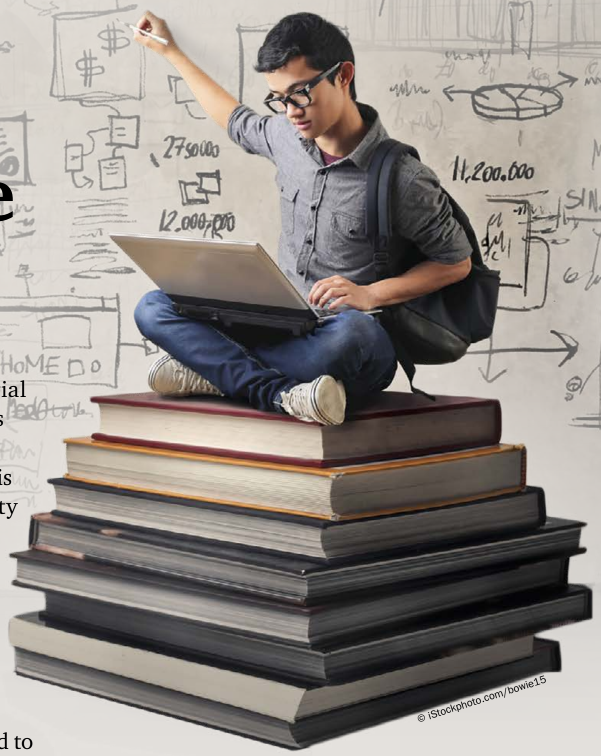
Loss of profits cases: the forensic accountant's role

George Sim looks at the ways in which a forensic accountant can add value.



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IN BRIEF

- Determining a loss of profits.
- Addressing potential difficulties.

A business may suffer a loss of profits through breach of contract or tort (eg negligent installation of machinery), or as a result of events such as floods. In these situations solicitors may need to obtain advice and possibly an expert report expressing an opinion on the quantum of the losses.

External & internal factors

Forensic accountants will establish how a business earns its income and the nature of the costs it incurs. They will consider the circumstances of a loss which is the subject of a claim, reviewing external factors such as markets and the general business environment and internal factors such as management, cost structures and plans for the business.

Reviewing external factors involves putting the claim into the context of the claimant's general financial position. It will be important to consider sales in the claimant's business sector at the relevant time and whether there were features of the sector which might have had an impact on profitability. Relevant information may be available from third party sources such as trade associations and publications, market researchers and industry experts.

Forensic accountants will be able to extract useful information from a company's internal sources. In addition to published financial statements, such sources will include detailed information such as: management accounts; board minutes; sales data; customer enquiries; labour cost information; materials costs; and details of overhead expenses.

What to ask forensic accountants to do

Instructions from claimant's solicitors

Expert accountants instructed in loss of profits claims will consider the strengths and weaknesses of the financial aspects of the claim. If forensic accountants are instructed by solicitors acting for the claimant, they will build up the quantum of the claim, which will always include for a standard business: loss of gross profits, ie turnover less cost of sales; and/or: extra costs of working; and may also include: uninsured material damage (eg to stock or equipment); less costs saved.

Fundamentally, a loss of profits claim is a claim for the contribution to profitability which the business might reasonably have expected had it not been for the incident in question.

Instructions from defendant's solicitors

Forensic accountants instructed by a defendant's solicitors are normally asked to carry out a critical review of the assumptions and calculations on which the claim is based. They will raise questions in several areas. For example:

Lost sales

- Could the claimant have handled any increase in turnover, or were there production or other constraints which would have limited sales in any event?
- Was competition in the claimant's markets increasing or decreasing?
- Was the demand for the claimant's products or services as high as asserted in the claim?
- Did other factors affect the claimant's business sector (eg the impact of new regulations, changes in distribution patterns, or changes in fashion)?

Lost production

- Did the claimant take all available steps to mitigate the loss, for example by subcontracting production or reallocating work within the business?
- Did lost production equal lost sales—what was the stock position?

Gross profit

- How reliable were the claimant's accounting records in differentiating between the cost of sales (which varies with turnover) and fixed overheads (which do not)?

Generally

- How reliable was management information, including management accounts?

Sometimes it is questionable as to whether a business has suffered any significant loss. In one such case a flood damaged a large number of negatives held by a photographic library. The proprietor claimed lost profits based on the estimated value of reprints from the archive. We reviewed sales invoices and found that in the years before the flood very few of the negatives which were damaged had been used for reprints. The case settled for a small proportion of the amount claimed.

Potential problem areas

It is important to address the issue of the 'remoteness' of the loss, as the courts will not normally be sympathetic to claims for losses over extensive periods, on the basis that the longer the period of a claimed loss, the more likely it is that the profitability of a business will be affected by factors other than the event, breach or negligence which is the subject of the claim.

It is also important to note that a claim for the loss in value of a business (as opposed to loss of profits) may be appropriate where a business has ceased trading or has been sold. In one case on which we advised, the proprietor of a café claimed against a local authority following a closure order which had not been effected properly. The business had been operating for only a few months, and its accounting records had been destroyed. We prepared a valuation based on the goodwill element of the purchase price and the enhancement of goodwill which it could be argued would have resulted following the acquisition.

Expert accountants will need to check that there is no double counting in a claim—for example between extra costs of working and calculation of lost profits. A loss of profits claim should similarly be reduced by the extent of any benefits received as a result of the incident. If a claimant's business is reinstated in a way which results in some improvement to its facilities and/or methods of working, this betterment must be excluded from the claim.

Claims for damages sometimes include the cost of managerial time in dealing with the problem which is the subject for claim. This element of a claim is only likely to be sustainable if it can be proved that management attention was diverted from more profitable activity. The claimant will need to disclose detailed records of the management time spent in dealing with the situation.

A further potential problem area may be the availability of accounting records and other documentation, especially if the incident which is the subject of the claim took place some time ago.

As in other types of work, expert accountants will need to have regard to accounting practices and standards which were extant at the time of the incident which caused the alleged losses.

It is important to bear in mind the distinction between an owner-director's personal loss, which may simply be a loss of salary and other benefits as a director, or which may also include loans to and money invested in the business if the business fails, and a company's loss, which may be the capitalised value of maintainable profits after deducting a notional salary for the director.

Expert accountants will need to consider the taxation aspects of loss of profits claims. Although it is common practice for experts to disregard taxation in their calculations, they should state the fact that they have done so in their reports. The incidence of income tax or corporation tax is not likely to be a major issue, given that damages as compensation for the loss of trading income are treated as income in the hands of the recipients. The receipt of such damages is normally taxed in the period in which the damages are received, although there are some exceptions.

Conclusions

Forensic accountants, having been trained in the analysis of business situations and the extraction of information from accounting records, can give extremely valuable assistance to instructing solicitors in loss of profits claims. As in other aspects of forensic work, they can investigate the circumstances of the loss, analyse the effect on quantum, and advise on the strengths and weaknesses of different aspects of the claim. For these reasons, it is often constructive to ask a forensic accountant for a view on the financial aspects of a loss of profits case. **NLJ**

Forensic examples

- In a case in which we were instructed by solicitors acting for a defendant, a firm of auctioneers claimed about £100,000 from a firm of building contractors in respect of loss of profits resulting from alleged damage to the auctioneer's premises. We concluded that there was a lack of evidence to underpin the assumptions about growth in sales on which the claim was based. It also appeared that the reasoning behind various parts of the argument on quantum was flawed. The claimant subsequently decided not to pursue the claim.
- In another case, we examined a claim for work-in-progress destroyed in a fire at a light aircraft manufacturing company. We established that the company had poor systems for recording the value of work in progress. As a result the defendants were able to reduce substantially the value of this head of claim.

George Sim is a consultant with Sim Kapila, a firm of chartered accountants based in London WC2 which specialises in forensic and investigative accountancy. *(gsim@simkapila.co.uk, www.simkapila.co.uk).*