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Consulting Services Section

What's Inside

Coming in Future Issues

- **Dealing with the rigors and challenges of giving expert testimony**
- **Managing change initiatives in an organization**
- **Preventing a "divorce" between partners**
- **Choosing a successor**
- **What makes a great consultant**

The AICPA Business Damages Survey: Select Findings

By Michael A. Crain

Many CPAs perform business damages (also known as lost profits damage) calculations. CPAs who provide these types of services typically are retained as expert witnesses in lawsuits. To determine the ways CPAs typically perform such calculations and the characteristics of those individuals and their firms, the AICPA conducted its Business Damages Survey. The research was designed in cooperation with the Economic Damages Task Force of the AICPA's Litigation and Dispute Resolution Services Subcommittee and performed by IntelliSurvey via an Internet-based survey. (See the rosters of task force members and other contributors on page 3.)

How the Survey Was Conducted

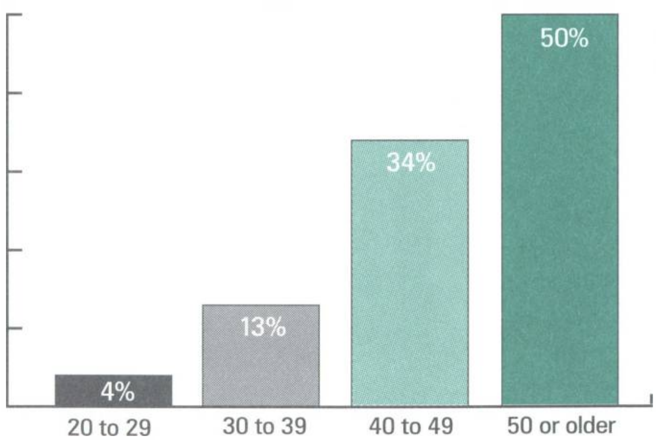
An invitation was sent via email to about 9,300 AICPA members who had expressed interest in litigation services. Approximately 8,000 of those email addresses were valid and about 1,400 individuals requested to be removed from the survey panel. The survey was conducted from September 28, 2002 to October 11, 2002. During that time, 398 completed the survey, a 6% completion rate.

Respondent Characteristics

The mix of the demographics of survey respondents was as follows:

Age of Survey Respondents

CPAs performing business damage calculations tend to be older practitioners. Half of the respondents were age 50 or over while 84% were age 40 or over (50% of the respondents were 50 years of age or older; and 34% were 40 to 49 years of age).



Age of Survey Respondents

Continued on page 2

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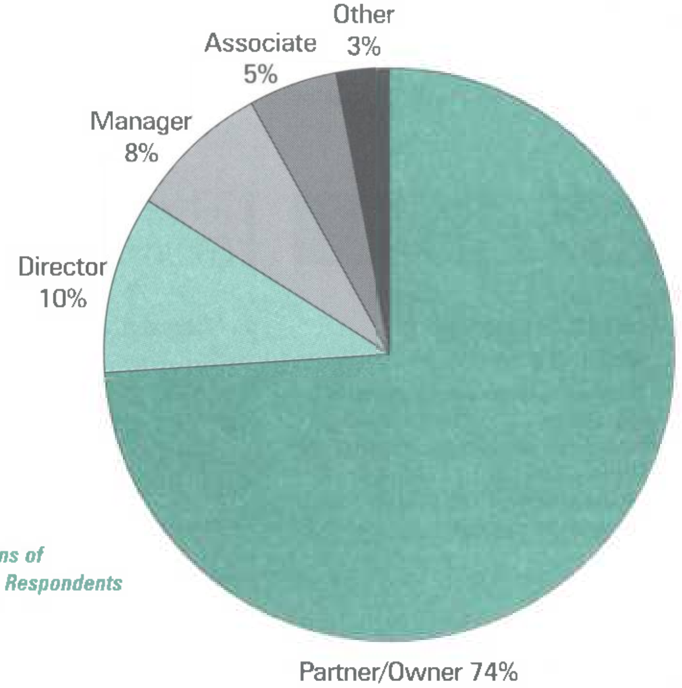
Editor

William Moran
wmoran@aicpa.org

Continued from page 1

Positions of Survey Respondents

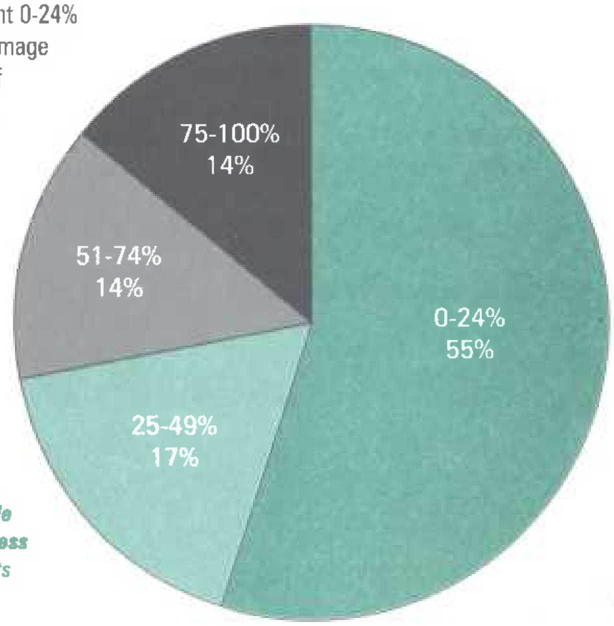
Most respondents (74%) were partners or owners in their firms; 10% were directors.



Positions of Survey Respondents

Percentage of Billable Time Spent on Business Damage Engagements

Most (55%) of the respondents spent 0-24% of their billable time on business damage engagements; 17% spent 25-49% of their time; 14% spent 51-74%; and 14% spent 75-100%.



Percentage of Billable Time Spent on Business Damage Engagements

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Firm Revenues

The respondents' firms had the following annual revenues:

Firm Revenues	Percentage of Respondents
$50 million+	11%
$10 – 49.9 million	14%
$5 – 9.9 million	9%
$2 – 4.9 million	15%
$1 – 1.9 million	14%
$500 – 999k	11%
$250 – 499k	12%
Less than $250k	13%

Continued on page 4

Michael A. Crain, CPA/ABV, ASA, CFE is a shareholder with Peed, Koross, Finkelstein & Crain, P.A. in Ft. Lauderdale, Florida. He practices primarily in the forensic accounting, damages, and business valuation areas. He is a current member of the AICPA's Business Valuation Subcommittee and a past member of the Litigation and Dispute Resolution Services Subcommittee. He can be reached at mcrain@pkfccpa.com.

Acknowledgements

Sandra K. Johnigan, Chair
Litigation & Dispute Resolution Services Subcommittee
Johnigan, PC
Dallas, TX

Economic Damages Task Force

Ann E. Wilson, Chair
Solana Beach, CA

Elliot A. Lesser
RSM McGladrey, Inc.
New York, NY

Michael A. Crain
Report Author and Researcher
Peed, Koross, Finkelstein & Crain, P.A.
Ft. Lauderdale, FL

Daniel L. Jackson
Alix Partners, LLC
Dallas, TX

Bjorn L. Malmlund
KPMG LLP
Los Angeles, CA

Regan R. Rockhill
Rockhill & Associates
Clarksburg, MD

IntelliSurvey

Jonathan Ephraim
Managing Director

AICPA

Anat Kendal
Director—Financial Planning

Derede Samuel-Whitlock
Market Research Manager

James C.H. Feldman
Manager of Business Valuation and Litigation Support Services

AICPA Specialty Credentials

Recently, the AICPA e-mailed a message to Consulting Services Section Members entitled "AICPA Specialty Credentials & Support for Consulting Services Section Members". If you do not have an e-mail address on file with the AICPA, or you did not receive this message, we would encourage you to read it. To view the original message, please visit http://www.aicpa.org/members/div/mcs/20030312ltr.asp

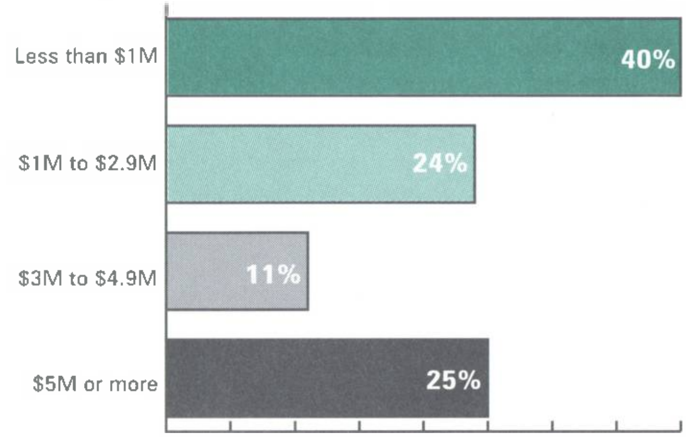
Continued from page 3

Average amount of damages

During the previous two years, the amount of damages in the average case was as follows:

- 40% had under $1 million in damages for their average case.
- 25% had $5 million or more.
- 24% had $1 to 2.9 million.
- 11% had $3 to 4.9 million in damages

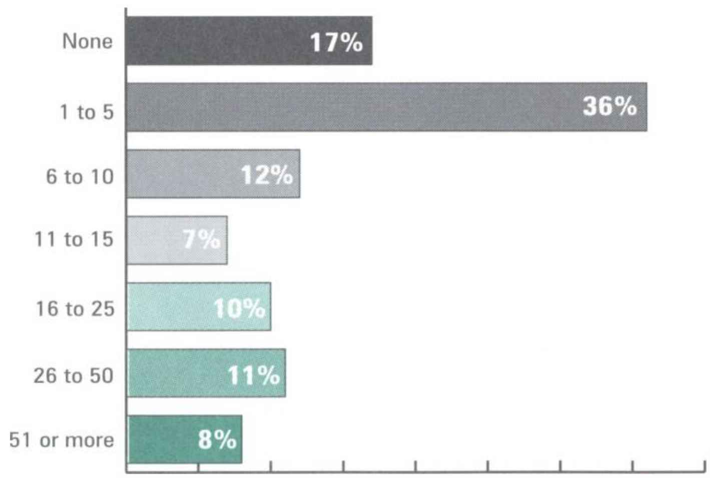
Average Amount of Damages



Number of Times Testifying as an Expert in Damage Cases

Respondents most frequently (36%) indicated 1 to 5 times as the number of times they had ever testified at deposition or trial in a business damage case, while 8% had testified 51 or more times. As for the rest of the respondents, 11% testified 26 to 50 times, 10% testified 16 to 25 times, 7% testified 11 to 15 times, 12% testified 6 to 10 times. Seventeen percent had never testified in a business damage case.

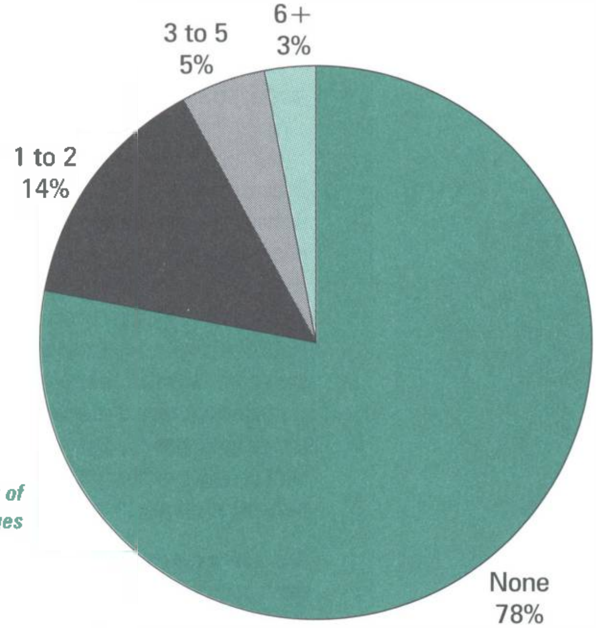
Number of Times Testifying as an Expert in Damage Cases



Continued from page 4

Frequency of *Daubert* Challenges

Most respondents (78%) had never been subject to a *Daubert* challenge or state equivalent in a commercial damages case. As for other respondents, 14% were challenged 1 or 2 times, 5% were challenged 3 to 5 times, and 3% were challenged 6 times or more.



Frequency of Daubert Challenges

Key Findings

Damages in excess of value

Respondents were asked if they believe that business damages can exceed the value of the business if no case law exists to provide guidance. Yes, said 39%, 29% said no, and 32% were not sure.

Damage period

When asked if they typically forecast lost future profits beyond the term of the contract, 35% said no, 12% said yes, and 53% said it depends on the attorney's instructions.

How long a damage period for lost future profits do respondents typically use to calculate damages when the company is unable to fully mitigate damages? For 9%, the period was under 3 years, for 26% it was 3 to 5 years, for 9% 6 to 10 years, and 13% said into perpetuity. In addition, 17% said they used the period the attorney instructed the expert to assume and 6% said that they make calculations under several scenarios and let the jury decide which one is most appropriate. The remainder used some other basis or were not sure.

Discount rates

Asked what discount rate they typically used to determine the present value of lost future profits in which the company is not totally destroyed, 27% said they used a risk-adjusted rate based on the riskiness of the forecast; 21% used a safe rate of return; 16% used the company's weighted average cost of capital; 12% used the rate of return of a similar business; and the remainder used some other rate. When the business is totally destroyed, 22% typically used a risk-adjusted discount rate based on the riskiness of the forecast; 20% used the rate of return of a similar business, 17% used a safe rate of return; 13% used the company's weighted average cost of capital; 11% said that they based damages on the value of the company; and the remainder used some other rate.

When asked what discounting convention they typically use, 46% say they use an end-of-year discounting convention, 47% use the mid-year convention, and 7% use another convention.

Profits vs. cash flow

Asked if they usually forecast lost profits or lost cash flow, 65% said lost profits and 35% said lost cash flow.

Lost compensation

When asked when the named defendant is only the damaged company and not the person who owns the company, do they typically include the owner's lost compensation in the damage calculation, 45% said no, 28% said yes, and 27% said it depends on the instructions from the attorney.

Conclusions

As we noted earlier, CPAs performing business damage calculations tend to be older practitioners. That half of the respondents were age 50 or over and 84% were age 40 or over is a natural expectation as those with more experience would generally have more expertise and, accordingly, would tend to be perceived as more qualified by juries and judges.

Continued on page 6

Continued from page 4

It was expected that the survey would display a wide diversity in practices or approaches in many of the technical aspects of business damage calculations. The results proved this expectation to be accurate. The diversity among the practitioners can basically be attributed to:

- Different facts and circumstances of the particular lawsuits.
- Differences in jurisdictional requirements or practices.
- Misapplication of methodology.

Because each lawsuit is unique in facts and circumstances and in the appropriate law, specific damage approaches and considerations can differ. The courts have not indicated a preference for a particular methodology to calculate business damages as there is little related case law. We can conclude that the courts recognize that business damages should not be limited to a particular damage methodology or set of variables because one prescribed methodology may not make the plaintiff whole in every circumstance. Nevertheless, good practice in determining business damages should be based on the application of sound financial theory, reasonable assumptions, and the correct application of the facts under the circumstances. Education about such matters and a good understanding of the role of the expert witness are desirable for the practitioner and can be obtained from a variety of sources. One source is the AICPA's National Conference on Advanced Litigation Services and Fraud.

The survey results indicate practitioners may need a better understanding in the area of the appropriate discount rate to determine the present value of future lost profits and its relationship to the income stream. Another potential area is a better understanding of the legal concept of making the plaintiff whole as the measure of compensatory damages. Also, practitioners with little experience in performing damage calculations or testifying should consider spending time in refining their technical and presentation skills through continuing education.

Finally, it is recommended that practitioners exercise caution when relying on the attorney's instructions to make critical assumptions in the measurement of damages unless they are reasonable assumptions or legal requirements. Juries and judges expect CPAs to bring all of their expertise into the courtroom including those skills that allow them to evaluate financial assumptions. Although it may not be practical in every situation to evaluate all assumptions, the practitioner should understand that juries and judges have certain expectations for the CPA who testifies as an expert.

FYI:

In a 2002 report on future career opportunities, *U.S. News and World Report* cited forensic accounting as a growth area.

Forensic Accountants: Independent Specialists

Fighting fraud is an issue worldwide. Corporate fraud seems to dominate headlines of late, and many reasons can be offered for this attention. Whatever the reasons, the reality is that the number of frauds reported in the media is increasing. In its 2002 biennial survey of managers and directors of corporations worldwide, Ernst & Young (E&Y) looked at the number of headlines reported in Reuters business briefing in the past ten years. In that period, nearly 385,000 articles reported on fraud. More striking, however, is the almost doubling of the annual number of headlines from 38,499 ten years ago to 89,397 one year ago.

In an aptly titled report, "Fraud: The Unmanaged Risk," E&Y asserts that the reported fraud cases are "only the tip of the iceberg, as only about 20% of frauds are exposed and in the public domain. Many frauds are either discovered but not made public or have not yet been detected."

Forensic Accountants Meet the Challenge

With the challenge to fight fraud come opportunities for CPAs to investigate fraud and to help organizations deter being defrauded. Although according to the E&Y survey, organizations most

Continued from page 6

frequently turn to employees to investigate internal fraud, managers and directors are most satisfied with the performance of forensic accountants in investigating fraud.

Forensic accountants were asked to conduct only one in five investigations. The report notes, however, that "this is much higher than in prior years, reflecting an increasing tendency to draw in specialist and independent skills on complex cases." Furthermore, 88% of respondents were satisfied with the forensic investigations.

Police were asked to conduct a quarter of the investigations, but their efforts were least satisfactory. The remaining investigations were referred to an external auditor (13%) or external lawyer (10%), whose services were found satisfactory by more than half the respondents. (See "Were you satisfied?")

Inside Jobs by the Usual Suspects?

The survey report offers useful information about who the likely corporate fraudsters are, what companies can learn from having fraud investigated, and what they can do to help prevent and detect fraud. Most fraudsters (85%) were on the company payroll. Of that group, more than half of the perpetrators (55%) came from management.

In a similar survey two years earlier, only a third of fraud arose from the ranks of management, according to Nick Hodson, an E&Y partner in charge of investigative and forensic accounting. This 20% increase Hodson thinks "would indicate there is a disturbing rise in the amount of fraud by managers." Hodson adds, "We can also conclude from the study that it pays to keep a close eye on new management since 85% of the managers committing the largest frauds have been in their jobs less than a year."

Prevention That Works

Organizations had fraud investigated primarily to determine the full extent of the fraud, thereby learning lessons that would help prevent more fraud. Frequently, the same organization will be defrauded in the same way either in a different location or at a later time.

Survey respondents think that internal controls are the best way to prevent and detect fraud. Even so, Hodson observes that in E&Y's experience in investigating fraud, "there is more often than not an internal control that should have prevented or detected the crime, but it was either overridden, or not properly understood by the staff responsible for the control."

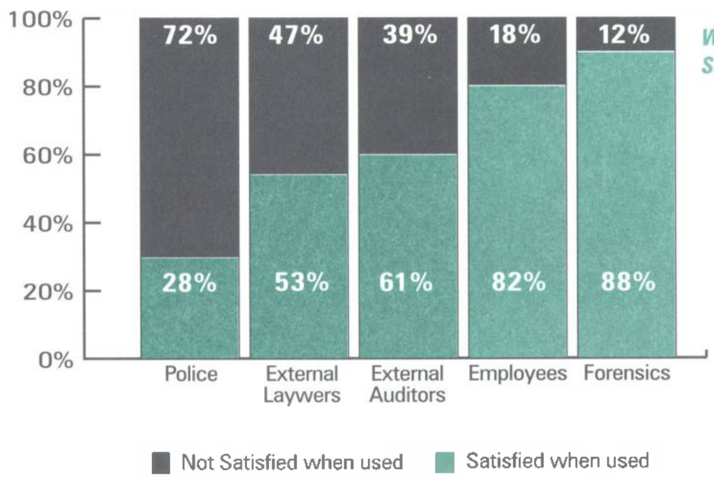
CPAs Need More Fraud Education

CPAs have always played a central role in fraud prevention, detection, and deterrence. From helping small businesses find holes in internal controls to providing reasonable assurance that no material fraud exists in a financial statement, the CPA is frequently the first line of defense in combating fraud.

CPAs providing services to small businesses — either as employees or as advisors — need especially to be aware of fraudsters' tricks and motives. "The reality," explains Joseph T. Wells, Chairman of the Association of Certified Fraud Examiners (ACFE), "is that fraud occurs more frequently in small businesses and causes more damage. CPAs are likely to be the first to spot the problem or the professional to set up the kind of controls that can prevent it."

Educating Employees on Fraud

The recently released "How Fraud Hurts You and Your Organization," is a free, one-hour training program that helps organizations educate their employees about fraud. It provides descriptions of three fraud schemes, including interviews with the fraudsters themselves, as well as an overview of how employees can protect themselves and their company against fraud. The program can be viewed on the Internet at http://www.aicpa.org/antifraud/training/homepage.htm.



Were You Satisfied?

Source: Ernst & Young

Continued on page 8

Preventive Measures

The AICPA and several other professional organizations have developed a document that will help CPA consultants help clients combat fraud. *Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud* identifies the measures an organization can take to prevent, deter, and detect fraud.

It can be accessed at http://www.aicpa.org/antifraud/management.htm

Supporting CPAs in getting the fraud education they need is a new CPE course, on interactive CD-ROM, called "Fraud and the CPA." Developed jointly by the AICPA and the ACFE, the course provides CPAs with a baseline education in fraud prevention, detection, and deterrence. Fraud specialists share insights into how fraud occurs within a company and how CPAs can better assist corporate America in detecting and preventing all types of fraud.

The course aims to help CPAs enhance professional skepticism and improve decision processes. Offering eight CPE credits, among the course highlights are discussions of the following:

- What the fraud-related responsibilities of CPAs and management within a company are.
- The new responsibilities imposed by the Sarbanes-Oxley Act of 2002.
- What's new about the new fraud audit standard, SAS No. 99.
- The CPA's duties under the Private Litigation Securities Reform Act.
- Challenges and strategies for CPAs dealing with financial statement fraud.
- The most common asset misappropriation frauds.
- The most dangerous form of cash fraud: fraudulent disbursements.
- Who can prevent fraud and what can be done.
- Developing corporate strategy for preventing fraud.

The price for "Fraud and the CPA" (Product No. 731810) is $99.00 for AICPA members and $123.75 for non-members. For more information or to read about the AICPA's ongoing antifraud campaign, visit the Spotlight area of the Antifraud and Corporate Responsibility Resource Center at www.aicpa.org/antifraud or call toll-free, (888) 777-7077.

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American Institute of Certified Public Accountants
Consulting Services Section
1211 Avenue of the Americas
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