

The Role of the Financial Expert in Damage Cases

QR quickreadbuzz.com/2016/02/24/financial-expert-damage-cases/

National Association of Certified Valuators and Analysts

Effective Trial Preparation and Presentations

What is the role of a financial expert? How important is the financial expert? In this article, the author answers these questions and shares his experience serving as a damage expert.



Financial experts have a defined focus and important role in litigation involving damages. Damage cases happen because of bad events. These events could be a breach of contract, a natural or man-made disaster, or any event that causes either a real or perceived diminution in an expected benefits stream or value. The expert's role is to understand the case, get the relevant documents, calculate the damages, and tell the story.

Understand the case

The facts, circumstances, and the guiding contracts or agreements are critical to knowing the qualitative aspects of the damages; and that is the prerequisite to quantifying the damages. (This is a classic reason when an attorney calls and says, "The trial is next week. Can you help me?" the financial expert should reject involvement in that case.) In any case involving damages, there are objective facts, subjective judgments, and assumptions that must be made in light of the facts. An incomplete understanding necessarily limits the effectiveness of the expert's ability to make reasonable judgments and assumptions based on verifiable facts.

The expert's understanding is also essential to assist counsel with making reasonable, effective, and efficient demands for production of documents. A good understanding of where the case is going guides the direction and depth of discovery. The financial expert is routinely

relied upon to give advice regarding what depositions must be taken and what the content of those depositions should be.

The expert should understand in the earliest stages of the engagement what type of litigation will be involved. Where there is a man-made disaster, there is the likelihood of civil litigation, insurance claims, and the potential for criminal litigation. In cases of natural disasters, the case will generally be limited to insurance claims and civil litigation. Legal counsel should be asked for a clear picture of what the litigation landscape looks like. These inquiries lead to a more precise, relevant, and efficient approach to discovery. Even if the expert is told by legal counsel this case will “definitely settle,” it is dangerous to prepare the case under that assumption. There is always a possibility, or even likelihood, that the case will go all the way to trial. Insufficient documentation because of an assumption of resolution can be painfully punitive when the case is going to trial after all and discovery is now closed.

Get the Documents

Relevant contracts are critically important. For example, a disastrous fire that destroys a business creates a loss. The calculation of that loss is probably driven by an insurance contract. The financial expert that does not request a copy of that insurance contract may be missing an important element to the case.

The financial expert’s opinion will be based on observed facts, discovered facts, and then several assumptions based on those facts. Document request lists should be designed with that in mind. Observed facts include historical financial statements, production reports, revenue, and whatever else in the historical record builds the basis for establishing how the business was functioning prior to the damage event. That historical data provides the basis for projecting what would have been but for the damage event.

Discovered facts include prior expert reports, opposing expert reports, prior valuation reports for the business, trial testimony if there has been prior litigation, depositions, and where applicable, the insurance adjusters report, calculations, and supporting documentation. An interview with the insurance adjuster is also very helpful in discovering facts that would not otherwise be available to the financial expert. Where an opposing expert may not be accessible to the financial expert, the insurance company will almost always make the adjuster available and even encourage that contact.

Calculate the Damages

Three significant points in time affect the calculation of damages. The first is the date of the damage event. The second is the date of trial or settlement (resolution). The third is the date at which the damage ends. The damage period is from the damage event until losses attributable to the damage event are no longer occurring.

Therefore, the date of trial or settlement can be before, simultaneous with, or after the end of the damage period. It is critical for the financial expert to understand where the case is chronologically in relation to those three key dates.

The damage period can be anywhere from hours, to months, or even years. Sometimes the loss is permanent. The calculation of damages, in simple terms, is simply the projection of what would have happened if the damage event did not occur minus the actual results of the business because of the damage event. For example, if there was a one-month damage period, and the measure of loss is net income, the expert would project what net income would have been in that month and subtract from it either the actual net income for that month or add the loss actually incurred in that month. In extended damage periods, the loss amounts must be brought to “present value” using appropriate discount rates.

The loss measurement can be revenue, gross profit, net income, or any other measure of income or cash flow. The most appropriate loss measurement will be established in the “understanding the case” phase of the engagement. Damage calculations should be based on reasonable projections that are an extension of well documented historical activity.

Where the loss is permanent, the business must be valued at the moment before the damage event. For example, a wildfire that destroys a business may create a permanent loss. The inability or unwillingness of a business owner to re-establish the business after the damage event presents a case where there is a permanent loss. Also, where the damage period may stretch out to many years, or decades, it may be more efficient to consider the loss permanent and use the business value as the damage amount. In a permanent loss, the damage (business value) calculation is based on projections of what the business would have done but for the damage event. Those projected earnings are discounted to present value to establish the value of the business.

Tell the Story

The financial expert’s role in quantifying damages is important. The ability to understand the case drives the knowledge to get the documents that feeds the basis for quantifying the damage. And of course, all of that is the foundation for telling the story.

There are three kinds of experts in this line of work:

1. Those who can do the work and can’t tell the story—This is more common than you might think.
2. Those who can spin a very good story but cannot do the work—These are the “professional experts” with the reputation of being hired guns. This is a dangerous way to make a living.
3. Those who do the work and tell a compelling story—Obviously, this is the goal. These experts are actually hard to find, according to the legal profession.

Obviously, the deficiencies in the first two types of experts prevent effectiveness. The financial expert who can tell a persuasive story built on the foundation of good technical work will do well. The inability to work through complex facts and circumstances to arrive at a damage amount is fatal to the expert as the inability to clearly, succinctly, and efficiently tell the story can make effective underlying work useless. If the expert cannot effectively communicate that work and conclusions, the hard work to get to that point may be in vain.

Sometimes, the story will be told in a written report. That written report should be written in a way that leads the reader to obvious and reasonable conclusions. All work and thought processes of the expert should be disclosed such that the calculations and processes can be replicated using only the written report. The report should be a one-stop stand-alone source of all information used, assumptions made, and processes/calculations required to arrive at the quantification of damages. A well written report accomplishes all of this in an interesting and persuasive manner. The financial expert is in the business of accounting, finance, economics, and persuasive communication.

The other area of potentially needing to “tell the story” is in front of a live trier of fact. Many financial experts who have had the privilege of testifying before juries and judges know that you have two battles to wage in a short amount of time during direct testimony. The first battle is to accomplish in about 15 to 30 minutes what most cannot do in several years of school and experience. That is, to understand complex financial and accounting theory. The next battle is to apply the theory to the actual facts.

Whether communicating the opinions or basis for those opinions, the following are some rather obvious tips to remember:

- Catch your mistakes before someone else does. That you will make mistakes is not in doubt. Effective communication, however, is error free so your work should be checked/reviewed by someone other than you before it is distributed. Everything should be footed, cross-footed, and spell checked. There is excellent software available that will check spelling, word usage, and grammar, thus improving the readability and effectiveness of written reports.
- Major on the majors and put all the minors in the back! The body of your report should read as much like a narrative as possible. The user of the report should be able to read through the body of the report in a single sitting without having to filter out extraneous or redundant information. Boilerplate and technical data should be included as exhibits to the report unless they add to the persuasiveness of the narrative. For example, the technicalities of how the discount rate was developed can largely be pushed to the back. This is not because of a lack of importance; it is because the granular detail may detract from the flow of the story. This is similar to trial testimony where on direct examination the story is told and the details are more likely to be dragged out in cross-examination.
- A picture is worth a lot of words. Graphic representations of data and conclusions can be incredibly useful when presented well. As much thought should be given to these decisions as given to the effort in writing and presenting a clear and concise account. A report with a hundred graphs probably goes the other way pretty strongly; overuse of graphs and tables will detract from the flow of a good narrative.
- Short can be sweet but long is almost always deadly. This is true in oral testimony. A facility with the topic and language is a necessity to briefly and adequately bring a trier of fact up-to-speed on the accounting and economic theory required to travel with the expert to a reasonable conclusion. Dwelling on jargon or arcane theory almost always

backfires. Some experts think it impresses the jury and that may occasionally be true. As a general rule, however, it does not serve the expert well.

- Practice makes perfect. Although perfection may never be achieved, it should certainly be the goal. A presentation of a damages case by the financial expert should never happen for the first time in open court in front of the trier of fact. The expert should talk through the presentation with the attorney. Rarely is the financial expert the most important witness in the grand scale of all that is happening in a trial. So, the expert may need to prompt the attorney for trial preparation time. The time spent on that preparation always pays off for all parties. It is also helpful to practice the testimony in front of others who know nothing of legalities and accounting. Feedback from that type of rehearsal can sometimes be painful but extraordinarily helpful in getting it right at “show time.” The same could be said for written reports. The person who reviews the report may not understand everything in the report but much can be learned from their observations of, and questions about, the contents of the report.

The combination of technical skill and presentation abilities makes the work of a financial expert in damage cases dynamic, interesting, and fun. It is always helpful to keep all of this in perspective, though. As one attorney regularly reminds this author, “You are not that important. By the time you get to the stand, I have either convinced the jury there was a loss or they don’t believe me. Either way, I barely need you!” While that is a funny line, and generally true, hopefully, he will never find out how a bad expert can unravel all his work. You and I do not want to be that expert who diminishes a well presented case through our careless preparation or the inability to present well.

Chris Hamilton, CPA, CVA, CFE, is a Partner with Arxis Financial, Inc., a Simi Valley, California CPA firm. Most of Mr. Hamilton’s professional time is spent in the areas of business valuations, fraud, forensic accounting and litigation related engagements. He has served as an expert in civil, criminal, probate and family court matters, and he is an Appointed Court Economic Expert in Ventura County Superior and Municipal courts. Mr. Hamilton is a Certified Public Accountant, Certified Fraud Examiner, Certified Valuation Analyst, and a Diplomate with the American Board of Forensic Accounting.

Mr. Hamilton can be reached at (805) 306-7890, or by e-mail to CHamilton@arxisgroup.com.