

**THE ACCOUNTING AND FINANCIAL EXPERT:  
DEVELOPING, DOCUMENTING, PRESENTING AND DEFENDING YOUR OPINION**

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**I. Introduction**

The CPA is increasingly involved in litigation in Federal and state courts. As litigation has become more prevalent and complex, the CPA's role as an expert witness has become more sophisticated. Accounting and financial issues are present in business litigation, bankruptcy, marital dissolution proceedings, white collar criminal matters, and estate and tax matters.

There is an important distinction between the role of the CPA expert and the role of an attorney representing a client in litigation. "When providing litigation services, the [CPA] practitioner is an objective consultant offering opinions about facts that may be in dispute to the trier of fact and is subject to the Statement on Standards for Consulting Services." The attorney's role is to advocate the client's position within the bounds of the ethical practice of law.

Once the CPA expert has competently derived a financial or accounting opinion, the CPA has a duty to present and defend that opinion against the client's adversary. The CPA is not an advocate on behalf of the client, but is an advocate for a competently derived financial or accounting opinion.

This paper is intended to provide the CPA expert with an overview for developing, documenting, presenting and defending the financial opinion in a litigation setting. The paper offers a perspective on the role of the CPA expert in the litigation process. It discusses techniques that will assist the CPA in developing and documenting the financial or accounting opinion in a way that will help the CPA withstand adverse litigation. Finally, the techniques of presenting and defending opinions in a litigation setting are discussed.

**II. Developing the Financial or Accounting Opinion**

A. It is generally recognized that the CPA's obligation is to arrive at an unbiased, objective financial or accounting opinion. The CPA's conclusion should not be tainted by the desires of the client.

**B. Format for Developing the Opinion (The "F.A.R.C." Rule).** At each point of the financial analysis, the CPA should identify and document the following elements of the analytical process:

1. **Facts** - the undisputed facts relating to this point of the analysis. If the facts are disputed, the CPA should consider making alternative analyses.

2. **Assumptions** - the assumptions that will be used in place of facts as well as the assumptions that are used in analyzing and interpreting the facts.

3. **Rationale** - a written statement of the underlying reasoning that links the facts and assumptions to the conclusion.

4. **Conclusion** - a clear statement of the conclusion on a particular financial, accounting or economic issue that has been arrived at as a result of applying sound rationale to the facts and assumptions relating to the issue.

**C. Facts.** Financial or accounting analyses and conclusions are based upon facts. A fact is defined as a thing that has actually happened or is known to be true. Facts are often assumed to be true by the CPA expert.

1. The underlying facts of a financial or accounting analysis can be agreed to or disputed. The CPA should be mindful of the distinction, and be cautious not to become a trier of fact.

2. If facts are disputed, the CPA should consider performing alternative analyses, each based on the disputed interpretation of the underlying fact.

3. There are many situations in which one party to a financial or accounting dispute will effectively request the CPA to assume the truth of an underlying fact, and it is certainly reasonable for a business CPA to do so. (See §II D for a discussion of assumptions.)

**D. Assumptions.** In most cases, a financial or accounting analysis will also be based on certain assumptions. By definition, an assumption is the act of conceding or taking for granted; supposing something to be a fact.

1. Certain assumptions are within the realm of the CPA's knowledge and experience and should be subject to the CPA's opinion as to their reasonableness. For instance, a typical assumption in the analysis of a business is the assumption of a going concern. Most CPAs would agree that this assumption falls within the purview of the CPA's experience. Since it is an assumption that is within the purview of the CPA's professional judgment, the reasonableness of the going concern assumption is within the scope of the opinion of the CPA.

2. Some assumptions are not within the scope of the CPA's judgment. For instance, the viability of a particular scientific technology would probably be outside of the scope of most CPA's experience. Consequently, the CPA should probably not opine as to the reasonableness of the assumption about the technology, but rather should defer to the opinions of others.

3. Some assumptions fall in the "gray area" of the CPA's knowledge and experience. For instance, the importance of a particular chief executive officer to the operations of a business and the resultant "key person" discount issues may be an area where the CPA has familiarity in some cases, but not in others. Care should be exercised when dealing with these "hybrid" assumptions.

4. In short, assumptions can be critically important in a financial or accounting analysis. Some assumptions are within the province of the CPA, and those assumptions should be understood and agreed to by the CPA. Other assumptions are not within the direct province of the CPA and,

while they may be important to the financial analysis, the CPA should recognize that these assumptions are outside of the scope of the CPA's expert opinion.

E. **Rationale** is the process of applying logic to facts and assumptions to derive supportable conclusions. By definition, rationale is the fundamental reason, or rational basis, for something. Stated informally, rationale is the "smell test" of reason as it is applied to facts and assumptions to derive conclusions. The process of applying rationale to facts and assumptions is undertaken many times in a financial or accounting analysis.

1. If every step of the financial analysis includes good, defensible rationale, the ultimate conclusion should make sense.

2. It is important to understand that sound rationale must be applied in every "sub-step" of the analytical process. For example:

a. What is the rational basis for concluding a particular amount of lost profits?

i. Are the lost profits *directly* supported by facts? (i.e., last year the company netted \$100,000; this year it netted \$60,000?)

ii. Are there *other reasons* for lost profits? (Can the projected losses be *directly* connected to the event, or can they be *assumed* to flow from the event?)

b. Why is a particular level of "but for" cash flow being chosen, given the historical and/or projected facts?

c. What is the basis for applying a particular growth rate to assume the profits (or losses)?

d. Why are particular adjustments being made to historical net income?

e. Why is officers' compensation of a particular amount being estimated?

f. What is the rational basis for choosing a particular discount rate to be applied to projected profits (or losses)?

3. In litigation, the importance of good rationale is heightened because the opposing side is challenging every step of the financial analysis, particularly the rationale of every step.

a. There are two ways to test rationale: negatively and affirmatively.

i. In litigation, the opposition generally challenges rationale negatively. They ask, "What's wrong with it?" Or, "How could this be different?"

ii. Rationale can also be supported affirmatively. That is the logical process of affirmatively defending the rationale. For instance:

aa. *X* conforms to traditional analysis, **AND**

bb. *X* conforms to the way that a presumed buyer and/or seller of the business would look at the issue, **AND**

cc. *X* conforms to the CPA's experience, **AND**

dd. *X* makes intuitive sense.

b. It is critically important to understand and accept that rationale is never perfect. There is always some "disconnect" between the facts and assumptions and conclusions. Competent opposing counsel will always try to stress the imperfections or "disconnect" in the rationale.

4. Every conclusion or sub-conclusion in an accounting or financial analysis should be supported by several theories of rationale, if possible. These "layers" of rationale support the conclusion and make it very defensible. For example, to determine the amount of "fair compensation" for the owner/operator of a particular business enterprise, the CPA would ideally employ as many of the following lines of rationale as possible:

a. Develop an understanding of the background, education and experience of the particular owner/operator along with a detailed description of the current duties, management skills and number of hours worked.

b. Undertake statistical studies of reported compensation of similarly situated officers in similar type businesses.

c. Analyze the compensation of the next level of management in the company and add some reasonable premium to those amounts as an indication of the reasonable value of the subject owner/officer.

d. Obtain data on salaries of chief executive officers in the geographic area in which the company is located.

e. If the company is not 100% owned by the subject owner/operator, seek to obtain some historical evidence of a negotiated salary amount among owners.

f. Obtain the opinion of the owner as to the reasonable value of his or her services.

It is not possible to create a formula for perfect rationale for solving any one issue, but it is important for the CPA to understand that broad-based rationale results in very defensible conclusions. It is usually very easy for a conclusion to be supplanted if it has only one line of rationale (i.e. one study, one method or one "comparable" sale).

### **III. Documenting the Accounting Expert's Work**

A. Documentation is the written record of the research and analysis that was undertaken to reach the accounting or financial opinion.

B. A review of the Statement on Standards for Consulting Services ("SSCS") and the relevant consulting services practice aids discloses that there is no requirement for a particular level of documentation in a litigation services engagement. The general standards for consulting services do require that the practitioner "obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed." However, no specific reporting standards or documentation standards apply to litigation services engagements.

C. In the environment of litigation, documentation can be a two-edged sword. On the one hand, proper documentation is helpful to record the details of the analysis. On the other hand, detailed documentation can be used against the CPA in cases where the underlying financial analysis is inaccurate, inadequate or incompetent. Even if the underlying financial analysis is competent, improper documentation can be used to criticize or cross-examine the CPA.

D. A discussion of adequate documentation must begin with the reminder that there are no requirements for a particular level of documentation in a litigation services engagement and the recognition that some CPAs believe that minimal documentation is the best approach to these types of engagements. That statement notwithstanding, the author of this paper believes that adequate documentation should include:

1. A complete record of all the material activities undertaken by the CPA.
2. Copies of all correspondence sent to or received from others in connection with the assignment.
3. Copies of significant notes of research, meetings or conversations that have occurred during the financial analysis.
4. Copies of all documents in your possession that were provided to you during the financial analysis.
5. Copies or excerpts of all relevant studies on which you have relied during the course of your analysis, where practical to include them.
6. Copies of all final financial calculations and analyses that you have undertaken during the assignment.
7. Proper documentation should be complete, accurate and thorough. It should clearly identify the steps that the CPA has undertaken and it should be able to be followed and understood by a knowledgeable observer.

E. Competent documentation of a financial analysis should probably not include the following things:

1. If you have a practice of reviewing a junior CPA's work in writing, those review notes should be considered to be communications that are intended to correct the file, and not part of the file themselves. (Remember, there is no privilege to prevent the production of these documents; your firm should consider having a policy of discarding them after they are used.)

2. Preliminary drafts of financial schedules or calculations. (Your firm should consider having a policy of discarding these preliminary drafts each time they are reiterated. These drafts do not represent your opinion or conclusions.)

3. Irrelevant scribbles or marginalia.

F. Examples of adequate documentation and poor documentation will be shown in the speaker's oral presentation.

#### **IV. Presenting your Financial or Accounting Opinion**

A. In a litigation setting, the expert's opinion may be presented in a **report**, in **deposition** and/or at **trial**. Each of these three forums has unique considerations:

##### **B. The Expert's Report.**

**The full text of this article is available by contacting our office.**

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