2013 lost profits were $153 and $150 respectively. He explained that the numbers were the result of determining the incremental profit the plaintiff would have earned during the damages period. "Incremental profit is the difference between the lost revenue and the additional costs that Roll-Rite would have incurred in order to generate those sales (i.e., incremental costs)." The expert's calculations took into account material costs, labor costs, variable overhead costs, warranty material costs, freight costs, working capital costs, and utility costs.

The defendant tried to exclude the testimony under Daubert. The expert's opinion was "incomplete, calculated to mislead the jury and based on unreliable methodology," the defendant argued. The expert failed to reconstruct the market accurately; specifically, the effect the 4500 Series had on the hypothetical market. Also, the defendant said, the expert failed to satisfy factors 1 and 4 of the Panduit test, which serve to show the infringement caused the lost profits.

Panduit to reconstruct the market. The court took a different view. It explained that the Panduit test was a widely used and approved method for establishing causation and reconstructing the market. It also pointed out that the defendant incorrectly separated the question of whether the expert reconstructed the market from the question of whether he failed to establish the test's four factors. The four factors of the Panduit test are as follows:

Factor 1. Did the patent holder establish demand for the patented product?

Factor 2. Was there an absence of non-infringing alternatives?

Factor 3. Did the patent holder have the manufacturing and marketing capacity to exploit demand?

Factor 4. What was the amount of profit the patent holder would have made?

The court concluded the expert's use of Panduit and his method of calculating lost profits were sufficiently reliable to admit the testimony under Daubert. A complete version of the transcript can be found at the following link: http://www.gpo.gov/fdsys/granule/USCOURTS-mied-1_12-cv-11150/USCOURTS-mied-1_12-cv-11150-0

Initiative Gathers Section 409A Data For Compliance Check, IRS Official Says

The Internal Revenue Service's current compliance initiative project was created as a formalized audit program to assess compliance with tax code Section 409A, an IRS official said during a Bloomberg BNA webinar. The project follows certain procedures, which Thomas D. Scholz, a senior technician reviewer in the IRS's Office of Division Counsel/Associate Chief Counsel, Tax Exempt and Government Entities, outlined during the July 30 program as follows:

* Fewer than 50 companies have been selected from a population already selected for examination by the IRS's employment tax division. One selection criterion was the probability that the taxpayer would have a nonqualified deferred compensation plan.

* Standardized or model information document requests (IDRs) were created for the project with the intent that all taxpayers would receive substantially the same IDR, with some minor differences. For example, those issued to privately held companies would be slightly different than those issued to publicly traded companies.

* The IDRs focus on three issues: initial deferral elections, subsequent deferral elections and payouts of nonqualified deferred compensation. As part of the examination of the payout, the IRS is looking at compliance with the six-month delay rule for specified employees.

* To reduce the burden on companies selected, the information being requested will focus on the top 10 most highly compensated employees of the taxpayer.

* It is expected that the project will be completed within 12 months. Many taxpayers have started receiving IDRs, so the project should be completed by the middle of 2015.

Generally, a compliance initiative project is designed to gauge the level of taxpayer compliance, and that is "what we hope to find with the Section 409A" compliance project, he said. "We hope it will shed some light on challenges to taxpayer compliance," Scholz said.

Keith E. Ranta, of counsel in the Baltimore office of Jackson Lewis P.C., asked whether the program will be confined to the last three taxable years or whether it will look back to prior years. Scholz said the cases brought into the project were existing employment tax cases, "so whatever years they had under examination for employment tax purposes are most likely what we are going to use for the CIP. Whether or not it will be expanded to additional years-I just don't know the answer to that," he said.

As to whether the IRS would issue a summary of issues discovered in its review of compliance initiative project responses, or a list of some common issues that can be used by employers to self-audit, Scholz said that it's too early to tell. As the project wraps up next year, the chief counsel side will be communicating with the employment tax side "and would be happy to disclose whatever they feel comfortable releasing," he said.

Thomas Scholz spoke in an unofficial capacity as part of the program, titled IRS' Section 409A Compliance Initiative Project: Audits, Compliance and Correcting a Plan Failure.

Excerpted from a story that ran in Pension & Benefits Daily (7/30/2014).

Estate wins big over valuation of personal goodwill

What do these amounts have in common: $0, $4.3 million, $9.3 million, $26 million, and $92.2 million? Amazingly, they are all valuation estimates of the same company at the same point in time. And the cause of these wild swings in value? The estimate of personal goodwill, as a recent estate case in Tax Court illustrates.

Son also rises:
Franklin Adell owned 100% of STN, a company that provided cable uplink services to a single customer: The Word, a 24-hour religious broadcast network. The Word was a 501(c)(3) organization formed by Adell and his son, Kevin, who was made president of STN. The driving force of the entire operation-the network and the uplink business-was Kevin's personal relationships with churches and religious leaders. He had no employment contract with STN, and there was no noncompete agreement. The deal was that The Word would pay STN a "programming fee" equal to the lesser of: (a) actual cost; or (b) 95% of net programming revenue received by The Word.

When the elder Adell passed away, his estate reported on Form 706 that the 100% interest in STN was worth $9.3 million based on a valuation from an experienced financial analyst who used the discounted cash flow method. Almost four years after Adell's death, the estate filed an amended return that claimed the STN stock was worth $0. The IRS issued a notice of deficiency and determined that the value of STN was $92.2 million. Next stop:Tax Court.

Do-overs:
At trial, the estate's expert submitted a revised valuation for STN of $4.3 million, based on liquidation value. The expert said his original valuation failed to account for the deal that put a limit on the

programming fee, which prevents STN from being profitable. One problem with this approach, however, was that the deal seems never to have been enforced, as STN had healthy profits.

The IRS also revised its valuation, coming up with $26 million also using the DCF method. The IRS expert based his calculation on the assumption that a hypothetical buyer could retain the son by paying him $1.3 million a year.

One-man show:
The court noted the estate's "substantially inconsistent positions" but adopted the estate's original $9.3 million valuation. It discredited the estate's revised valuation in light of the company's historical profitability and expectations that it would make a profit in the future. At the same time, the IRS expert's goodwill approach also was inappropriate. He greatly undervalued the pivotal role the son played in operating both companies and his personal relationship with customers. Plus, if he quit, he could compete directly with the company, the court pointed out. (Postscript: Later on, the son actually did quit and took all of the business with him to a new company he formed.)
Find an expanded discussion of Estate of Adell v. Commissioner,2014 Tax Ct. Memo LEXIS 153 (Aug. 4, 2014), in the October issue of Business Valuation Update; the court's opinion will be available soon at BVLaw

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Valuation, Like Beauty, Is in the Eye of the Beholder

Most startups
have little or no revenue, no earnings and negative cash flows, which makes valuation a complex undertaking. Despite these limitations, the actions of investors in early stage startups like Snapchat and WhatsApp have produced valuations in the billions.

Many have questioned whether these valuations are reasonable. "Valuation metrics in some sectors do appear substantially stretched-particularly those for smaller firms in the social media and biotechnology industries, despite a notable downturn in equity prices for such firms early in the year," read a report issued by the Federal Reserve in July.

So what should entrepreneurs and investors expect in startup valuations?

One source of valuation complexity is the inherently risky nature of investing in a company where the entire investment return is based on uncertain future events. Valuation is typically based on two simple concepts: return on investment and the risk of receiving that return. However, these ordinarily straightforward concepts are not so simple in the valuation of a startup entity. The returns on investment may not be realized until sometime in the distant future, and the risk of investment is often the result of an unproven technology or an unproven business model.

Due to these difficulties, the valuation of startup is sometimes based upon industry metrics. An example from the social media world is the number of users and time spent on the website, which are common valuation metrics. These market-based valuation methods may have some merit, but they are by no means a perfect proxy for eventual future cash flows.

However, there are steps entrepreneurs can take to assist with the valuation process.

One is to prepare a well-thought-out set of prospective financial information in the form of forecasted cash flow, which can include different scenarios representing likely operating outcomes as well as estimated probabilities for each scenario. The data can then be used by management or an outside valuation specialist in conjunction with statistical and other valuation techniques, such as Monte Carlo simulations and option pricing methods, to provide an indication of the value of the startup.

There are several milestones in the life of a startup when it would be wise for an entrepreneur to obtain a valuation of the entity. Anytime there is a significant investment in the entity, a valuation may provide comfort to the entrepreneur that the equity "give-up" is worth the amount of the investment. Second, financial accounting and tax reporting rules require the valuation of grants of equity-based compensation in the form of shares of stock, options or warrants. If the startup acquires or merges with another entity, financial accounting requires a valuation in order to measure the fair value of the assets of the acquired entity. Finally, a valuation may be prepared prior to an exit event, through an IPO or an acquisition by a strategic acquirer, to assist with setting the pricing for the event.

The valuation of a startup, like beauty, is in the eye of the beholder. Consequently, an entrepreneur should understand that the purpose of the valuation influences the assumptions underlying it, and therefore influences the value conclusion. For example, the value of a startup on a standalone basis would be different than the value of the same entity in a strategic acquisition where an acquirer is willing to pay a premium for synergies achieved through the combination of the two entities.

Valuation of startups can be complex. However, it is beneficial for an entrepreneur to obtain a valuation of the entity at various points in its life cycle, and industry metrics, such as the number of users, can be useful to provide an indication of value.

Excerpted from an article written by Mark Zyla of Acuitas, Inc. for the Wall Street Journal's on-line series

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