



Forensic Accounting, Business Valuation and Consulting

Forensic Accounting Services

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Some examples of the services most commonly provided by forensic accountants include computation of economic damages; punitive damage studies; professional standards analysis; valuation of businesses, pensions, and intangibles; and fraud prevention, detection, and investigation. Forensic accountants can provide such services in conjunction with both civil and criminal trials.

The AICPA has three authoritative professional standards that are applicable to forensic accounting services: the Code of Professional Conduct, CS section 100, and VS section 100. CS section 100 refers to the most relevant parts of the code for consulting services.

CS section 100 generally applies to all forensic accounting services, as well as other consulting services. CS section 100 does not apply to services subject to other AICPA professional standards, such as attestation services, financial planning and bookkeeping, reports and advice relating to the application of accounting principles to specified transactions or events, and certain recommendations and comments that directly result from observations made while performing excluded services. For engagements involving both consulting and attestation services, CS section 100 applies to the consulting part of the engagement.

For attestation services, both independence and objectivity standards apply. For consulting services, however, the integrity and objectivity standards apply, but the attest independence requirement does not. For CPA firms providing clients with attest and consulting services, certain consulting services could impair their attest independence, and thus prevent them from performing future attest services.

VS section 100 applies to services that estimate the value of a business or business ownership interest, security, or intangible asset using valuation approaches and valuation methods and situations in which professional judgment is used to apply these approaches and methods. In addition to complying with VS section 100, the valuation analyst must also comply with the code, CS section 100, and all relevant law and regulations.

Important elements of managing forensic accounting engagements are planning and preparation, information and evidence management, and communications with clients and attorneys. Planning and preparation involve evaluating and accepting (or rejecting) the engagement. Once the decision is made to accept the engagement, the issue becomes one of the reaching an understanding (an agreement) with the client. Agreements may be oral or in writing. If they are in writing, the forensic accountant provides the client an engagement letter that sets forth the terms of the engagement.

Before accepting an engagement, the forensic accountant must first understand certain fundamental issues: who the client is, the needs of the client, the relevant legal considerations, and the information available. After reviewing these fundamental issues, the forensic accountant then decides whether to accept or reject the engagement.

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Forensic Accounting Services (Continued)

The decision to accept an engagement is a very serious one. The forensic accountant should carefully weigh all aspects of the case in light of the case's merits, the expert's qualifications, and any possible conflicts of interest. However, once the forensic accounting expert decides to accept an engagement, the forensic accountant must reach an understanding with the client regarding the terms of the engagement. In most cases, the forensic accountant drafts an engagement letter for the client to sign. CS section 100 does not require an engagement letter, and oral agreements are acceptable.

In some cases a forensic accountant might be initially hired to serve as a non-testifying expert consultant, but at some point the forensic accountant's role might change to that of testifying expert. In such cases, some forensic accountants require a second engagement letter to replace the first one.

Although there is no such thing as a standard engagement letter, there are certain elements generally applicable to engagement letters. The exact elements in a particular engagement letter will depend on the particular engagement and practitioner. Examples of such elements are introductory information (dating, addressing, and case name); a description of the services; the scope of the services; a basic understanding of the services; an applicable timeline for completion of the services; any reports, demonstrative evidence, or oral testimony to be provided; a statement of applicable professional standards; applicable contingencies; a statement regarding independence and conflicts

of interest; rights and responsibilities of the parties; privacy and confidentiality requirements; and fees and retainers. Generally speaking, contingency fees are inappropriate.

The testifying expert must be very careful regarding all communications with the retaining counsel. This is because almost any communication between the expert and the retaining counsel is likely to be subject to discovery.

Various administrative issues must be taken into consideration as part of the planning and preparation for an engagement. Some of these may be incorporated into the engagement letter or dealt with at the beginning of the engagement. These issues include setting timetables, scheduling, staffing and supervision, and identifying the location and custodian for key documents. Special care should be exercised to avoid spoilage.

Experts have a unique problem in marketing their services in that any advertisement, directory listing, e-mail, website, or other marketing creative can be used in cross-examination to attack the expert's credibility. Therefore, experts must be extremely careful in all advertising.

The expert's CV is important for both marketing and actual litigation. The CV is one of the most visible aspects of an expert's expertise and experience, so it must be prepared and maintained with the utmost care.

- 1 Source: Adapted from *Essentials of Forensic Accounting*, authored by FVG member Michael Crain with William Hopwood, Carl Pacini, and George Young; published by American Institute of Certified Public Accountants 2015.

Announcements:

- Mr. Donald Wisheart has completed serving as president of the local Rotary
- The Financial Valuation Group, Tampa Office, relocated downtown to The Tampa City Center
- Michael Crain completed and received his doctorate degree from Manchester Business School, University of Manchester, England
- Dr. Michael Crain co-authored, *Essentials of Forensic Accounting*, published by American Institute of Certified Public Accountants
- Dr. Michael Crain made two presentations at the 2014 American Institute of CPAs national conference on valuation and forensic accounting
- Dr. Michael Crain will be the conference keynote speaker at the 2015 Florida Institute of CPAs conference on valuation and forensic accounting

Specific Examples of Forensic Accounting Services

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| Computation of economic damages: <ul style="list-style-type: none">● Lost profits● Lost value● Extra costs● Lost cash flow● Mitigation● Restitution |
| Punitive damage studies |
| Professional standards analysis |
| Valuation of the following: <ul style="list-style-type: none">● Business● Pensions● Intangibles |
| Fraud, prevention, detection, and investigation |
| Bankruptcy consultant, trustee, and examiner |
| Tax analysis, including the following: <ul style="list-style-type: none">● Tax basis● Cost allocation● Treatment of specific transactions |
| Marital dissolution assessment and analysis |
| Contract cost and claims analysis |
| Historical results analysis |
| Special accountings, tracing, reconstructions, and cash-flow analyses |
| Antitrust analysis, including the following: <ul style="list-style-type: none">● Price fixing● Market share● Market definition● Predatory conduct● Dumping● Price discrimination |
| Business interruption and other insurance claims assessment and analysis |
| Attest services, if specifically engaged to perform them in connection with litigation services |

Source: Adapted from *Essentials of Forensic Accounting*, authored by FVG member Michael Crain with William Hopwood, Carl Pacini, and George Young; published by American Institute of Certified Public Accountants 2015.

Florida's New *Daubert* Standard

The *Frye* standard has been replaced by the *Daubert* standard¹ in Florida in assessing the admissibility of expert opinions. Section 90.702 Florida Statutes Testimony by Experts reads:

If scientific, technical, or other specialized knowledge will assist the trier of fact in understanding the evidence or in determining a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify about it in the form of an opinion or otherwise, if:

a) The testimony is based upon sufficient facts or data;

b) The testimony is the product of reliable principles and methods; and

c) The witness has applied the principles and methods reliably to the facts of the case.

While many interpret *Daubert* as providing a checklist guiding the court as gatekeeper, the original U.S. Supreme Court decision actually says “[t]he Federal Rules of Evidence, not *Frye*, provide the standard for admitting expert scientific testimony in a federal trial.”² The responsibility rests heavily with the trial court judge.³ The judge reviews the expert’s methodology, not

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Valuation for Financial Reporting

Fair Value Measurement in Business Combinations, Early Stage Entities, Financial Instruments and Advanced Topics, 4th Edition

by James R. Hitchner and Michael J. Mard

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- Gives clear guidance for early stage companies with complex capital structures for stock compensation for both 409A tax compliance and ASC 815-40-15 financial reporting compliance.
- Offers new techniques for applying options methods, including addressing GARCH methodologies in Black Scholes Merton Model and procedures for implementing the probability-weighted expected returns method.
- Presents advanced topics in fair value including
 - measurement of brand value,
 - measurement of intangible assets in ad valorem matters,
 - determining the Discount for Lack of Marketability using empirically tested stochastic processes and
 - analyzing the developmental and reporting standards of all major valuation groups.

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Daubert (Continued)

his opinions, and those methods must be anchored in some scientific and, thus, testable basis.⁴

Florida's Recent Cases

In *Hedges*, a Florida trial court partially excluded the financial expert's testimony and explained its reasoning in terms of general accepted methodology, degree of subjectivity, and analytical rigor:⁵

A [financial expert] testified that he used a goodwill valuation method called the Multi-Attribute Utility Theory or 'MUM' approach in which he looked at various factors and subjectively applied to each factor a number from 1 to 5 to obtain a weighted percentage attributable to enterprise goodwill. Using "MUM" [the expert] opined that 50% of the goodwill was attributable to the enterprise. [The expert] did not conduct a site visit, did not interview the employees or the clients of the company and did not obtain any other relevant data for this valuation...In effect, his testimony as to goodwill was pure opinion testimony. In adopting the Daubert standard in Florida, our legislature clearly stated its intent to prohibit the admission into evidence of pure opinion testimony. Furthermore, there was no evidence that the "MUM" approach is generally accepted in the valuation community or that it is based upon reliable principles and methods.

As we piece together what *Daubert* means to Florida's financial experts, we can observe that this Court focused on the following aspects of the expert's analysis as it related to his opinion about personal goodwill:

- No site visit;
- No interview of employees;
- No interview of clients;
- No obtaining of any other relevant data;
- Testimony was pure opinion testimony (ipse dixit);
- No evidence that approach was generally accepted; and
- No evidence that approach is based upon reliable principles and methods.

In a recent case about a medical expert, Florida's Third District was even more forceful about the *Daubert* standard in its *Perez* opinion:⁶

Under *Daubert*, the subject of an expert's testimony must be scientific knowledge...In order to qualify as scientific knowledge, so as to be an admissible subject of expert testimony, an inference or assertion must be derived by the scientific method; the touchstone of the scientific method is empirical testing, that is, developing hypotheses and

testing them through blind experiments to see if they can be verified.

General acceptance in the scientific community alone is no longer a sufficient basis for the admissibility of expert testimony; it is simply one factor among several.... subjective belief and unsupported speculation are henceforth inadmissible.

The *Daubert* test applies not only to "new or novel" scientific evidence, but to **all** other expert opinion testimony...Expert testimony that might otherwise qualify as "pure opinion" testimony is expressly prohibited. The legislative purpose of the new law is clear: to tighten the rules for admissibility of expert testimony in the courts of this state.

Under *Daubert* "the subject of an expert's testimony must be 'scientific knowledge.'" "[I]n order to qualify as 'scientific knowledge,' an inference or assertion must be **derived by the scientific method.**" The touchstone of the scientific method is empirical testing – developing hypotheses and testing them through blind experiments to see if they can be verified.

Thus, "a key question to be answered" in any *Daubert* inquiry is whether the proposed testimony qualifies as "scientific knowledge" as it is understood and applied in the field of science to aid the trier of fact with information that actually can be or has been tested within the scientific method. "General acceptance" [from the *Frye* test] can also have a bearing on the inquiry, as can error rates and whether the theory or technique has been subjected to peer review and publication...However, "general acceptance in the scientific community" alone is no longer a sufficient basis for the admissibility of expert testimony...Subjective belief and unsupported speculation are henceforth inadmissible.

The *Perez* decision may have direct impact on testifying financial experts (although courts may make some distinctions between scientific experts and technical experts):

- The subject of experts allowed to testify must be some level of scientific or technical knowledge. There are, of course, not only the standard physical sciences, but also the social sciences.
- Subjective belief and speculation are unreliable and, thus, inadmissible. (We also see, from *Hedges*, that such inadmissibility can apply to part of an opinion. Thus, what is the left of the larger opinion when a subset of it is disallowed is likely fact-specific)

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Footnotes:

- 1 http://www.myfloridahouse.gov/Sections/Documents/loadoc.aspx?FileName=_h7015__docx&DocumentType=BilB&BillNumber=7015&Session=2013
- 2 *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
- 3 *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), <http://www.law.cornell.edu/supct/html/97-1709.ZS.html>
- 4 Supreme Court's Kumho Decision a Boon to Public, by Kenneth S. Geller and Michael E. Lackey, Jr. <http://www.appellate.net/articles/kumhodecision.asp>
- 5 *Hedges v. Klaus Doupe, PA*, (20th Cir. 2014), Order
- 6 *Perez v. Bell South Telecommunications, Inc.*, 138 So. 3d 492 (Fla. 3d DCA 2014).

