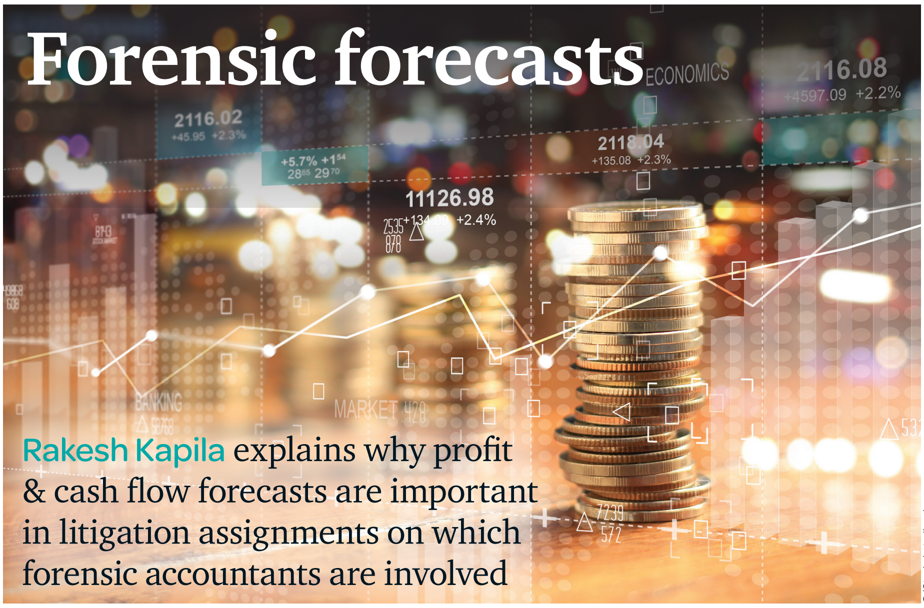
# Forensic forecasts






Rakesh Kapila explains why profit & cash flow forecasts are important in litigation assignments on which forensic accountants are involved

**IN BRIEF**

- Relevance of profit and cash flow forecasts in litigation assignments.
- Types of case in which forecasts are likely to be important.

Information on the financial affairs of a business is important in many types of legal action, including loss of earnings or loss of profits claims, and cases in which valuations are necessary, for example shareholder disputes and matrimonial settlements. Since the available information such as financial statements and management accounts relates to the past, forensic accountants often also need profit and cash flow forecasts in many litigation assignments on which they are involved. This article highlights the types of case in which such forecasts are likely to be important.

## Loss of earnings

Income projections are required for an injured self-employed claimant who has sustained a future loss of earnings and in considering 'loss of dependency' calculations representing the loss suffered by the dependants of the deceased after a fatal accident. Forecasts will need to be prepared of the likely future profits of the business. The period for which the loss of earnings is calculated will depend on the circumstances of each case.

Since a small business may not have the expertise to provide profit forecasts, the forensic accountant may need to extrapolate from the past to the future and consider general economic conditions, the industry sector of the business, its customer base and the trading profiles of competitors. A critical consideration of forecasts will be required if the business has a lack of trading history or if the expert accountant is provided with unrealistic projections.

## Loss of profits

A loss of profits may be suffered by a business from a breach of contract or tort, or as a result of accidents, fires, floods or other causes. In considering a loss of profits, a forensic accountant will need to appraise critically the claimant's own forecast for the period during which the claimed loss occurred as well as extrapolating from the past to the future and possibly obtaining data on the performance of comparable businesses during the period concerned.

Many calculations of lost profits are driven by a 'predicted' sales subject to uniform gross profit margins and the deduction of certain overheads. The forensic accountant needs to be aware of the constraints which may restrict the ability of the business to achieve the forecast sales. Such constraints may include access to required funds and production restrictions. In addition, account would need to be taken of expenses which increase in 'steps' rather than strictly in proportion to turnover, eg the need to rent larger premises beyond a certain point. It may also be necessary to consider whether any future loss is permanent and whether it needs to be discounted to account for the benefit of receiving a future income stream at an 'earlier' stage.

## Business valuations

Business valuations are often needed in connection with legal actions such as divorce cases, disputes between shareholders or partners and cases involving the loss of a business opportunity. In addition, valuations may occasionally be required in personal injury or loss of profits cases in which a business has ceased trading or has been sold.

In many cases, the primary focus of the valuation will be on the capitalised maintainable earnings of the business or on the value of discounted future cash flows. In addition to reliable data on the business' most recent performance, data on the order book and any budgets, forecasts or business plans prepared by the business will be required as indicators of future performance. Careful consideration will need to be given to trends in the turnover of the business and changes in its customer base as well as to the level of competition in the sector. Maintainable earnings as a basis for valuing businesses often need to be considered for longer time horizons than those involved in loss of profits cases.

## Matrimonial disputes

In addition to the importance of profit forecasts in business valuations, cash flow forecasts play a crucial role where a family company's funds are used to provide a capital sum or to increase the income of the shareholders/directors. The business' future cash needs and its ability to provide 'surplus' cash will be based on many aspects including its underlying trading performance, future planned repayments of loans, budgeted capital expenditure and the timing of future tax liabilities.

The effects on cash flow of selling 'surplus' assets will require careful consideration, ie large inflows from disposals may be offset by lower cash inflows after the disposal of income-producing assets.

## Wrongful trading

In order to have been wrongfully trading, it must emerge in the course of a company's winding up that a director, prior to the commencement of the winding up, knew or ought to have concluded that there was no reasonable prospect that it could avoid going into insolvent liquidation. A key consideration is the extent to which the directors relied upon updated financial data including profit and cash flow forecasts and considered the company's solvency and its ability to be profitable in the foreseeable future.

## Conclusion

Given the inherent uncertainties in the economy and the volatility in the trading activities of many types of business, the skills of the expert accountant are likely to be required to review the assumptions underlying profit and cash flow forecasts in various types of legal action. **NLJ**

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