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ASSESSMENT OF DAMAGES: some practical difficulties of implementation

Accuracy is a corporate finance consulting firm specialising in litigation support.

Assessment of damages involves appraisal of the incurred loss (*damnum emergens*) and the lost profit (*lucrum cessans*). Behind financial and accounting calculations, which can seem simple, hide the practical difficulties of interpreting numerical concepts. These difficulties often explain a large part of the difference between the assessments respectively made by each of the parties involved.

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Valuation of loss incurred: pricing of internal hours.

The incurred loss includes that costs that were sustained by the injured party because of the damages incurred. These costs may be comprised of external costs, which are easy to measure and demonstrate (evidenced by invoices). They may also include work performed by employees of the injured party, who have spent time, for example, repairing a defective product, regaining customers (wrongful termination of business relationships), or even designing a replacement product (industrial property).
In this case, a tricky first step is counting the number of hours worked. Only hours spent by the staff involved can be considered, at the expense of other work that itself would have created value for the injured party. Thus, the allocation of under-capacity hours, without value if the dispute did not exist, does not constitute a loss.
A second difficult step is determining the hourly rate that will be used to value these hours. This rate may correspond to the amounts of wages to which costs are added and include a share of the company's fixed costs. It can therefore vary up to fivefold. The fixed costs allocated to the hourly rates represent the company's costs (depreciation of machinery, supervisory personnel) – rarely associated with the existence of the dispute and the resulting damages – that the company may be forced to mobilise in order to repair the damage. Their inclusion in the assessment will therefore depend on the impact of damages on the company's activity.

Valuation of loss incurred: assessment of the contribution to earnings.

Assessing the incurred loss often means going back to assess the contribution to earnings of a defective product, a lost activity, a contract not renewed, etc.
This loss is often seen as the result of the calculation: lost revenue – corresponding variable costs.
However, performing this simple calculation poses the problem of defining variable costs. The accounting doctrine ("PCG 82") describes them as "costs that vary with the volume of activity, without there necessarily being exact proportionality between the change in costs and the change in volumes obtained".
When applied concretely to the assessment of damages, this fixed cost/variable cost distinction amounts to classifying the costs that could have been saved if there had been no damage as variable, an exercise made even more difficult by another distinction existing between "direct" costs and "indirect" costs.
For example, in a case of assessment of damages for wrongful termination of a distribution agreement:

- Should the salaries of the salespeople who were dedicated to sales of the products covered by the contract but also sales of other products be deducted from revenue and therefore be considered variable?
This question raises a problem of information “clipping”: here the data related to the damages should be isolated.
- Likewise, should the salaries of part of the distributor’s financial department, which was restructured two years after the contract was lost, be considered variable?
This question highlights the problem of fixed costs by level: firms gradually adjust their structure following a decline in revenue. This adjustment can be slow, and its financial consequences can be difficult to define precisely.
- How to deal with “indirect” costs, which cannot be allocated, without an intermediate calculation, to the product affected by the terminated contract but are still variable: for example, overtime of the design department or warehouse handlers?
The answer to such questions requires the use of auditing techniques: detailed investigations of cost accounting and cross-checking with management data and non-financial indicators.
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