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Vol. 25, No. 8, August 2019

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Reasonable Certainty for New Business Lost Profit Calculations

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Recently, I had an engagement that involved calculating lost profits for a new business, which can be a challenge for accounting and valuation experts. Little guidance has been provided, and what is available is limited in its application. An expert's biggest concern is to avoid providing speculative, unsupported lost profit estimations. However, the recent 5th Circuit Court of Appeals decision in *Mansour v. Youtoo Media*[1] has provided practical guidance for experts to mitigate such concerns. Along with guidance such as the Fannon and Dunitz's 5th edition of *The Guide to Economic Damages,*[2] experts working for either the plaintiff or defendant can form a supportable opinion.

Five focus areas. Courts and triers of facts are looking for experts to support their lost profits of a new or unestablished business by displaying an understanding of the new business market and the company's own internal abilities. An expert should supply information about the subject company and the market in which it is looking to operate. Experts should focus their work on the following five areas:

1. Subject company's ability to penetrate the market;
2. Strength and experience of the subject company's management;
3. Subject company's capital resources;
4. Market's need for product and/or service; and
5. The ability of the subject company to recognize a profit.

The following discussion focuses on the five areas above and what information an expert should investigate in relation to those areas and how to provide support for exculpatory and inculpatory evidence. As with any lost profits engagement, the expert needs to be cognizant of not skewing the results to the benefit of their client while ignoring prevalent factors.

1. Ability to penetrate the market. The expert needs to conduct a market analysis similar to what he or she may have done in business school or when writing a business plan. This analysis includes:

- A description of the state of the industry and where it is headed. Relevant industry metrics such as size, trends, life cycle, and projected growth should all be included here.

1 *Mansour Al-Saud v. Youtoo Media, LP & Christopher Wyatt,* 2018 U.S. App. LEXIS 29680.

2 *The Comprehensive Guide to Economic Damages,* 5th edition, Nancy Fannon and Jonathan Dunitz, Business Valuation Resources, 2018; see also Allyn Needham, "Lost Profits: Fifth Circuit Decision Clarifies Reasonable Certainty for the Modern New Business Rule," *QuickReadBuzz*, Feb. 28, 2019, and Victor P. Goldberg, "The New-Business Rule and Compensation for Lost Profits," *The Criterion Journal on Innovation*, Vol. 1, 2016 p. 341-372.

BUSINESS VALUATION UPDATE

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Business Valuation Update™ (ISSN 2472-3657, print; ISSN 2472-3665, online) is published monthly by Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update (BVU)*, Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814.

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- Identification of the specific target market and the various qualitative and quantitative characteristics of that target market. These include target market characteristics of your customer such as their age and median income. Other items to address are target market spending habits and the market's size in terms of dollars and units. Understanding how much market share the subject company believes it can garner will be very important in determining the ability to profit.

- An analysis of competition detailing the subject company's direct and indirect competitors. Understanding of the supply chain and distribution channels is also necessary information in supporting your lost profits estimation.

- A "SWOT" analysis identifying the subject company and competitors' strengths, weaknesses, opportunities, and threats is a valuable procedure as well as a demonstrative exhibit.

- Barriers to entry need to be documented and understood.

- Time to entry is the last component that not only affects the ability to penetrate, but ultimately the lost profits calculation.

2. Management's strength and experience. While an interview with management is important to understand individual capabilities, experts can perform other procedures to assess the strength and experience of management and its relevance to the new business. First, interviews with employees and "colleagues" in the same or similar industry will help to identify strengths as well as weaknesses. Understanding an individual's weaknesses and determining whether that individual has identified and mitigated such weaknesses is an important indicator of business acumen.

A benchmark analysis, against other leaders, is a strong piece of information to use in interviews.

Design questions that not only address management's plans and beliefs, but also how they plan to make up for any limitations they or their team may have. For example, if a manager is not adept with finance, ask what individuals or other resources have he or she employed to make up for this.

3. Capital resources. Just because someone wants to enter an industry or market doesn't mean he or she has the capital adequacy to do so. An expert should evaluate the balance sheet of the subject company and/or related entities or individuals. This step further addresses management strength and experience.

If internal capital is not available, ask whether management has an alternative plan for funding. If so, how does this affect the profitability and viability of the new business?

4. Target market's needs. No one knew they needed an iPhone, but that didn't deter Apple. This is a harder category to analyze for products and services in unfound industries. However, the expert should study the subject company's trends and the viability of a new product or service by researching the intended users. The answer most likely won't come from a single source of information. Experts should evaluate the legitimacy of any new business especially those in new or emerging industries or markets.

5. Ability to profit. If an expert can "check the box" on the above, the ability to profit section is easily confirmed and stated. Experts need to explain how the categories above allow for the ability to profit. More importantly, experts need to explain and define when profits will occur as it is common for many new businesses to incur losses for a period of time.

Case in point. In my recent engagement, I had to address a new business and lost profits. The breach by defendant was based upon a contractual item, and counsel asked me to calculate lost profits. I first addressed the company's ability to penetrate the market. One of the key findings was that, but for the breach, the subject company would have been able to penetrate because of existing relationships and the brand image of the defendant.

What was key in this analysis was detailing the balance sheet strength of the subject company in order to fund its new business without any debt financing. In my opinion, this one variable showed that the subject company had the "stuff" to purchase fixed assets and utilize capital to fund operations without any outside hypothetical financing. Third, included with my financial analysis was a detailed assessment of management and their qualitative capabilities. The most important aspect was explaining the niche market and correlating future growth based upon capacity figures.

By following the five focus areas above, experts can provide triers of facts with a complete analysis to support their lost profits cases. If assumptions are used, it is important to note them. Any new business will incur attacks from opposing counsel on the speculative nature of future performance. This is expected, but, by articulating the sections above along with the causation, experts can provide triers of facts with a reasonably objective analysis.

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