Lost Profit Claims In A Recessionary Environment

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According to economists, the "Great Recession" began in late 2007 and ended in June 2009. To many individuals and businesses, the end date is nothing more than an academic label, as the effects of the recession linger. History and labels aside, attorneys presently involved in lawsuits for lost profits may find the recession is front and center. This is especially true for lawsuits involving lost profits where the underlying action occurred during the 2007 through 2009 timeframe.

A recessionary environment presents a myriad of challenges for dealing with lost profits. These challenges include, but are not limited to, establishing the causal link between an action and the alleged lost profits (causation), as well as forecasting sales and expenses to establish profits but-for the alleged action.

Issues with Determining Causation

The swiftness and severity of the late 2008 downturn attacked companies' income statements and punished their balance sheets. The books and records of many companies undoubtedly reflect a sudden, and in many cases, sustained, deterioration in performance. But how much, if any, of the deterioration is related to the allegations in a particular lawsuit? Any claim for lost profits that occurred during the late 2007 through early 2009 timeframe should be carefully scrutinized for causation.

Due to the financial complexities brought to bear by the recession, it is not enough to study the books of the company alleging lost profits. Rather, one must study general economic trends on a national, regional and local basis. A fundamental understanding of economic conditions and trends will assist one in developing an expectation for how the subject company should have performed. These expectations pave the way for separating the decline in business performance due to the alleged action from the decline due to economic conditions.

Proper industry analysis is also paramount. This includes not only the subject company's industry, but also the industry of its customers if the company is engaged in business-to-business transactions. Some industries are affected more than others in a recession. An industry analysis allows one to consider any events, trends or circumstances affecting business performance that is unrelated to the alleged action.

Issues with Forecasting Sales

Lost profit claims start with a determination of lost sales. Sometimes, the analysis involves a simple "comparison to last year" method. While forensic accountants think this method is often long on simplicity but short on accuracy, there are times when it is appropriate. However, in a recessionary environment, this method is down right toxic; one year is inherently incomparable to the next. For this reason, trend analysis is critical.

A year-to-year, or even quarter-to-quarter, trend may prove inadequate in isolating the impact of the alleged action versus the impact of the recession. Instead, one must carefully study the intra-year trend, month-over-month trend, as well as the rate of change in the trend. An analysis of the subject company's trend relative to competitors, the general industry, and various economic indicators may also prove insightful.

In a recessionary environment, one may need to employ several trends in stages. For instance, it may be unreasonable to forecast an unabated declining sales trend into a long period. Depending on economic and industry conditions, one may need to apply a recovery factor during the measurement period. Another issue arises for those businesses that rebound off of a severely low base period and give the illusion of a growth trend. This illusory trend may only reflect the company is recovering from unusually low levels and not actually growing.

Issues with Forecasting Expenses

The determination of but-for profits, and ultimately lost profits, involves the study of both sales and expenses. Just as the sales part of the equation presents challenges in a recessionary environment, expenses do as well. For instance, if a company lowers its selling price to attract more customers, the gross margin is affected. In times of recession, companies typically first respond by reducing payroll. Also, some companies may fall behind with creditors. If such a company keeps its books on a cash basis, reported expenses are unreliable.

The bottom line is this – just as sales trends may require forecasting in stages, expenses may as well. Depending on the timing of the alleged action, as well as the length of the measurement period for lost profits, one may find that pre-recession, as well as recessionary, financial statements are not reliable for forecasting without extensive adjustments and analysis.

Economists tell us the recession is officially over, but the impact continues for those dealing with lawsuits for lost profits. Determining causation, accurately forecasting sales and expenses, and obtaining reliable, normalized financial information will be in focus for years to come.

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