BVA Consulting Group – Forensic Accountants

Forensic Accounting File

Case studies from the forensic files of BVA Consulting Group

FIVE YEAR CLAIM TURNS OUT TO REALLY BE 75 YRS.

This case involved a claim for damages based on a breach of contract between a hospital and a group of physicians who covered obstetrics in the emergency room.

The contract provided for annual renewal with termination upon 60 days written notice by either party. This could result in various scenarios based on the timing of providing notice. In our way of thinking, this means that the maximum amount of time for damages related to wrongful termination would be one year. However, that is not for us to decide. We can opine on another aspect of the damage calculation that we found extremely creative.

The narrative of the plaintiff's economic expert report stated that damages were calculated for a period of 5 years. The report did not provide a rationale for this time period. There was no indication in the narrative that the damage period extended beyond 5 years.

Examination of the calculation revealed a very interesting twist to the 5-year damage calculation. It was presented as a 5 year discounted cash flow, with a *terminal value.* This means that the calculation of damages did not end at 5 years, it continued in *perpetuity*.

The terminal value was based on the projected damages for the fifth year, capitalized at the discount rate for the five years, less the growth rate. A quick evaluation of this calculation showed that this extended the damages for at least another 75 years.

We talk about this in detail in the next column.

CAPITALIZATION ASSUMES INCOME IN PERPETUITY

The terminal value calculation was simple in appearance. An assumed rate of return was divided into the income projected for the fifth year. This is actually a present value calculation for a constant amount of income over an unlimited number of future years, which is income "in perpetuity".

The result of dividing an assumed amount of income by a fixed rate of return is the same as making an individual calculation for each future year and adding up the result. The amount of income for each future year constantly declines to recognize its present value, reduced over time by the capitalization rate. Eventually the amount annual income declines to fractions of amounts, but it never diminishes to zero. Thus, it is income in perpetuity.

You can assume that income will remain at a constant level. This is a common technique in business valuation.

In the calculation of alleged losses suffered as the result of a breach of contract that has a stated term, this is completely inappropriate. It would only make sense if the contract were for a period, in perpetuity. It makes no sense in a contract that is renewable annually.

We can help you and your client evaluate the plaintiff's claim, call me at (201) 398-1800

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