Do You Have A Lost Profits Case?

Remember the Balance Sheet

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In the accounting world, there are four financial statements: (1) balance sheet, (2) income statement, (3) cash flow statement and (4) retained earnings statement. The cash flow and retained earnings statements are primarily for Wall Street types and are not often prepared by a lot of companies.

The income statement (or "profit and loss" statement as many call it) shows a company's sales, expenses and profit, if sales exceed expenses. Lost profits claims involve the comparison of forecasted profits but-for a particular action, compared to the actual profits after the action. Therefore, the income statement is typically front and center.

However, one should not ignore the balance sheet! The balance sheet has the potential to undermine a lost profits analysis by effectively pushing a seemingly reasonable forecasted income statement into the realm of pure speculation. On the flipside, a balance sheet may serve to buttress the forecasted income statement that is the backbone of the lost profits analysis and enhance the credibility of the analysis.

The Balance Sheet Explained

A balance sheet is a point-in-time summary of a company's assets, liabilities/debt and equity. A balance sheet is often presented with a left side and right side; think of an open book. The assets are on the left, while debt and equity are on the right. An easy way to think of this, as well as an easy way to explain it to a jury, is this: the left side represents what the company has (assets) and the right side represents how they obtained it (debt and equity). For further explanation, consider a person who owns a house. The house is the asset. It was obtained by a mortgage (liability) and a down payment (equity). A corporate balance sheet holds true to this concept.

Claims for lost profits involve a forecast of what sales and expenses should have been but-for a particular action (i.e. a forecasted income statement). Unfortunately, a forecasted balance sheet rarely accompanies a lost profits claim; in some cases, especially when dealing with forecasts for long time periods, it really should. The balance sheet and income statement are related. The balance sheet actually needs a piece of the income statement to make it "balance," while a forecasted income statement needs a balance sheet to help it "make sense."

A Balance Sheet Can Contradict a Claim

The balance sheet plays a critical role in lost profits claims where there is a large growth component in the forecasted income statement. Growth is limited to the capacity allowed by the operating assets of a company. A red flag arises when a forecasted income statement reflects a level of growth that is unsupported by the asset base. An obvious example of this is when a forecasted income statement for an apartment complex reflects revenue in excess of 100% occupancy. The same issue may arise in a more complicated scenario, as sales for a manufacturing company are forecasted in excess of the capacity of the machines and workforce.

Generally speaking, businesses that are expanding or contracting rapidly need additional capital. That said, when a forecasted income statement reflects a large amount of growth, consideration must be given to how that growth will be financed. In a tight credit environment, the forecasted growth may not be achievable, or may be deemed highly speculative. In such a case, if one were to prepare a related forecasted balance sheet, the shortcomings would be obvious. Furthermore, a forecasted balance sheet would allow one to account for the interest and depreciation expense associated with expanding the balance sheet base to accommodate growth. Not doing so would lead to a materially incomplete analysis.

The bottom line is that if a lost profits claim is built upon a forecasted income statement that reflects a large growth component, there is a huge risk in not preparing a forecasted balance sheet. A forecasted balance sheet may clearly demonstrate that a forecasted income statement does not make sense, or is otherwise speculative.

A Balance Sheet Can Strengthen a Claim

When a lost profits analysis includes a well-prepared forecasted balance sheet, the analysis is likely able to withstand scrutiny. The forecasted balance sheet serves to demonstrate how a company could have achieved a forecasted level of sales and profits growth. Accordingly, the trier of fact will understand that the analysis was logical, well reasoned and free of material omissions. This is especially true if there are competing analyses, and only one side considered the balance sheet and income statement relationship. It certainly has the potential to tip the scales.

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