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SR&ED Newsletter **Edition 2010-1**

Welcome to the first 2010 edition of our newsletter regarding recent developments to Scientific Research and Experimental Development (SR&ED) project management and tax credit claims.

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Basic principles for determining the value of a business

Definition of “Fair Market Value”

“The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”¹

Methods to estimate value

There are three primary methods to estimate the “value” of a particular business:

1) Value of net assets

This is usually the bottom end of the valuation scale (i.e. what could I sell the assets for and how much is left after I pay out the liabilities). Even within this framework the values could vary significantly based on various assumptions (e.g. forced vs. orderly liquidation).

2) Present value of future income or cash flows

Perhaps the most common basis of comparison is based on an estimate of the future earnings or cash flows, typically supported by historical figures.

3) Percentage of revenues (sales)

The third common basis for valuation is to use a percentage of the annual sales (i.e. revenues).

Factors to maximize perceived value of a company

Generally speaking the estimate of value for a corporation is done by:

- stock market analysts for “public” companies (i.e. listed on stock exchanges) &
- certified business valuers (CBV’s) for other “privately owned” businesses.

Some of the major factors they might consider in estimating the value of a particular business typically include:

Company size

Often larger companies (i.e. those publicly listed) trade for multiples higher than similar smaller companies in the same industry.

Growth potential

Ultimately it is the expected future income of the business which drives the current value in the market.

Industry sector

Certain industries trade at earnings and revenue multiples many times higher than others. In particular three industries T.M.T. (Technology, Media and Telecommunication) tend to trade at very high premiums in relation to their actual performance.

Proprietary advantage(s)

What makes you able to beat the competition? Perhaps one of the best ways to inform shareholders of new technical improvements is through the proper disclosure of “development costs” under Canadian “Generally Accepted Accounting Principles” (discussed further in the next article).

Current economic environment

An uncharacteristically harsh operating environment has been experienced during the past two years. This has affected all industries however some appear to be more volatile than others.

Special purchasers

Can a purchaser of the business add additional synergies (e.g. technologies, distribution networks, etc.) which will allow it to obtain additional profits?

Operating margins

High profit margin companies typically have higher earnings multiples.

Notable quote:

“A thing is worth precisely what it can do for you, not what you choose to pay for it.”

- John Ruskin

¹ As defined by the Canadian Institute of Certified Business Valuers (www.cicbv.ca/Glossary)

Market Value Comparative Summaries

Market Value Comparative: Technology vs. heavy mfg. : May 2000 (pre- "Dot com" crash) & 2009 (present)

Industry / Company	Stock market listing symbol (NASDAQ)	Market Value \$ Billions		Revenues \$ Billions		Value/ Revenues		Net Income \$ billions		Value/ Income	
		2000	2009	2000	2009	2000	2009	2000	2009	2000	2009
Technology											
Oracle Corporation	ORCL	224.0	107.3	9.3	22.4	24.0	4.78	1.4	5.5	155.3	19.4
Sun Microsystems Inc.	JAVA	139.0	7.2	13.1	13.9	10.6	0.52	1.3	0.4	108.5	17.7
Microsoft Corp.	MSFT	366.0	209.9	22.4	58.4	16.4	3.59	8.7	14.6	41.8	14.4
<i>Average</i>		252.5	108.1	14.9	31.6	13.5	3.0	3.8	6.8	101.9	17.2
Heavy Mfg. - U.S. Auto											
Ford Motor Co.	F	60.0	25.8	162.6	146.0	0.4	0.18	7.2	-14.7	8.3	-1.8
DaimlerChrysler AG	DAI	56.0	34.2	150.4	135.1	0.4	0.25	5.8	2.0	9.7	17.1
General Motors Corp.	GRM(@NYSE)	56.0	0.5	176.6	149.0	0.3	0.003	6.0	-30.9	9.3	-0.01
<i>Average</i>		57.3	30.2	163.2	215.1	0.4	0.1	6.3	-14.5	9.1	5.1

Hi vs. low technology stock values

Not all industries are created equal. Stock values of various types of industries vary in relation to their actual revenues and earnings.

The table above compares the value of selected "technology" vs. "heavy manufacturing" (U.S. automotive) stocks from 2000 to 2009, examining the volatility of these markets.

In the author's opinion these values are typical for the industries in question and provide a basis for several observations:

- The Market rejects "mature industries"- Major U.S. Automakers each had profits in excess of \$3 billion during 2000, revenues in excess of \$150 billion yet none exceeded \$61 billion in market capitalization!
- Market nurtures "new industries"- In May 2000 (the peak of the "Dot Com" boom) the three **selected technology stocks** (Oracle, Sun & Microsoft) had market capitalization (values) of:
 - 13.5 x revenue (vs. 0.4 for US auto) &
 - 102 x net income (vs. 9 for US auto).

Author's commentary: Implications of "technology" on perceived shareholder value

- Dependent on the overall strength of the market, **technology and media companies** sell at values of roughly 3 to 10 times that of other industries.
- Due to the lack of "real earnings" to bolster their values, the "technology" sector exhibits considerable **volatility** in stock pricing.

Implications to today's high-tech companies are multiple, but clearly outline some of the potential economic benefits from keeping shareholders informed of the "technology value" of a company.

Notable quote:

"If you can dream it, you can do it."

- Walt Disney

Identifying and valuing development costs

Development vs. research expenses

Canadian “generally accepted accounting principles” (GAAP) require that costs be matched to their expected earnings streams.

With respect to “research” expenses, there are several criteria to be used in determining the respective “earnings streams” of the resultant products or processes.

When, at year end, the “research asset” created meets all five of the following criteria all research costs **MUST BE** capitalized as “development costs” and amortized over their expected revenue streams.

- (a) the **product** is clearly **defined and the costs** attributable to it can be identified;
- (b) the **technical feasibility** of the product has been established;
- (c) management has indicated an **intention to produce** and market the products resulting from each project;
- (d) management has been able to **identify a market** for the products resulting;
- (e) management has indicated that **adequate financial resources** are expected to be available to complete the project.

Implications to financial statement readers:

As an investor in a technology based company, the principal value of the investment is likely attributable to the technologies developed to date rather than the value of tangible assets (i.e. furniture and computer equipment) disclosed on the financial statements.

If the statements indicate that expenses were research rather than development the financial statement user may be misled into assuming that work to date was not “successful” when in fact it was.

They may in turn, perhaps justifiably, sue management and the auditor of the company for misrepresentation in cases where they sold the stock without the benefit of this knowledge.

As a result, in the author’s opinion, the entire **capital market** for investing in **technology based companies** in Canada is **inefficient**: in other words,

- investors are required to seek additional information on the company’s products and processes since,
- this information is NOT being disclosed in the financial statements (as originally intended under GAAP).

Example of Development cost disclosure in Financial statements (F/S’s)

In particular the **preparers of the SR&ED claims** are in an excellent position to provide further **guidance** to management on **which projects** in question have met the “**technical feasibility**” criteria and therefore should be considered for disclosure as “development costs” in the financial statements.

An example of how a company might then capitalize and amortize development costs is provided in the following schedule (next page).

Notable quote:

“The way to get good ideas is to get lots of ideas and throw the bad ones away.”

- Linus Pauling

Step 1: Determining if technology capitalization criteria met

Universal Research Corporation

Identification of development vs. research costs for financial statement disclosure for the fiscal year ended December 31, 2009

Capitalization criteria per CICA handbook section 3450.21 *

Project #:	Name:	start	end	Net costs to date @ Dec. 31, 2009:	1) product defined & costs identified	2) technical feasibility established at year end	3) mgmt. intent to market the product	4) future market clearly defined	5) adequate resources exist to bring to market	Devel. Cost (Y / N)?
901	Widget development	Jan-08	Jun-10	\$315,582	Y	Y	Y	Y	Y	Y
902	Widget improvement	Jan-09	Aug-10	\$24,131	Y	Y	Y	Y	Y	Y

Notes:

* - MUST capitalize & amortize costs if ALL 5 "development cost" capitalization criteria have been met at year end.
This is performed EACH taxation year. In this example, project 901 had met the criteria for both the 2008 and 2009 taxation years

Step 2: F/S disclosure of technology "development costs"

Project / product	Amount	Total Cost	Year	ITC on expenses*	Total capitalized cost*	Amortization			NBV 2009
						start	rate**	Accumulated Amortz'n2009	
901 Widget development	\$66,000	\$66,000	2008	\$27,390	\$38,610	2008	20.00%	\$7,722	\$315,582
	<u>\$512,000</u>	\$578,000	2009	\$212,480	\$404,130	2009	20.00%	<u>\$80,826</u>	
902 Widget improvement	\$55,000	\$55,000	2009	\$22,825	\$32,175	2009	25.00%	\$8,044	\$24,131
Totals	<u>\$633,000</u>	<u>\$699,000</u>		<u>\$262,695</u>	<u>\$474,915</u>			<u>\$96,592</u>	<u>\$339,713</u>

Notes:

* The capitalized costs should be net of related grants &/or SR&ED investment tax credits on this research
** Amortization rate - straight line over estimated economic life of the technology (5 years) with NO half year provision

Results & implications to F/S users:

In the case above the company would have:

- the net book value (NBV) of these development costs
- disclosed on the balance sheet (i.e. as an asset)
- rather than in the "retained earnings" of the company.

In the author's view this will allow users to ask questions such as:

- Does the world need this widget (i.e. demand)?
- What advantage does this technology represent in the marketplace &
- How much is it worth?

CRA's SR&ED watchdog

SR&ED Ombudsmen request for feedback

As part of a performance review of the Canada Revenue Agency's overall management of the SR&ED program the Ombudsmen has requested feedback on **5 main questions** for claimant & preparer feedback:

Re. Post Feb. 21/07 SR&ED claims:

- Did CRA adequately inform taxpayers about the recent changes to the T661 form?
- Has the cost of filing and defending an SR&ED claim changed?
- Did CRA accept your request for a "second opinion"?
- Did CRA review and audit your claim in a professional and courteous manner?
- Has any CRA person ever attempted to dissuade you from retaining professional advice?

Notable quote:

“A committee is a cul-de-sac down which ideas are lured and then quietly strangled.”

- Sir Barnett Cocks

The Forms for submission are available at:

<http://www.taxpayersrights.gc.ca/frm-fll-eng.pdf>

Author's commentary:

While the firm has found that virtually all CRA SR&ED officials operate in the most professional of manners there have likely been isolated incidences of complaints which have resulted in the creation of the “ombudsman” as a mechanism to prevent any abuse (real or perceived).

Though the events in question are likely few and isolated, in the author's opinion it indicates a strong commitment by the federal government to maintaining (perhaps enhancing) the integrity of the program with respect to;

- objectivity of the reviewers
- consistency of review procedures &
- overall professionalism of conduct.

As a result we encourage claimants and claim preparers to provide feedback on any issues they deem appropriate.

Questions or feedback

We welcome your questions or feedback on any issues raised in this letter.

We also encourage interested parties to examine:

- past SR&ED newsletters &
- our SR&ED tax guide [the Guide to R&D Base],

all of which are designed to simplify the SR&ED tax credit claims. These are available from our website at,

www.meuk.net

- For an overview of our “R&D Base” software &
- additional tutorials defining eligible SR&ED activities,

please go to:

www.rdbase.net

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