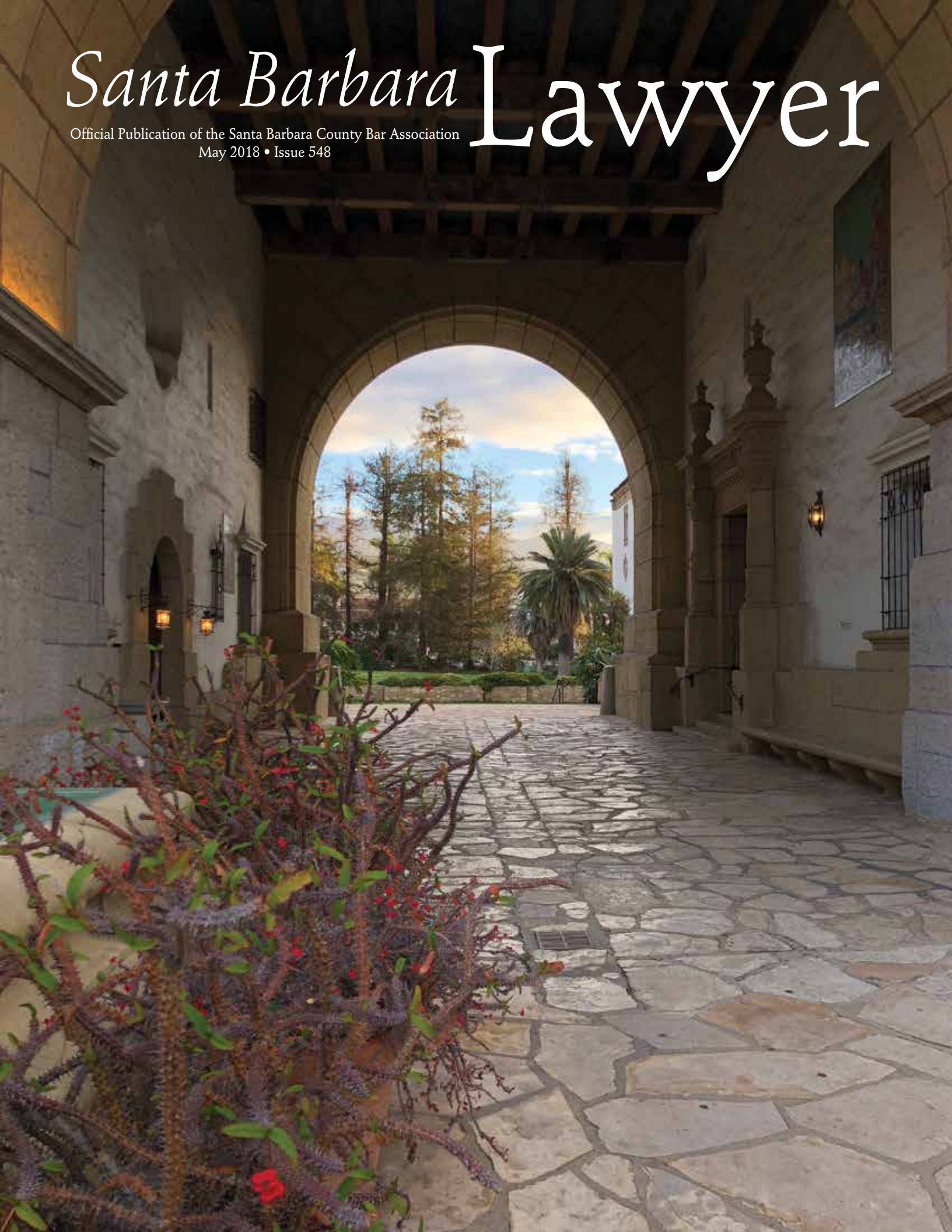


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# Working Effectively with Accounting Expert Witnesses

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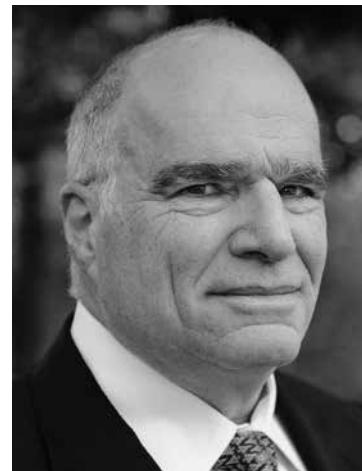
**D**uring the past thirty-three years, I have been retained as an accounting expert witness by hundreds of attorneys. Here are some lessons learned about how to maximize the efficiency and quality of the attorney and the accounting expert witness relationship:

First of all, attorneys should understand the nature of accountants. Courts uniformly have accepted the accountant, in particular the certified public accountant, as an expert.<sup>1</sup> Trial attorneys, however, have been known to consider accountants to be poor expert witnesses. This perception is often justified. Accountants often seem unable to avoid the use of arcane terminology and detailed qualifications to explain accounting issues. Such testimony will more likely mystify than persuade the judge or jury. After all, accounting deals with numbers, and it would seem reasonable to expect an expert opinion based on numbers to be clear, precise, and unqualified.

Accountants are not entirely at fault, however. Often the issues facing accountants are not simple. Most laypersons do not understand the large role that subjective judgment and assumption play in the development of accounting and financial statements. An example of the role of judgment in what at first appears to be a simple arithmetic task is valuing inventory. If the costs of supplies and manufacturing are known, the value of the product would seem easy to calculate. But which value should be used, cost or market? If cost is used, is historical or replacement cost appropriate? If historical cost is chosen, what method should be used to compute historical cost: last-in-first-out, first-in-first-out, or some other cost method? If market value is used, should it be based on normal selling price or liquidation selling price? The expert witness testifying to the value of inventory clearly has to do more than add up columns of numbers. He or she must make sophisticated accounting decisions and explain them to the judge or jury.

For their part, in presenting complex issues in court, accountants often take for granted that the judge or jury understand accounting principles and terminology. Accountants may use technical terms without explaining them

adequately, and they may dwell on subsidiary issues of minor importance in their overall conclusions. This is a frequent problem among accountants, most of whom spend their time working with other financial professionals. Most accountants are more comfortable with the role of practicing their craft than with the often more difficult task of explaining it to nonaccountants by testifying in a trial.



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Many accountants make excellent witnesses. As is true with most technical subjects, accounting transactions can be explained in terms understandable to judges and jurors who have no background in accounting. The attorney should retain the accountant who says, “They bought the tractor with a cash down payment and borrowed the rest,” instead of, “the acquisition of the farming machinery resulted in a debit to fixed assets and credits to cash and notes payable.”

## ***Bring Expert in Early (and Save Money)***

The first conversation with an attorney about a new matter frequently starts out with the attorney saying: “Well, it turned out we didn’t settle the case. I have to designate my experts by tomorrow. Trial is scheduled for next month, and your deposition will have to take place sometime next week. Please tell me the documents you need, I’ll see what I have, and I’ll send them to you soon. Can you give me an estimate of your fees?”

I understand attorneys’ impulses to wait until the last minute to hire accounting experts. We are expensive. It turns out, however, that it is almost always less costly and more efficient to retain the accounting expert at the very beginning of a case. The result of last-minute calls is usually extra effort and cost as well as a weakened ability to present an effective case. The expert may have to redo work already performed by the attorney or the attorney’s client because the expert must be able to testify as to his independent analysis of the facts. Experts brought in after the close of discovery may find the credibility of their analyses undermined because important information is not available to them – information which could have been obtained readily if an expert had been available to point out its significance earlier.

Both the attorney and client benefit by bringing in experts

early. Two of the most important services an accounting expert can provide at the early stages of a litigation are to assist in preparing requests for documents and to prepare a preliminary estimate of damages. These tasks may require only a few hours' work.

### **Requests for Documents**

Nothing is more important to an accounting expert than the documents on which he or she will rely to perform his or her analysis. Bring in your accounting expert early to maximize the likelihood of obtaining the right documents. The expert can enable the attorney to prepare document requests that avoid an imprecise request like "produce all financial records," which often results in one of two costly and inefficient results: (1) a truck-full of unorganized documents that, even when produced in electronic format, require many hours to index and review, or (2) a motion to disqualify the document request as overbroad and burdensome, effecting time-consuming motion practice to clear up the production issues and obtain the documents needed.

Usually, the most useful and important documents an accounting expert wants to see are the company's financial statements (assuming respondent is a business). The accounting expert can assist in avoiding improperly-worded document requests seeking financial statements. For example, a request for copies of all "audited profit and loss statements and balance sheets" may result in the truthful response that the responding party has no documents responsive to the request, rightfully neglecting to produce any of the company's many "reviewed" financial statements. The respondent also will have no obligation to produce copies of other important financial statements (the statement of cash flows, for example).

A well-worded request for financial statements is this:

*"For the period beginning [five years from today] to the present, produce all financial statements, notes thereto and reports thereon, whether prepared weekly, monthly, quarterly or annually, whether audited, reviewed or compiled, whether prepared for internal or external reporting purposes, including but not limited to: income statements, balance sheets, statements of cash flows and statements of changes in retained earnings."*

In addition to financial statements, there are many other financial records that may be useful to the accounting expert, e.g., general ledgers, cash disbursement journals, accounts payable and accounts receivable journals, invoices, and accounts receivable aging reports, just to name a few. It usually takes little time for the accounting expert to help identify these documents and make properly-worded requests for their production.

Be sure to ask for a copy of the data file for the accounting

software package used by the company (e.g., the file [Company Name].qbw, if the company uses QuickBooks). This is the mother-lode of all financial productions. It contains all the information in the documents discussed above and allows the accounting expert to create reports and export data as he or she sees fit, obviating the need to reenter the data contained financial records produced by respondent.

One additional document request often is useful:

*"For the period beginning [five years from today] to the present, produce all budgets, forecasts, projections, one-year or long-term financial plans and management reports relating to anticipated sales and financial activity."*

### **Preliminary Analysis of Damages**

Whether retained on behalf of the plaintiff or defendant, one of the most useful tasks an accounting expert can perform early in a litigation is to prepare a preliminary estimate of potential damages, accepting the assumption that liability has been proved. Although the final damages analysis may be quite complex, it is often possible to develop a back-of-the-envelope estimate of damages in a few hours. Such an estimate necessarily will involve a series of estimates and (sometimes heroic) assumptions. Nonetheless, having even an order-of-magnitude estimate of damages is extraordinarily valuable in the conduct of case management and in early settlement negotiations.

In even the most complicated case, a good expert can develop a rough estimate of damages in a matter of days. This analysis can be refined as further information becomes available. Developing a preliminary damage estimate as soon as possible in litigation offers several advantages to the client. First, it helps determine the appropriate level of further effort. If the exposure or potential is lower than first thought, a more detailed damage analysis may not be cost-effective. Second, this information is also extremely useful in settlement negotiations. Third, the preliminary analysis may reveal that further discovery is needed.

A fourth advantage of developing a preliminary analysis and subsequent updates is that they provide the accounting expert with a basis to testify to his or her findings even if time or budget constraints do not allow the expert to finish every aspect of the analysis. In a sense, it is an insurance policy against the possibility that the expert will run up large fees while collecting, organizing, and analyzing the data without reaching any opinions.

As documents are produced, the accounting expert can update, revise, and replace the preliminary damages calculations with more refined estimates, which can be used in final settlement negotiations and at trial.

### ***Work as a Team***

The expert and the attorney must work together to develop the expert's testimony. The good expert witness makes it clear, albeit diplomatically, that he will not say simply what the lawyer wants the witness to say. The attorney must take care not to impose his or her preconceptions on the expert. In most litigations, the attorney is far more familiar with the facts of the case initially than is the expert. However, the attorney often has only an incomplete understanding of what the expert potentially could do to assist in the litigation. The attorney should solicit the expert's advice concerning the tasks the expert will perform. At the same time, the expert must be guided by the attorney, who is responsible for presenting the case.

After the expert's deposition, the attorney and the accounting expert should work together to develop the script of the expert's direct testimony to be presented at trial. Personally, I always prepare the draft direct testimony outline, which I present to the attorney for consultation and editing.

### ***Establish and Monitor a Budget***

To repeat a time-worn lawyer joke, a famous lawyer was once asked, "How much will this case cost to litigate?" His answer was, "Everything you've got." Experts rarely are, or should be, in a position to treat budgets so cavalierly. Litigant parties and insurers take a dim view of exploded budgets for experts, and they respond by refusing to pay the fees of the experts and the attorneys who hired them. Estimated budgets can and should be developed for any litigation task. Attorneys should be informed before budgets are exceeded so that they may react appropriately, either by authorizing further expenditures or by scaling back the expert's scope of work. Doing this helps protect both the expert and the client against disputes concerning fees. In major litigations, when budgets take a second seat to frantic efforts to meet deadlines, attorneys and their clients should be kept informed on a frequent basis of fees incurred.

It is not fair to ask an accounting expert how much it will cost to perform an analysis before the expert has had the opportunity to take a look at the documents on which he or she will rely to perform the analysis. Once that is done, however, budgets can and should be developed and monitored. This reduces the probability that the client will react unpleasantly to an unexpectedly-large bill from the accounting expert. For very large cases, I have on a few occasions agreed to perform a preliminary survey of documents produced, after which I prepared a proposed budget for performing the analyses identified during the survey. Performing the survey typically required a few hours' work, for which I was reimbursed.

### ***Confer Frequently***

The attorney must be informed of the progress the expert is making, both in terms of the analysis and the fees being incurred. Experience shows that the experts often must take the initiative to contact the attorneys to let them know what they have accomplished and what they intend to do next. When dealing with experts, many attorneys seem to take the attitude that no news is good news, and they may be unpleasantly surprised when the expert's findings or fees were not as expected. Similarly, when using multiple experts, for example, a marketing expert, an accountant, and an appraiser, information must be shared. Lack of communication during preparation of the case can lead to disaster in the courtroom.

### ***Establish a Primary Contact***

Major litigations often involve multiple attorneys and law firms representing different parties in the case. To save costs, several parties may agree to share the services of an expert. Because the interests of parties in litigation rarely converge exactly, the expert may be pulled in conflicting directions. To avoid this potential problem, the attorneys should establish one attorney as the primary contact to whom the expert reports and from whom the expert receives his or her instructions. This attorney also should be responsible for making sure that the expert is provided with the resources (documents and access to individuals) he or she needs to accomplish tasks. Often this role is delegated to a more junior attorney involved in the litigation. A better choice is the litigator who will examine the expert on the witness stand.

### ***Be Aware of Expert-Client Interactions***

Accounting experts frequently interview officers and employees of the litigant party to obtain information about the company and/or its industry. Often information obtained in these interviews is used as the basis for assumptions the accounting expert accepts to arrive at his or her final opinion. Attorneys must be aware of these interactions, and they must be sure to include in the company's representative's testimony outline the relevant facts (and in some cases opinions) on which the accounting expert has relied.

### ***Know the Rules of Discovery of Expert Opinions***

Both experts and attorneys should be familiar with the work products doctrine and attorney-client privilege as they relate to the discovery of expert opinions. The laws can differ among states and from the federal rules of evidence.

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Generally speaking, observations and opinions of an expert employed as a pretrial consultant rather than a potential witness are deemed *work product* of the attorney and are protected from discovery.<sup>2</sup> Once an expert is employed to testify at trial, his or her opinions are relevant evidence and generally are not protected by the work product doctrine.<sup>3</sup>

The law can be complex, and misunderstandings may have important consequences in litigation. For example, an expert's examination and analysis of confidential client documents may be privileged, but certain types of direct testimony may constitute a waiver of the privilege and enable the adverse party to cross-examine the expert on the subject of the privileged information.<sup>4</sup>

### ***Understand the Rules of Evidence Regarding Expert Testimony***

Whatever your understanding of the rules of evidence regarding expert testimony may be, the only understanding that matters is that of the particular judge in your case. Do all documents on which the expert relied need to be admitted into evidence? In my experience, some judges have said yes, and others have said no. When an expert relied on information obtained in an interview with a third party, must the third party testify at trial to support the basis for the information relied on by the expert? Again, in my experience, some judges have said yes, and others have said no. Find out the rules of evidence used by your particular judge and prepare accordingly.

### ***Rehearse Testimony***

When time and budget allow (which seldom happens, unfortunately), the attorney and accounting expert should have a full-dress rehearsal of the accountant's proposed direct testimony at trial. This allows the actual trial testimony to be delivered more smoothly and effectively. It also can bring into focus weaknesses in the presentation, which then can be fixed before trial. ■

*Mr. Neches is a Certified Public Accountant, a Certified Valuation Analyst, a Certified Fraud Examiner, and is accredited in Business Valuation and certified in Financial Forensics.*

#### ENDNOTES

- 1 *Computer Sys, Eng'g, Inc. v. Qantel Corp.* (1st Cir. 1984) 740 F.2d 59; *Westric Battery Co. v. Standard Elec. Co.* (10th Cir. 1973) 482 F.2d 1307.
- 2 Fed. R. Civ. P. 26(b)(3); *Scotsman Mfg. Co. v. Superior Court* (1966) 242 Cal. App. 2d 527, 531.
- 3 *Quadrini v. Sikorski Aircraft Div.* (D. Conn. 1977) 74 F.R.D. 594. See also Fed. R. Civ. P. 26(b).
- 4 *People v. Whitmore* (1967) 251 Cal. App. 2d 359.