PERSPECTIVES

Lost Business Profit Damages Claims: Calculating Lost Revenues

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

Lost profit damages are calculated when a plaintiff's business alleges that the defendant's actions impaired its operations in some manner. Determining lost revenues is a critical component in calculating lost profits. Lost profits are based primarily on lost revenues net of the cost associated with generating the lost revenues (saved and/or extra operating expenses can be additional components to lost profits).

This article will discuss some of the most common methods used to calculate lost revenues and the importance of facts and data supporting such calculations.

DEFINITION OF LOST REVENUES

In simple terms, lost revenues measure the net difference between the plaintiff's projected ("but-for") revenues, assuming no incident, and the plaintiff's actual and projected revenues following the defendant's actions.

LOSS PERIOD

Lost revenues are typically calculated from the date when the defendant's actions first impact the performance of the plaintiff's business ("the incident") to a specified date following the subject incident. This post-incident date can be based on the time period required for the plaintiff's projected operating performance to return to a level it would have achieved but-for the defendant's actions. This date can also be based on other factors such as the terms of a particular contract.

The length of the loss period is often a source of contention. Calculating lost revenues (lost profits) on an annual running total basis allows this measure of damages to be quickly evaluated at various points in time.

BUT-FOR REVENUES

Assuming the plaintiff's business has enough operating history and revenue data to evaluate pre-incident trends, projected post-incident revenues "but-for" the defendant's actions are usually based on the average annual pre-incident revenues ("basis") and revenue growth rate.

In the case where a plaintiff's business does not have enough operating history prior to the defendant's actions, lost revenues can be based on a comparison between the plaintiff's revenues and those of comparable companies or industries over the same time period.

Revenue Basis

The basis should reflect the average annual pre-incident revenues as of the date of the incident. The pre-incident period used to determine the basis should be long enough to account for the most recent pre-incident revenue trend.

For example, if revenues were consistently trending up or down over a multi-year period prior to the incident, the revenues for the 12 months prior to the incident could be used as the basis. However, if pre-incident revenues fluctuated from year to year with no clear trend, it might be more appropriate to use a multi-year average, or weighted average, for the revenue basis.

The pre-incident period used to determine the basis should also be long enough to account for any seasonality related to revenues. Seasonality, or regular fluctuations in business performance that recur every calendar year, can only be determined if there is at least 12 months of pre-incident revenue data. For example, if a plaintiff's business typically generates 75% of its annual revenues during the second half of each calendar year, projecting post-incident revenues based only on data for the second half of the most recent calendar year prior to the incident could overstate future revenues.

Revenue Growth Rate

The average annual change in pre-incident revenues, or growth rate, is typically applied to the pre-incident revenue basis to determine projected post-incident revenues.

The appropriate pre-incident time period should be used to determine both the growth rate and basis. For example, let's assume that a plaintiff's business started in Year 1 and achieved average annual revenue growth of 30% from Year 1 to Year 3, before leveling off to a more sustainable 10% average annual growth rate for Year 4 through the date of the incident in Year 8. In this case, the revenue basis and growth rate for Year 4 through Year 8 should be a better indicator of post-incident performance than Year 1 through Year 8, since Year 4 through Year 8 represents the most recent period of operations prior to the incident, and the growth rate for Year 1 through Year 3 did not appear to be sustainable over the long term.

In certain cases, a plaintiff will claim that, but-for the incident, a future event would have occurred, necessitating a deviation from revenue projections based on pre-incident trends. For example, a plaintiff might claim that a distributor or client contract was signed just prior to the incident that would have accelerated the growth of revenues going forward. However, unless supporting documentation and analysis can be produced, this type of claim could be dismissed as overly speculative.

ACTUAL/PROJECTED POST-INCIDENT REVENUES

The next step in calculating lost revenues is to determine the actual and projected post-incident revenues assuming that the plaintiff's business has been impaired as a result of the defendant's actions. Actual post-incident revenues should be based on supporting documentation.

Assuming actual revenues do not extend to the end of the future loss period, revenues can be projected from the end of the "actual" period to the end of the future loss period based on various methods. If actual post-incident revenues exist over a multi-year period, a post-incident basis and growth rate can be used to project revenues to the end of the future loss period. If there is limited post-incident revenue data, industry or comparable company growth rates can be used for future projections. Any methods that are used should result in projected post-incident revenues that are realistic given the but-for revenues over the same future period.

CONCLUSION

This article has discussed some of the most common methods used to calculate lost revenues. Given the subjective elements of business projections and damage models, the appropriate methodology should be based on specific facts related to the plaintiff's claim, along with the availability of data related to the plaintiff's business, plaintiff's industry, and comparable companies.

ACKNOWLEDGMENTS

We would like to thank Mike Cordova for providing insight and expertise that greatly assisted this research.

Mike Cordova is an Assistant Vice President in J.S. Held's [Forensic Accounting / Economics / Corporate Finance] practice. With more than 15 years of experience, specializes in the calculation of economic damages in complex commercial litigation and personal injury matters related to lost profits, business interruption, and business valuation. He also has a diverse professional background in marketing, operations, and entrepreneurship, providing him with specialized industry and functional knowledge. Mike works with both plaintiff and defense law firms and has analyzed financial matters within hundreds of industries. He consults with businesses and provides expert testimony.

Mike can be reached at mcordova@jsheld.com or +1 213 223 0406.

This publication is for educational and general information purposes only. It may contain errors and is provided as is. It is not intended as specific advice, legal or otherwise. Opinions and views are not necessarily those of J.S. Held or its affiliates and it should not be presumed that J.S. Held subscribes to any particular method, interpretation or analysis merely because it appears in this publication. We disclaim any representation and/or warranty regarding the accuracy, timeliness, quality, or applicability of any of the contents. You should not act, or fail to act, in reliance on this publication and we disclaim all liability in respect to such actions or failure to act. We assume no responsibility for information contained in this publication and disclaim all liability and damages in respect to such information. This publication is not a substitute for competent legal advice. The content herein may be updated or otherwise modified without notice.