

Kluwer Arbitration Blog

Do Costs Matter?

Anthony Charlton (FTI Forensic and Litigation Consulting) · Wednesday, October 6th, 2010

As a forensic accountant specializing in the quantification of damages, I listened with keen interest to the various presentations at the recent Swedish Arbitration Days event ‘damages and other relief in international arbitration’. One of the more lively debates centered on whether it is appropriate, as has happened in several well-known treaty cases, to make an award on the compensation standard of ‘fair market value’ on the basis of the claimant’s historical investment costs or ‘actual expenditure’.

As Mark Kantor argued in his presentation, ‘fair market value’, which represents the estimated amount for which an asset may be exchanged on a given valuation date between a willing buyer and a willing seller in an arm’s-length transaction, rarely provides the same measure of damages as the sum of costs which have been incurred in the past. Whilst this may be true, in the absence of other ‘hard data’, tribunals have often looked to past actual expenditure to provide at least some guidance in awarding compensation.

In an early panel discussion on the role of experts, a fellow forensic accountant opined that, whilst experts are sensibly instructed to assist the tribunal on matters involving loss of profits and asset valuation, they have little or no role to play in matters involving ‘historic costs’ or ‘actual expenditure’. Having been instructed on many matters where the measure of historic costs was the precise bone of contention between the parties, I found my confrere’s statement surprising.

If ‘historic’ or ‘incurred’ costs could always be calculated as simply the aggregate value of a few invoices, arguably, there would be no need for audit firms! In reality, determining the actual costs that a claimant has in fact incurred can often be a complex exercise requiring deep accounting and financial knowledge together with an awareness that all may not be what it seems. It is important to get this right in my view since ‘historic costs’ can often form a major element of a damages claim, whether in the case of claimant seeking to recover the incremental costs incurred as a result of the respondent’s actions or perhaps where ‘historical investment costs’ are used as a ‘minimum’ measure of damages suffered in an expropriation claim. In this post I set out some of the typical reasons why costs may not always be fairly presented and can frequently be overstated.

At the simplest level, a claim for additional costs suffered as a result of some breach will usually require an understanding of the difference between fixed, variable, and semi-variable costs. The injured party would normally be entitled to claim the incremental costs resulting from the breach; it would not be entitled, however, to recover costs it would have incurred regardless of the breach (i.e. fixed costs). In the case of semi-variable costs, ascertaining which parts of those costs are

fixed and which parts are flexible can be a difficult exercise, sometimes requiring detailed quantitative and statistical analysis. It should be borne in mind that financial accounting systems are often not designed to identify variable and fixed costs separately and sometimes this data is not readily identifiable even from management accounting information.

The quantification of historic costs in the context of disputes in international arbitration can be especially complex. Many participants in both commercial and investment arbitration are multinational groups and hence organize themselves across different divisions, have operations in several countries and transact not only with external markets but also on an inter-company basis; immediately, it will be appreciated that when dealing with costs, we need to understand the impact of issues such as transfer pricing, overhead allocation, foreign exchange and hedging contracts and the like.

I saw all of the above issues and more in a recent commercial arbitration I was involved in. In this case, the claimant incurred many millions of Euros in taking urgent action to remedy the damage caused to its business from the use of unreliable products supplied by the respondent. Where the claimant sourced certain raw materials from several of its overseas subsidiaries, I discovered that the related invoices often included a sizable profit element. These profits had been added to the invoices to comply with transfer pricing requirements, but they patently did not represent a true cost to the claimant (a multinational group) and were therefore deducted from the claim. Similarly, when reviewing high-value invoices for internal labor costs, it became clear that these had been determined on the basis not only of the actual underlying employee costs (i.e. salary and social charges) but also included many different overhead re-charges unrelated to the employees' actual activities. Worst still, the accounting methodology used to allocate overheads varied both between the claimant's various divisions and between different time periods. Understanding exactly what incremental costs the claimant had incurred was not a simple exercise. Multinational companies routinely transact internally on the basis of 'standard costs that may themselves be either out of date or inaccurate.

There are many other ways in which a damages claim may be stated incorrectly through the treatment of historic costs; whilst the below is not an exhaustive list, it contains many of the most common 'abuses'.

- Failure to understand the difference between accruals and cash-accounting – the accruals method of accounting measures costs when they are incurred regardless of when cash is exchanged.
- Double-counting – it is surprising how often, in my experience, a cost item is included more than once in a claim.
- Inclusion of non-relevant costs—it is not unheard of for a schedule of costs to include items that have nothing to do with the particular facts of a case or else reflect events outside the defined 'loss period'.
- Failure to account for 'credit notes' or discounts – claimed costs should be reduced by the value of any associated credit notes or supplier discounts the claimant has received.
- Incorrect treatment of foreign exchange –I have seen many instances where the costs in one currency were translated into a different currency using an inappropriate rate of exchange.
- Inclusion of costs that were not actually incurred.
- Non-inclusion of cost savings –in my experience, claimants are more diligent(!) in identifying additional costs they have suffered as a result of a breach than they are at adjusting their claim for any cost savings they have enjoyed.
- Inclusion of non-specified 'overheads', and management time – whilst the inclusion in principle of such items of course depends on the particular contract and/ or jurisdiction, I have rarely seen

such costs supported with adequate evidence.

Against this, there are many damages claims of low value and complexity where appointing an expert is unlikely to be warranted. Above a certain threshold, however, the respondent's counsel who is happy simply to accept the Claimant's historical cost figures without challenge may well be doing their client a disservice.

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