

The Role of the CPA in the Determination of Economic Damages

Alpha Kappa Psi

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SEMINAR OBJECTIVES

A discussion of:

- 1) Basic Elements in a Calculation of Damages Engagement
- 2) Practical Considerations for CPAs when conducting Economic Damages Calculations
- 3) Report Contents
- 4) Professional Standards applicable to CPAs working in the Determination of Economic Damages

- **Basic Elements in a Calculation of Damages Engagement**

Lost Profit Determinations

- Lost profits are typically measured by anyone or a combination of the following methodologies, depending on the facts and circumstances involved:
 - Before-and-after method.
 - Yardstick method.
 - But For method.

Before-and-After Method

- This approach is based on what the damaged business was able to achieve both before and after the damaging act occurred.

Yardstick Method

Using industry metrics, comparisons to similar companies, and/or market data, yardstick methodologies are modeled to present the levels of operating performance that could have been achieved if the damaged entity could have grown as its industry peers.

But For Method

Under this methodology limiting conditions and assumptions are prepared to indicate, under current market conditions, what the damaged company could have achieved, but for the damaging act that took place.

Regardless of the methodologies chosen, Economic Damages Calculations also require that:

- 1) Accounting records, business tax returns, financial statements issued to third parties such as creditors, and internal business records can support the loss of profits claimed
- 2) The loss period be clearly established
- 3) In most cases, a business must also establish that it was profitable before the loss period
- 4) The lost profits were not caused by market forces, changes in consumer trends, industry trends, changes in economic conditions, and similar causes
- 5) A careful analysis of expenses be made to isolate incremental revenues, variable expenses, fixed expenses as well as any expenses that could have been avoided or "saved" during the loss period
- 6) The lost profits were unequivocally lost. In addition, any make up possibilities must be considered, accounted and quantified – This is commonly referred to as "Mitigation"

Regardless of the methodologies chosen, Economic Damages
Calculations also require that:
(Continued)

- 7) The cause for the lost profits must be established. This requires that legal counsel be consulted early on to determine the legal facts connecting the wrongful acts, or events, causing any alleged lost profits
- 8) Usually, unreported revenues and expenses cannot be used to establish lost profits

- Practical Considerations for CPAs when conducting an Economic Damages Engagement

Caveats^(*) for the CPA

- A damages analysis is an economic analysis that answers a legal question.
- Each damages analysis depends on
 - the facts and circumstances of the specific case and
 - the applicable statutory authority and judicial precedent within the relevant jurisdiction.
- Legal guidelines or administrative rules may require the use of a damages calculation model or method that differs from how the analyst would perform the damages analysis absent that legal restriction.

- ^(*) Robert Reilly – 2009 NACVA/IBA Annual Consultant's Conference. Boston. Massachusetts

Tips on responding to a subpoena for the production of records and/or testimony:

- Consult Client's Legal Counsel right away
- If you are going to testify at a deposition make sure that you are represented by your own Counsel at the deposition

ASSUMPTIONS AND LIMITING CONDITIONS

- Disclose and clearly explain any *special limiting conditions* or *hypothetical assumptions* included in the methodology utilized
- Consider presenting Different Scenarios

Examples of assumptions and limiting conditions

- Subject 's past performance is a reasonable proxy to predict its performance during the loss period
- Subject 's customer base, or its customers' preferences for its services were not materially affected by other factors during the loss period.
- No New competitors entered Subject 's marketplace during the loss period

There is a causal relationship between the events alleged in the Complaint and Subject 's lost profits

- All documents provided to CPA have been duly authenticated according to judicial requirements

Typical Report Contents

- 1 Opinion
- 2 Background of the Engagement
- 3 Assumptions and Limiting Conditions
- 4 Information Considered and Work Performed
- 5 Key Assumptions
- 6 Methodology Used to Calculate Lost Profits
 - 6.1 Subject's Growth but for the loss Triggering Events
 - 6.2 Analysis of Post Interruption Productivity Growth
 - 6.3 Comprehensive Calculation of Subject's 200X Lost Profits
- 7 Calculation of Loss Period
- 8 Qualifications, Other Expert Testimony and Compensation
- 9 Certifications
- Exhibits
 - Exhibit A
 - Exhibit B
- Appendix
 - Sources Relied Upon:
 - Curriculum Vitae

NATURE OF METHODOLOGY USED IN YOUR REPORT

- Is there sufficient information on which to form a basis for an opinion?
- Is the information and methodology Relevant?
Your analysis needs to be **probative** of your opined conclusion.
- Are the Methods Reliable?
Your analysis must rely on the same “tools of the trade” relied upon by other experts in your field
- Does the methodology reference the recognized body of knowledge?
Your methods must be those used by other experts when dealing with similar fact patterns and circumstances

CRITICAL IMPORTANCE OF

Professional Standards Applicable to Litigation Support Engagements

Response:

- Adherence to AICPA professional standards, related interpretations, quoting published experts in the field on positions presented at conferences and other environments subject to peer review and utilizing published practice aids goes a long way to adhere to the requirement that the methodology used must generally accepted by experts in the same field.

AICPA PROFESSIONAL STANDARDS APPLICABLE TO THE CALCULATION OF ECONOMIC DAMAGES

- Services involving the calculation of economic damages are consulting services provided by CPAs and their employees, and, therefore, adherence to the Statement on Standards for Consulting Services (SSCS) is required.
- The CPA engaged in the calculation of economic damages must also comply with the general standards of the accounting profession contained in the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct, as well as relevant standards established by the state boards of accountancy or other licensing agencies and by other professional organizations to which the practitioner may belong.

The AICPA Code of Professional Conduct

- The AICPA *Code of Professional Conduct and Bylaws* applies to all services rendered by AICPA members. The following sections of the Code of Professional Conduct have particular applicability to the practice of litigation services:
- Rule 102, *Integrity and Objectivity*
(AICPA, *Professional Standards*, vol. 2, ET sec.102.01)
- Rule 201, *General Standards*
(AICPA, *Professional Standards*, vol. 2, ET sec. 201.01)
- Rule 202, *Compliance With Standards*
(AICPA, *Professional Standards*, vol. 2, ET sec. 202.01)
- Rule 301, *Confidential Client Information*
(AICPA, *Professional Standards*, vol. 2, ET sec. 301.01)

LITIGATION SERVICES AND APPLICABLE PROFESSIONAL STANDARDS

- Rule 302, *Contingent Fees*
(AICPA, *Professional Standards*, vol. 2, ET sec. 302.01)
- Rule 501, *Acts Discreditable*
(AICPA, *Professional Standards*, vol. 2, ET sec. 501.01)
- In some instances, the following also apply:
- Rule 101, *Independence*
(AICPA, *Professional Standards*, vol. 2, ET sec. 101.01)
- Rule 203, *Accounting Principles*
(AICPA, *Professional Standards*, vol. 2, ET sec.203.01)

Rule 102-2 on Conflicts of Interest states, in part, the following:

- "A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a significant relationship with another person, entity, product, or service that could be viewed as impairing the member's objectivity. If this significant relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service..."
- AICPA independence standards relate only to the performance of attestation services; objectivity standards apply to all services.

Rule 201, *General Standards*

- Rule 201, *General Standards*, of the AICPA Code of Professional Conduct applies to litigation services as well as to all other services rendered by CPAs to their clients.
- The general standards cover professional competence, due professional care, planning and supervision, and sufficient relevant data.

LITIGATION SERVICES AND APPLICABLE PROFESSIONAL STANDARDS

- Professional competence includes, among other things, identifying client needs, applying an analytical approach, and being knowledgeable about the technical areas involved in the litigation engagement.
- As a result of *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and *Kumho Tire Company, Ltd. v. Patrick Carmichael*, 526 U.S. 137 (1999), the practitioner should consider that the **reliability and relevance** of the expected testimony is likely to be subjected to careful judicial scrutiny before it will be allowed to be presented at trial. When deciding whether to accept a litigation services engagement, the practitioner should consider whether it is likely that he or she has the knowledge and skills necessary to provide a reasonable basis to present relevant and reliable testimony on the issues to be presented in the particular case.

Professional Competence

- Practitioners should undertake only those litigation services that they reasonably can expect to complete with professional competence.
- Consequently, practitioners may be unprepared to meet client needs adequately in every area and in every phase of litigation engagements.
- To comply with this standard in providing litigation services, practitioners may need the assistance of other individuals with the required education and experience.

Primary sources of Information used in this presentation:

- Litigation Services Handbook. The Role of the Financial Expert
John Wiley & Sons 3rd Edition. Editors: Weil, Wagner, and Frank
- AICPA Consulting Services Special Report 03-1: Litigation Services and
Applicable Professional Standards

Some Useful Links:

AICPA Forensics and Valuation Services Center

- <http://fvs.aicpa.org/Resources/>

Federal Rules of Evidence

- http://www.law.cornell.edu/rules/fre/#article_vi

Listing of IRS Rulings:

- <http://www.taxlinks.com/rulings/findinglist/revrulmaster.htm>
- Online Dictionary & Thesaurus
- <http://www.websters-online-dictionary.org/>

**Thank You for your Attention
And Good Luck!!**

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