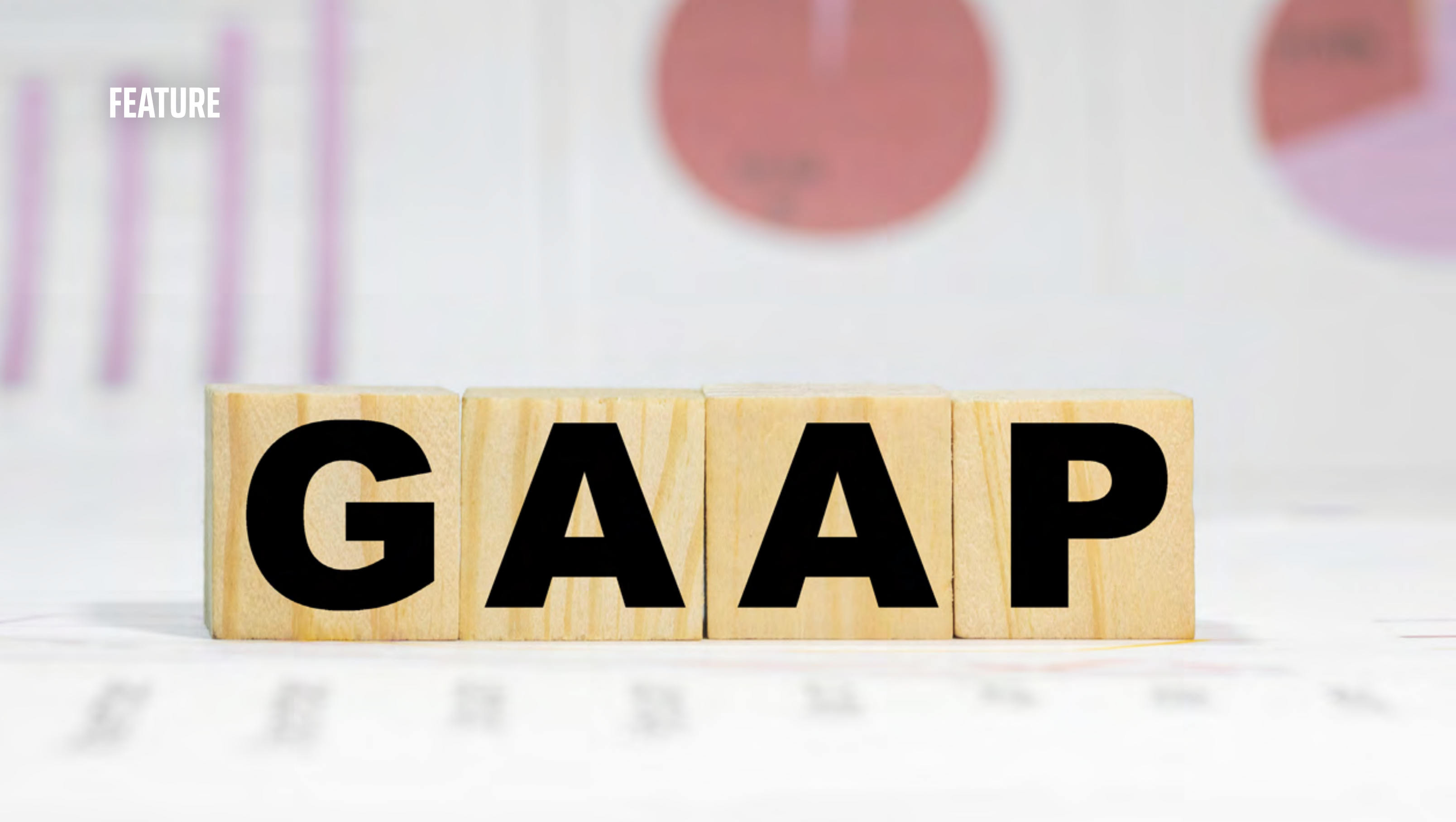

GAAP AND Economic Damages

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In litigation disputes, it is not uncommon for damages experts to rely on financial information from one party or multiple parties. The information produced may be audited or unaudited.

In the United States, a company's financial statements are often prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Attorneys, judges and other interested parties who are aware of GAAP, but unfamiliar with its purpose, may seek to understand whether the expert's damages methodology "applies" or is "consistent with" GAAP.

In this article, we review the purpose of GAAP and clarify the nexus between GAAP and the analysis of litigation damages in the United States. With certain exceptions, such as where the financial statements themselves are a basis for the dispute (e.g., allegations of accounting fraud), it is not the expert's role to "apply" GAAP or perform an analysis that is "consistent with" GAAP. This is because GAAP is a reporting standard applicable to the preparation of financial statements, while an expert will typically take financial statements as an input to which standard damages methodologies are then applied.

Accounting Overview

Generally Accepted Accounting Principles are a collection of commonly followed accounting rules and standards for financial reporting. The purpose of GAAP is to allow the users of financial statements to be able to understand the financial condition of entities subject to GAAP, and to provide transparency in financial reporting and consistency from one entity to another.[1] GAAP rules vary by country, which has historically made it difficult (without performing adjustments) to compare closely an entity subject to one country's GAAP to an entity subject to another country's GAAP.

As a result, there has been an impetus globally to adopt International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB). Such an adoption would make comparisons significantly easier.[2] Currently, 120 countries have adopted IFRS in whole or in part, but for the foreseeable future, the U.S. will still be using its GAAP, as no decision has been made on a timeline to adopt IFRS.[3]

Since July 2009, the Financial Accounting Standards Board (FASB) has been the official source of nongovernmental U.S. GAAP.[4] U.S. GAAP is required by the U.S. Securities and Exchange Commission (SEC) for companies whose stock is publicly traded in the United States.[5] Additionally, adherence to U.S. GAAP is often viewed favorably by private company investors (and other users of financial statements) and can be a requirement of lenders and acquirers, even if the subject company would not normally be required by law to conform to GAAP. Generally, auditors of financial statements subject to U.S. GAAP indicate as part of their audit opinion whether the financial statements conform to GAAP:

> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.[6]

However, as we explain in the following section, GAAP does not necessarily, and in general does not, apply to the determination of economic damages.

Application (or Nonapplication) of GAAP to the Determination of Economic Damages

The Federal Judicial Center's *Reference Manual on Scientific Evidence (Reference Manual)* identifies five categories of damages measures:

- Expectation;
- Reliance;
- Restitution;
- Statutory; and
- Punitive.[7]

The *Reference Manual* states that when measuring economic damages, "the goal … is to find the plaintiff's loss of economic value from the defendant's harmful act."[8] A relevant question is whether the practitioner's pursuit of this goal needs to be done in a matter that is "consistent with GAAP."

In most cases, the practitioner will rely on financial information provided by the parties in the determination of economic damages.

As discussed earlier, unless a party's financial records are the basis for the dispute, the damages analysis is conducted independent of GAAP. The reason, again, is that GAAP standardizes financial reporting so that financial statements are comparable across companies.

GAAP is not a methodology for the calculation of economic damages. As others have summarized, an "expert opinion in litigation, while invariably rooted in the financial books and records of the disputing party or

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parties, is not an auditor's opinion on financial statements and may therefore be exempt from GAAP and GAAS."

> Practitioners need to understand the distinction between auditors' opinions and expert opinions. GAAP and generally accepted auditing standards (GAAS) relate to the preparation and examination of a company's financial statements. An auditor's opinion as a result of an audit, review or compilation engagement addresses whether – in the opinion of the auditor – the financial statements fairly present the results of the company in all material respects. An expert opinion in litigation, on the other hand, while invariably rooted in the financial books and records of the disputing party or parties, is not an auditor's opinion on financial statements and may be therefore exempt from GAAP and GAAS.[9]

The fact that GAAP itself is not a damages calculation methodology does not absolve the practitioner from undertaking reasonable efforts to confirm the validity of the data relied upon. While the "validity of data is ultimately a matter of judgment ... [v]alidation of data turns in part on commonsense indicators of accuracy and bias."[10]

The *Reference Manual* provides "a list, in rough order presumptive validity, of data sources often used in damages measurement."[11] In this list, the first category of information is official government publications and databases. The second and third items listed are a "company's audited financial statements and filings with the Securities and Exchange Commission" and a "company's accounting records maintained in the normal course of business."[12]

This is not surprising, as a company's SEC filings, such as form 10-Ks, are signed by its CEO and CFO as to their accuracy[13] and a company's audited financial statements are typically based on its accounting records maintained in the normal course of business. Thus, while practitioners should evaluate the reasonableness of the information they rely on, practitioners do not routinely

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evaluate whether the underlying data they rely on was prepared following GAAP. This typically would be duplicative of the work performed by the company's auditors and accountants and outside the scope of the expert's engagement, which is presumably to reach an expert opinion on damages.

In certain instances, it may fall to an expert to apply GAAP and/or GAAS. Such instances may include disputes as to the accuracy of the financial statements, where the plaintiff files suit against firm management for not reporting financial statements to auditors in accordance with GAAP, or purchase/sale disputes in which one party questions the accuracy of prior financial statements that may impact the determination of a post-closing working capital adjustment.[14]

Outside of these and related scenarios where the statements are in dispute, the practitioner typically relies on the financial information provided in performing the calculation of economic damages.

Best practices for the determination of economic damages are beyond the scope of this article; however, the determination of economic damages itself is neither consistent with nor inconsistent with GAAP. The nexus of GAAP and economic damages occurs when the expert relies on data as an input that has or has not been prepared in accordance with GAAP.

In the lost profits context, the determination of but-for revenues, incremental costs, and other considerations such as prejudgment interest and the application of taxes is performed in a manner that is agnostic to GAAP.

Similarly, in an intellectual property context, the determination of a reasonable royalty rate is based on considerations such as comparable license agreements, cost savings, available non-infringing alternatives and profitability attributed to the patented invention, and is also agnostic to GAAP.

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Role of the Damages Expert

In summary, GAAP is directed toward the preparation of a company's financial statements and facilitates comparison of financial performance across companies and

GAAP itself is not a methodology for the determination of damages.

With certain exceptions, it is not the role of the damages expert to "apply GAAP" or perform a damages analysis that is "consistent with" GAAP. This is because frequently (though not always), the expert's analysis relies on a party's financial statements as an input.

If the financial information relied on is not in dispute and the expert reasonably believes the information to be accurate, it generally does not fall to the damages expert to apply GAAP.

ABOUT THE AUTHORS

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FOOTNOTES

[1] CFA Institute, *US GAAP: Generally Accepted Accounting Principles*, available at https://www.cfainstitute.org/en/advocacy/issues/gaap.
[2] In addition to simplifying comparisons across entities, the adoption of IFRS would simplify the financial reporting of international companies subject to multiple accounting jurisdictions and with subsidiaries located across the globe.
[3] AICPA, "IFRS FAQs," IFRS Resources (2020), available at https://www.ifrs.com/ifrs_faqs.html#q1.
[4] FASB, "Implementing New Standards," available at https://www.fasb.org/jsp/FASB/Page/LandingPage&cid=1175805317350.
[5] SEC Division of Corporation Finance, *Financial Reporting Manual*, Section 1410, p. 48.
[6] AICPA Reports on Audited Financial Statements, AU §508.04, p. 2152.
[7] Mark A. Allen, Robert E. Hall and Victoria A. Lazear, "Reference Guide on Estimation of Economic Damages," in *Reference Manual on Scientific Evidence*, Third Edition (2011), at p. 433.
[8] Id., p. 429.
[9] Elizabeth A. Evans and Roman L. Weil, "Serving as a Financial Expert in Litigation," in Roman L. Weil, Daniel G. Lentz and Elizabeth A. Evans (eds.), *Litigation Services Handbook: The Role of the Financial Expert*, Sixth Edition, Chapter 2 (see 2.6), Hoboken, NJ: John Wiley & Sons, Inc. (2017).
[10] Allen, Hall and Lazear (2011), at 484.
[11] Ibid.
[12] Ibid.
[13] SEC Rule 13a-14(a)/15d-14(a), Certification of Chief Executive Officer, and Rule 13a-14(a)/15d-14(a), Certification of Chief Financial Officer.
[14] Evans and Weil (2017), see 2.7.