In commercial litigation matters, including contract disputes, intellectual property infringement, fraud and unfair competition or negligence claims, a primary role of a financial expert is to quantify economic damages that may have been suffered by the plaintiff or to defend against such claimed damages. Economic damages are meant to restore the plaintiff to the financial position the plaintiff would have been in, “but for” the defendant’s alleged harmful acts.

When quantifying economic damages, financial experts are commonly faced with the question of which approach may be most appropriate to use — lost profits or lost business value?

**Lost Profits Approach**
When the harm is for a finite period of time and is related to a separately identifiable cash flow, a lost profits approach is generally to a lost business value analysis due to the finite period of damages. This approach represents the difference between profits the plaintiff would have attained, “but for” the harmful event, and profits actually attained. Profits can be defined variously depending on the venue, facts and circumstances of the underlying engagement. The calculated lost profits are then adjusted for mitigation, if any. A lost profits analysis is commonly employed in breach of contract, intellectual property and general commercial litigation cases.

There are five generally accepted methods in calculating lost profits: sales projection, before and after, accounting for profits, yardstick and market share methods.

1. Financial experts commonly apply the sales projection method which compares forecasted profits before the harmful event to actual profits after the harmful event.

2. The before—and after method, which compares profits before the harmful event to profits after the harmful event, is appropriate for many businesses.

3. The accounting for profits method is based on incremental sales or profits achieved by the defendant as the result of the harmful event. While applying this method, financial experts should be reasonably certain that the plaintiff would have attained the same amount of sales or profits as the defendant, “but for” the harmful event.

4. The yardstick method compares profits to a quantifiable yardstick, before and after the harmful event. This method is typically used in industries where profit margins are closely tied to a measurable yardstick such as the price of raw material.

5. The market share method is based on the market share the plaintiff would have attained, “but for” the harmful event. This method may be suitable for industries where reliable data regarding the overall market is readily available.

**Lost Business Value**
In circumstances where the loss of earnings is considered or assumed to be permanent and into perpetuity, or where a business is destroyed completely, a lost business value approach is generally appropriate. This approach is commonly applied in business destruction, shareholder oppression, dissenting shareholder and tax court.

There are three generally—accepted approaches used in a lost business value determination analysis: the asset—based, market...
and income approaches. Using each of these approaches, a business valuation is performed before the date of harm and after
the date of harm, with the resulting difference regarded as the lost business value.

1. The asset–based approach involves analyzing the plaintiff’s tangible and intangible assets net of liabilities. This approach
does not directly address the operating earnings of the business and, as such, is useful in estimating the value of a non–
operating business where cash flows are nominal, such as a holding company or an asset-intensive business.

2. The market approach uses pricing multiples taken from guideline companies or transactions and applies these multiples to
the appropriate performance measure of the company being valued. One of the challenges in using this approach occurs when
only limited guideline company or transaction data can be identified.

3. The income approach calculates a business’s value by applying a discount or capitalization rate to a measure of its expected
future earnings to arrive at a present value of the future benefit streams. This approach is commonly used in estimating the
value of both publicly-traded and closely-held businesses.

The Differences
Theoretically, both the lost profits and lost business value approaches should result in the same amount of damages. However,
in practice, financial experts often arrive at different conclusions because of the following differences in procedure:

Terminal Value
A key difference between a typical lost profits and a lost business value determination analysis using the income approach
involves the application of a terminal value, which is calculated based on the assumption that the business has an indefinite life,
whereas lost profits are generally finite in nature. In a lost business value analysis, it is assumed that the terminal cash flows are
permanently impaired while, in a typical lost profit analysis, the harmful event does not impact the terminal cash flows, and the
impairment is only for a finite period of time.

Measurement Date
Often, the measurement date for the lost profits approach is the date of trial, while the measurement date for the lost business
value approach is the date of harm. Generally, when using the lost profits approach, all information available up to the date of
trial, irrespective of the date of harm, is considered in calculating damages. By contrast, in some jurisdictions, when using the
lost business value approach, information available subsequent to the date of harm is typically excluded and only information
known or knowable as of the date of the harm is considered in calculating damages.

Discount Rate
In a lost business value approach, the discount rate used is reflective of the overall risk of a business (i.e., invested capital). In
lost profits analysis, the discount rate used is reflective of risk associated with specific cash flows. Depending on the
circumstances, the risk associated with specific cash flows can be higher or lower than risk associated with an overall business.
For example, risk associated with a specific research and development (R&D) project may be higher than risk associated with a
portfolio of R&D projects, all other things being equal. Alternatively, risk associated with a long–term contracted client with
increasing purchases is lower than risk associated with multiple clients with decreasing purchases. Risk–adjusted discount
rates in lost profits analysis include: weighted average cost of capital (WACC), cost of equity, plaintiff’s internal rate of return,
cost of debt, returns on investments of similar businesses, and risk–free returns. In lost business value analysis, WACC is
commonly used, as well as equity rates utilizing the capital asset pricing model.

Consideration of Expenses
In lost profits analysis, generally only incremental costs are included, but there are exceptions in different venues. These
incremental costs include variable and some semi–variable costs. In the lost business value approach, all costs related to the
generation of overall revenue and profits, including fixed costs, are included.

Taxes
Lost profits are calculated on a pre–tax basis and an after–tax discount rate is applied. Lost business value is based on after–
tax cash flows and after–tax discount and capitalization rates.

Using Both Methodologies
A plaintiff is not entitled to duplicative damages. Therefore, if both lost profits and lost business value approaches are applied in
calculating damages, the financial expert should ensure that doing so will not cause duplicative damages. However, both
approaches together can be applied in certain circumstances, as in the case of the slow death of a business. During the slow death of a business, lost profits are calculated for the time period between the harmful event and up to the complete destruction of the business. For the time period subsequent to the complete destruction of business, lost business value is calculated.

**Conclusion**

Depending on the facts and circumstances of litigation, either lost profits or lost business value approaches can be utilized. Whichever approach is used, the financial expert should ensure that the methodology and related processes are described fully and correlate to the cause of damage.

**Source URL:** https://www.alvarezandmarsal.com/insights/damages-measured-lost-profits-or-lost-business-value

**Links**


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