

Three Ways for Counsel to Mitigate Litigation Risk:

AN ACCOUNTING EXPERT'S PERSPECTIVE

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On the most basic level, the role of the general counsel is to ensure that the organization is acting within the limits of the law. Additionally, corporate counsel should be concerned with minimizing the risk of litigation. Oftentimes, conflicts arising from disputes in a business setting require the use of accounting professionals in the role of consultant, expert or third-party trier of fact. Based on one author's experience as a CPA involved in litigation for over 30 years, presented below are three key ways that corporate counsel can mitigate the risk of litigation in their organizations.

Encourage the implementation of a comprehensive system of internal controls

In 1992, COSO published *Internal Control -- Integrated Framework*. The COSO Framework defined internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories: (i) effectiveness and efficiency of operations; (ii) reliability of financial reporting; and (iii) compliance with applicable laws and regulations. The scope of internal control therefore extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company. The ACFE notes that lack of internal controls is by a large margin the most commonly cited factor that allows fraud schemes to succeed (followed by absence of management review and over-ride of existing controls). Comprehensive, effective internal controls can not only largely prevent the occurrence of fraud, but can aid forensic accountants in detecting fraud, should it occur, and identifying the guilty parties.

Be proactive in dealing with external auditors

Financial statements are the responsibility of management, but a review of the auditors'

working papers can be vital to understanding the extent of management's reliance on the auditors' advice. Although management alone makes financial reporting policy decisions, when it seeks the auditors' advice on technical issues, the auditors will typically prepare a "memo to file" on the advice sought and offered. Corporate counsel should advise management to also fully document its own understanding of consultations with its outside auditors. Oftentimes, this type of documentation will aid the litigation team in defending white collar actions as it can help to reveal management's intentions and motivations, and the extent to which it was diligent in seeking expert guidance. In the event of later allegations of financial statement misrepresentations, should litigation become inevitable, a review of the auditors' working papers can assist defense attorneys in understanding how the auditors came to render an unqualified audit opinion on financial statements that are later contended to have contained material errors or deliberate irregularities.

Control the risks inherent in M&A

When acquisitions are largely based on projected future profitability, the use of contingent pay-out arrangements, most commonly earn-out agreements, can help mitigate the effects of information asymmetry. However, the biggest concern in devising earn-outs pertains to how future profitability is to be measured. Most contracting parties believe that, by specifying GAAP, future disputes will be obviated. However, a surprisingly large number of disagreements develop even when GAAP is the agreed-upon metric. As there still remains a surprising amount of flexibility within acceptable application of these principles, a duty lies with sellers to complete a comprehensive due diligence of the buyers' financial statement presentations and the accounting treatments of those business transactions and events that may play a roll in ultimate pay-outs. An understanding of recent and forthcoming ac-

counting pronouncements, including the consideration to stipulate "frozen GAAP" for the duration of the contract, as well as defining specific choices for those accounting standards that permit choices among alternative accounting treatments, such as for inventory costing, depreciation methods and computation of bad debt reserves for valuing customer receivables, will greatly assist in mitigating the risks of consequences unintended by either party at the execution date of the agreement.

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