How Many Accountants Does It Take to Go to Trail

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was going to trial. My client was a mid-sized business. I needed to prove damages, and show that my client's internal controls were appropriate. The budget was tight — as it always seems to be — but I had an ace in the hole. My client was audited.

I figured, no problem; I'll just put the auditor on the stand. She can testify to the lost profits and the internal controls that prove the accuracy of the lost profits calculation. She is an expert and, best of all, she already did the work during the audit. That will keep the cost down.

I couldn't believe it when she told me that she couldn't do it. She said something about independence. Independence? Who does she think she works for, anyway?

It turns out she works for the audit committee of the board of directors. I checked the rules put out by the American Institute of Certified Public Accountants (AICPA). Not only do the rules say that the auditor works for the audit committee of the board, they say that the auditor has to be "independent."

It seems, in those long ago days before the Enron mess, some accounting firms made a lot of money doing consulting work, rather than auditing. The auditors would go in and say things like, "Gee, we think there is a problem with this computer system; let me introduce you to my consulting partner who can fix it for you (at the low, low price of only a few million dollars)." For some reason, people got the idea that auditors wouldn't really "go to the mat" and make their clients correct accounting errors for fear of losing all of that consulting income.

As a result, under Sarbanes-Oxley, SEC and Public Company Accounting Oversight Board rules, auditors cannot provide legal services and expert services unrelated to the audit. While auditors can recommend improvements to systems, structures and processes, they cannot provide bookkeeping or other services related to the accounting records or financial statements of the audit client, financial information systems design and implementation, appraisal or valuation services, fairness opinions or contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions or human resources, broker or dealer, investment adviser, or investment banking services, or anything else the Public Company Accounting Oversight Board decides is impermissible.

Although the American Institute of Certified Public Accountants rules governing privately held companies are not as specific, they also say that an accountant has to be independent in order to

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audit a company. The AICPA defines a lack of independence as anything that would be perceived by an informed third party as compromising the accountant's professional judgment. The AICPA goes on to say that advocacy — "promoting an attest client's interests or position" — is a threat to an auditor's independence.

Under the interpretations of these rules, it doesn't matter if the lawyer (rather than the audit client) hires the accountant to provide expert testimony. No wonder my client's auditor ran the other way when I asked her to get on the stand. And I thought it was just because she didn't like lawyers.

To further confuse things, there are even different sets of rules governing audits and litigation support work. Litigation support work falls under the Statement on Standards for Consulting Services. Although there is a fair amount of overlap, the rules governing accountants' provision of litigation support services explicitly require accountants to maintain "integrity and objectivity."

While judges and juries love to hear that an expert has to be objective (and act with integrity), my client's auditor told me that even if she could provide the expert testimony I wanted, she couldn't do it as quickly as needed because she would have to do a great deal of work to prepare. Apparently, she took her obligations of integrity and objectivity seriously.

So what can an auditor testify about? A fair amount, actually. The AICPA rules explicitly say the auditor can testify as a fact witness and can defend the services the auditor provided. This means that the auditor can "validate" the numbers in the client's financial statements, which is critically important if you are using those financial statements as the basis for a damages calculation. Although it isn't quite the Good Housekeeping Seal of Approval, it is probably as close as you are going to get in a commercial case. The auditor can also describe the tests he or she did on the systems that generated the financial statements and provide a good response to the most common cross examination questions on the limits of audit testing.

As every auditor is quick to remind you, the preparation of financial statements is the responsibility of management, not of the auditor. The auditor "only" tests the financial statements to gain reasonable assurance that the financial statements taken as a whole accurately reflect the financial position of the company in all material respects.

For example, an auditor will not trace the revenue generated by every contract through the company's entire financial reporting process from the issuance of the purchase order to the contribution to net profits. Instead, the auditor will pick a sample of the purchase orders (they usually use statistics to figure out how many they need to pick) and trace them through. If those purchase orders are booked correctly, the auditor has a reasonable basis to believe that all of the company's purchase orders are booked correctly, and that the net profit reported is materially — even if it is not perfectly — accurate.

So how can an auditor say that the profit associated with a particular purchase order is correct if she never tested that particular purchase order? Sometimes she can't. This is because an auditor does not give an opinion on specific transactions. Instead, the auditor offers an opinion on the financial statements taken as a whole. An auditor assumes, based on her testing and her procedures, that the company's internal financial systems are working properly and generating reliable numbers. If the auditor couldn't make this assumption, she couldn't give a clean opinion. As with so many other things, if you phrase the question correctly, you can get a helpful answer.

Naturally, an auditor will never give absolute assurance that the particular financial entries in question are accurate. Audit opinions always disclaim fraud and have materiality qualifications. You can, however, ask an auditor what she would have done if she'd gotten even a hint of any improprieties with respect to the company's financial statements. While the answer may be self-serving, it will go a long way toward convincing a jury that they can trust the company's numbers.

An auditor can give even better testimony when it comes to internal controls. If the auditor doesn't think that a company's internal controls are appropriate, at a minimum she has to issue a special letter to the audit committee describing the problems. At worst, an auditor's lack of faith in a company's internal controls will require the auditor to issue a qualified audit opinion, or even disclaim the ability to give any opinion (an event that usually leads to bankruptcy). The lack of an internal control letter must mean that the auditor concluded that the internal controls were appropriate.

And don't forget to ask the auditor how she knows that the internal controls were appropriate. The answer will almost certainly involve the auditor's knowledge and experience with internal controls at other companies, and the fact that the company's internal controls are as good or better than those of other similar companies. Volia, an instant industry practices expert.

Therefore, in the case of my client, the company's auditor was able to get me most of the way to the jury. She validated the company's numbers and apparently convinced the jury that they were accurate. She also testified to the jury that the company's internal controls were appropriate and that the company had good processes in place. All that was left to do was to hire a forensic accountant to calculate the specific lost profits at issue. While that did involve some additional expense, it wasn't as much as I had feared.

It turns out that the audit took care of a lot of the work the forensic accountant would have to do, and the forensic accountant only had to make a few calculations. Because he could rely on the auditor's work, he didn't have to reinvent the wheel.

So the bottom line is, while your client's auditor can't give all of the testimony you want, she can be a very helpful witness. It is therefore better if you go to trial with two accountants.