

# Back to the Future: New Approach to Lost Profits

**Consider the Probabilities**, Gary L. Freed, CPA, CVA, (Clifton Gunderson, LLP, Phoenix), Benjamin Miller, ASA (CG, Denver), and Rick Takemoto, ASA (CG, Denver), *National Litigation Consultants' Review*, (January, 2006) pp. 1- 4

Most analysts are well-acquainted with the four standard methodologies used to calculate lost profits, but they may not be aware of their pitfalls. The "Before and After" approach, for example—where you consider the economics of the plaintiff prior to the harm and after, and then use the difference to quantify damages—doesn't isolate other events or issues that may have contributed to the change.

Similarly, in the "Forecast of Sales" method, regression analysis attempts to scale the plaintiff's prospective economics back to the present—but may confuse the trier-of-fact. (The authors recall how one judge rejected the use of multiple linear regressions in a case—not because it was wrong, but simply because he didn't understand it.) The "Yardstick" and "Market Share" approaches likewise have their limitations as well as their strengths. A lost profits calculation might warrant the use of one or a combination of these four approaches, in addition to the AICPA's *Prospective Financial Information—AICPA Audit and Accounting Guide*.

## Probabilistic approach

The authors present their "probabilistic methodology," which considers multiple damages scenarios and then attributes a percentage of probability to each. "By doing this, the practitioner attempts to quantify the risk factors inherent in the model."

First, the analyst obtains or develops multiple alternatives and then assigns each a weight. For example, what follows are four possible damage amounts under different assumptions:

Most likely (forecast)	\$100
Other likely (projection)	\$150
Other likely (projection)	\$ 70
Other likely (projection)	\$ 0

Keeping in mind that the AICPA standards define

a "forecast is what is expected to happen, while a projection is what might happen given certain hypothetical situations"—what's the best use of these numbers? Analysts might average them, or weight them simply, i.e., 4-3-2-1. Some might take the median while others would drop the high and low and average the remainder.

Under the probabilistic approach, however, analysts would interview the plaintiff and all other relevant sources, and then attempt to determine the relative likelihood of each result. "Usually...a qualitative judgment can be reached if not a quantitative judgment as well." Assuming that the analysts has assessed the relative probabilities of the outcomes in the above example as 50%, 30%, 15% and 5%, respectively, the damages would be \$105.50.

Skeptics may question whether the method injects another layer of subjectivity into the analysis, thereby exposing the advocate to increased risk. "Given the need for the many assumptions the practitioner must make, the added ones of probability do not represent such an incredible stretch," especially if the analyst has done the appropriate and accurate research.