

Attaining Reasonable Certainty

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National Association of Certified Valuators and Analysts

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in Economic Damages Calculations (Part I of III)

The AICPA has issued two practice aids, one on 2015 and most recently in November 2018, focused on the calculation of economic profits and damages. The purpose of this article—the first of three on this topic—is to provide the reader with an understanding of Chapter 1 (Revenue and Growth Rates) of the 2018 Practice Aid as well as certain other publications containing a body of knowledge on the best practices for developing “but for” revenues and revenue growth issues in lost profits models. Later articles will deal with Chapter 2 (Costs) and Chapter 3 (What Constitutes Best Evidence) of the 2018 Practice Aid and related topics.



Resources:

[Financial Litigation Specialty: Commercial Damages and Lost Profits](#)

[The Reasonable Certainty Requirement in Lost Profits Litigation—Best Practices for Proving Your Damages Calculation](#)

[Explaining Damages to Judges and Juries](#)

Economic Damages Calculations

In 2015, the American Institute of CPAs (AICPA) Forensic and Valuation Services (FVS) issued a practice aid entitled, "Attaining Reasonable Certainty in Economic Damages Calculations". That publication added to the body of knowledge available to experts calculating lost profits and other forms of economic damages.

In November 2018, the AICPA FVS issued a second practice aid entitled, "Attaining Reasonable Certainty in Economic Damages Calculations" (hereafter, the 2018 Practice Aid) further adding to the body of knowledge. The 2018 Practice Aid was updated after the AICPA decided that case law research may yield additional topics worth presenting. (The AICPA also recently updated its "Calculating Lost Profits" practice aid and added a new practice aid entitled, "Communicating in Litigation Dispute Services.")

The purpose of this article—the first of three on this topic—is to provide the reader with an understanding of Chapter 1 (Revenue and Growth Rates) of the 2018 Practice Aid as well as certain other publications containing a body of knowledge on the best practices for developing "but for" revenues and revenue growth issues in lost profits models. Later articles will deal with Chapter 2 (Costs) and Chapter 3 (What Constitutes Best Evidence) of the 2018 Practice Aid and related topics.

AICPA FVS practice aids are prepared by AICPA staff and volunteers and do not reflect AICPA positions, nor establish standards or preferred practices. The AICPA's position is the practice aids provide illustrative information on the subject matter. The author is both an AICPA and NACVA member and notes in certain of his expert reports, where applicable, that the work performed was guided by the *AICPA Standards and Practice Aids*; the *Litigation Services Handbook, The Role of the Financial Expert*, Sixth Edition, Roman L. Weil, Daniel G. Lentz, and David P. Hoffman (the Weil Text); and the *Comprehensive Guide to Lost Profits and Other Commercial Damages*, Fifth Edition, Nancy J. Fannon and Jonathan M. Dunitz (the Fannon Text).

While the authors of the 2018 Practice Aid were members of the AICPA Forensic and Litigation Services Damages Task Force, I submit the materials discussed in the 2018 Practice Aid—as well as in the Fannon Text and the Weil Text—would be useful guidance for AICPA members, NACVA members and/or other experts performing lost profits and/or other economic damages calculations.

The 2018 Practice Aid noted that lost profits claims include key elements: (1) the estimate of "but for" revenues ("the estimate of revenues that would have been earned but for the alleged bad act")^[1] and (2) revenue growth ("how the lost revenues ... would have grown ... over the applicable damage period").^[2] The 2018 Practice Aid noted "there is a robust body of case law" that examines the expert's role in estimating "but for" revenues and revenue growth.

Courts concern themselves regarding the expert's use of accepted methodologies and whether revenue estimates and growth rates are grounded in solid analytical processes. Courts examine both the application of reliable principles and methods as well as the integrity and reliability of the underlying data used to estimate "but for" revenues and revenue growth.

The court cases cited within the 2018 Practice Aid focused on whether defendants or third parties had prepared marketing plans and/or sales projections; the expert's understanding and/or independent analyses, verification and/or testing of such plans and/or projections; and the expert's explanation of the analytical gap between the data and opinion offered regarding the "but for" revenues and revenue growth within economic damages calculations.

As a generalization, courts require experts both (1) to "conduct some sort of independent investigation or verification to ensure that the data [used] is both accurate and helpful to the Court"^[3] and (2) to "[gain] a working familiarity with the borrowed data so that the expert can demonstrate the data's reliability".^[4]

The court cases cited within the 2018 Practice Aid concerned themselves with the experts' improper dismissal of evidence that contradicted the underlying conclusions; the expert witnesses' failure to analyze competing products; the experts' assumptions regarding static competitive positions over time; and any contradicted market share estimates. As a generalization, courts view unfavorably assumptions that are arbitrary and/or the "cherry-picking" of evidence.^[5]

The 2018 Practice Aid focuses on two separate hurdles that experts may need to cross: one relating to the admissibility of testimony (under *Daubert, in limine* and/or other motions seeking to bar the expert), the second being the weight given the testimony (likely after cross-examination). In the latter instance, the factfinder generally decides how much weight to give or not give expert's opinions. In the latter instance, the issue is no longer about the selection of a methodology, but the more granular decisions involving the elements of the calculations of economic damages.

These granular decisions involve (for example) selecting the appropriate base period for measuring "but for" revenues and revenue growth; analyses of trends (and rejection of "outliers"); performance of comparable benchmarks; "the selection of data inputs to employ in [the economic damages] model";^[6] and "[that] there is an analytical basis for the data used in the method employed".^[7]

The expert should evaluate, where applicable, that the yardsticks are sufficiently comparable to the target: that "the samples [are] fair congeners"^[8] (things of the same kind or category as another); any averaging performed (because "an average of unknowns [is]

also an unknown”);^[9] and the sufficiency of a historical track record (both of the target and the benchmarks).

The 2018 Practice Aid concluded that “courts will exclude expert opinions that contain revenue and growth estimates not based upon accepted methodologies and approaches, and which are generally untethered from any meaningful analyses.^[10] Moreover, “the courts are clear that experts need an analytical basis for relying upon data.”^[11]

The Fannon Text also provides guidance on estimating the relevant lost revenues as part of the chapter on “Performing Credible Lost Profits Analyses.”^[12] The Fannon Text^[13] reinforces that the focus on estimating lost revenues in a lost profits analysis should be on approaches and methodologies but goes somewhat further than the 2018 Practice Aid as follows: “The approaches/methodologies that a financial expert uses to determine the amount of estimated lost revenues should consider and address the reasonableness of his or her analyses, including the documents relied upon and assumptions utilized on which the calculations are based”.^[14]

The Fannon Text provides additional guidance over the entire lost profits claim, not just the baseline year, noting^[15] analyses forecasting multiple years have the risk that, over time, lost profits models may become more speculative and/or unknown unless supported by sufficiently relevant data. As to growth rates, the Fannon Text notes that^[16] the financial expert may look at growth rates experienced prior to and after the analyzed damages period and/or the subject company’s actual experience with other operating units of the company.

By way of illustration, the author successfully used similarly-themed restaurants run by the same owners, the same management company, with similar employee headcounts, but in different cities, as an internally-available benchmark to evaluate the profitability (or lack thereof) of the subject company being analyzed. Ultimately, the restaurant benchmark data was used to develop projections of “but for” revenues and revenue growth in lost profits models. However, this process, did not always produce clear trends of “but for” revenues and revenue growth—requiring significant additional analyses and explanations.

The Weil Text^[17] extends the above discussion when discussing measuring “but for” revenues for a newly established business—an additional difficulty for a lost profits expert. The Weil Text provides that Courts now hold that such businesses can recover damages, provided they have been proved with “reasonable certainty”.^[18] In the context of “but for” revenues and revenue growth issues in lost profits models, The Weil Text provides additional guidance regarding the use of averages and indexes^[19]; the use of ranges^[20]; lost profits vs. lost business value^[21]; time considerations^[22]; causation^[23]; regression analysis with confidence interval^[24]; and Monte Carlo simulations^[25].

While “it’s tough to make predictions, especially about the future,” (a thought generally ascribed to Yogi Berra), experts preparing lost profits calculation now have ever-increasing levels of guidance regarding best practices for developing “but for” revenues and revenue growth issues in lost profits models—the 2018 Practice Aid now contributes further to that body of knowledge.

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[1] AICPA FVS Practice Aid: Attaining Reasonable Certainty in Economic Damages Calculations: Pg 11.

[2] *Ibid.*, Pg 11.

[3] *Ibid.*, Pg 15.

[4] *Ibid.*, Pg 15.

[5] *Ibid.*, Pg 18.

[6] *Ibid.*, Pg 21.

[7] *Ibid.*, Pg 22.

[8] *Ibid.*, Pg 23.

[9] *Ibid.*, Pg 24.

[10] *Ibid.*, Pg 28.

[11] *Ibid.*, Pg 28.

[12] The Fannon Text Ch 10.

[13] *Ibid.*, Pg 236.

[14] *Ibid.*, Pg 236 drawing on an appellate courts position in *Wallace v. Kalnis* (2013).

[15] *Ibid.*, Pg 238.

[16] *Ibid.*, Pg 238.

[17] The Weil Text, Sec 4.20.

[18] *Ibid.*, Sec 4.21, citing Robert L. Dunn, *Recovery of Damages for Lost Profits*, 4th ed., vol. 1 (Westport, CT: Lawpress Corporation, 1992), pg 345.

[19] *Ibid.*, Sec 4.5 (a).

[20] *Ibid.*, Sec 4.5 (b).

[21] *Ibid.*, Sec 4.5 (c).

[22] *Ibid.*, Sec 4.5 (d).

[23] *Ibid.*, Sec 4.5 (e).

[24] *Ibid.*, Sec 4.5 (f).

[25] *Ibid.*, Sec 4.5 (g).