

Forensic Accounting in Legal Disputes

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There may be legal disputes that arise between individuals and/or between businesses that require the analysis of economic damages in Court. In order for the attorney to properly understand the economic issues, a forensic accountant will often be retained. The forensic accountant must gain a complete understanding of the background of the dispute, as well as a background to the underlying business operations and legal issues that led to the dispute. It is important to make certain that the attorney both fully understands the business itself, and is able to give adequate explanations or, if not, to gain that information elsewhere.

All of this can only be accomplished with the team being in full communication from the beginning of the case. The team is, of course, the attorney, the client, and the forensic accountant. The forensic accountant may need to use other experts. The client may need to involve the existing accountant in order to gain a full understanding of the business. Several individuals from the business may need to be involved, including those in Marketing, Advertising, Purchasing, etc. Other issues with regard to staff retention, the need to hire new replacement staff after the location is able to open, and other related issues, may all come into play. This can all be best understood and incorporated in the work of the forensic accountant if the forensic accountant and the attorney gain a complete understanding of the operations and the legal issues that could impact the determination of damages early in the game.

Often, the litigant will be able to explain many of the detailed business operational issues. In some cases, the client (litigant) does not have a full understanding of the details of the business that is being sued. In other cases the client whose attorney has retained the forensic accountant has a more complete knowledge because it is his/her business than has been impacted by the alleged act or action.

One of the first things that should be done is to gain a full understanding of the financial background of the business. This can be done by gaining access to financial statements and/or tax returns for the period of time preceding the alleged events. Routinely, a period of five years will be utilized to fully understand the financial implications of the alleged acts.

If the company is a start-up or if the company had significant changes within the five years prior to the event in question, either five years of information will not be available, or will not be as meaningful. In those cases, the forensic accountant will still need to gain a full understanding of what has occurred in order to understand the potential economic implications of the alleged acts.

While the forensic accountant is being provided with appropriate and adequate information with regard to the financial history, it is also important to gain an understanding of what the litigant believes occurred, and how it impacted the business. In many cases, the actual economic impact of an act or actions will not be immediately determined by only the single obvious financial changes.

As an example, a dispute over a covenant not to compete may involve direct competition, but in addition, some of the acts and discussions that led up to the determination that a covenant not to compete had been violated, such as a potential merger or other financial transaction having been contemplated but then not consummated because of the acts that are the underlying cause of the litigation. In such a case, the financial implication of the loss of the potential merger/acquisition activity may be a second area of damages that needs to be considered.

Many of the issues that relate to these damages will have, as an underlying issue, a party being determined to be “at fault”. Notwithstanding the fault, in many cases the forensic accountant will need to assume that fault has been determined. It is also important for the attorney to make certain that the accountant recognizes that, with a few exceptions (which will not be discussed here), the accountant is not going to be in a circumstance where he or she can be the expert with regard to fault. Part of this thought process will always be a discussion between legal counsel and the forensic accountant to gain an understanding of how fault may be determined. In some circumstances, there will be different levels of fault or culpability, that may be able to be determined, and the forensic accountant will need to be provided with significant information with regard to each of the potential areas of fault.

In one circumstance, a contract had been violated, and that was all but admitted when the initial complaint had been filed. Nonetheless, it became a very problematic issue to fully understand what the damage calculation would be because the underlying agreement was somewhat vague with regard to the methodology for calculating a stream of royalty payments. The attorney needs to give the forensic accountant sufficient and necessary information to allow an understanding of what either a judge might decide, or a judge might charge a jury to decide with regard to alternate interpretations of an agreement and/or the law. In those cases, the forensic accountant may need to determine several different scenarios and what the damage calculation would be under each.

Many of the damage calculations are considered to be “but for” calculations where a calculation is determined as to what the profit of a business would be “but for” the alleged wrongful act. In many of these circumstances, the initial thought process is “what was the economic condition of the business prior to the wrongful act, and what would the likely scenario be for the continuation of the business and its profitability had the alleged wrongful act not occurred”. For these reasons, it is important to completely understand what impact different economic issues have with regard to the operation of the business.

The attorney and the forensic accountant should work together to make sure that, with the client, they gain a complete understanding of each of the various impacts that different scenarios might have. If a truck drives through the front door of a retail operation, and the retail operation is closed for several months due to building damage and safety issues, it may appear, at first glance, to be simple to understand the financial impact. Nonetheless, different issues with regard to seasonality, as well as other changes in economic circumstances, separate and apart from the truck closing down the business, could impact the financial forecast.

- What are the year-to-year variances based on the history prior to the accident?

- What are the other changes in the competitive environment with regard to the direct geographic area separate and apart from the truck?
- What underlying price changes may have occurred in the wholesale market and/or the retail market that could have impacted both the gross profit as well as the total volume of the store?
- Have new competitors arrived in the market recently?
- Have competitors left the market recently?

All of these issues need to be addressed in order to present a well-developed and sound determination of how the likely damages are determined and will be best-addressed for the client by a technically trained, experienced forensic accountant.