2011

Divorce : the accountant as financial expert

Kalman A. Barson

Forensic accounting in divorce matters is a growth industry. If you do your job well, judges and lawyers will seek you out and boost your business. This new, in-depth resource offers fresh ideas to any CPA who serves as a financial expert in divorce cases. Full of practical examples based on author Kalman Barson's decades of experience as a CPA specializing in divorce, the book frankly discusses the many ways spouses hide assets from each other.

It also features chapters on hot topics such as best practices in data forensics and the financial ramifications of the dissolution of civil unions.

This expert guide poses questions you may not have considered on topics such as:

- how to work strategically with attorneys on both sides of the case
- how to handle messy personal financial records
- how to bring out the best in your clients
- why visiting a company remains vital to your work
- how to create a compelling lifestyle analysis
- 25 essential elements of your expert witness report

Bonus practice aids include comprehensive checklists on the valuation of medical, legal, and accounting practices and a personal budget form for clients who need help managing their finances.

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By **Kalman A. Barson**, CPA/ABV, CFE, CFF

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Dedication

Short and sweet, a sincere and heartfelt dedication to a few people:

- ***Janet Barson***—My wife of over 42 years who is still my high-school sweetheart; besides it being impossible for me to imagine what life would have been without her, she is also responsible for so much of my accomplishments over the years.
- ***Rebecca and Emily Barson***—Our two daughters who have already proven themselves academically and in the professional worlds that they have chosen for their careers and to whom, years ago, I was able to come home after numerous days of insanity in my chosen niche and simply be thankful for their daily hugs.

Unfortunately, eight very special people are not alive to have the pleasure of seeing their son, grandson, and son-in-law in print:

- ***Harry and Naomi Barson***—My parents, whose memories remain. In particular, my father who set the example for me in so many things, including following in his footsteps in accounting.
- ***Colman Barson***—My namesake who I never knew.
- ***Esther Barson***—A happy woman who was always a treat to visit.
- ***Abraham Cohen***—A man with whom I spent many a pleasurable and educational Shabbos.
- ***Fannie Cohen***—A wonderful, wise, and loving woman who will be missed as much as her life was long.
- ***Sam and Ruth Klotz***—My in-laws, to whom I owe a debt of gratitude for creating their daughter, my wife.

In some way, every one of them had a hand in this book.

Acknowledgments

First and foremost, there is no way that I would have been able to accomplish this book without the extensive assistance of my wife Janet, and our firm's administrative assistant/paraprofessional, Laura Johnson. The hours devoted to the production of this book by them probably exceeds the hours I spent; and their collective/joint inputs as to various related issues were invaluable.

I would also like to thank Amy Krasnyanskaya as well as Andrew Grow of the AICPA. Amy and Andrew were the main people within the AICPA with whom I worked in developing this book – they were always prompt, helpful and a pleasure to work with. Their assistance in guiding this book through the process and the inevitable editing were crucial to making this work.

I would also like to thank what some would call my competition, but which I prefer to call my peers. In particular, I'm referring to those members of our informally organized fellow practitioners group (Divorce Services CPAs) where we candidly share issues and concerns impacting our daily services in the investigative and valuation arenas, particularly as to divorce cases. This area can often be difficult and stressful, and having this group of peers to share ideas, and from which to learn, to have a back and forth repartee, to share and develop ideas, provides invaluable assistance in this type of work. At the risk of omitting someone, I would like to specifically name and thank (listed strictly in alphabetical order) the following with whom I have had the pleasure of being involved in this peer association for quite a number of years:

Marty Abo • Sharon Bishop • Bob Bonavito • Lynne Broza • Robert Chalfin • Stacy Collins • Don DeGrazia • Paul Gazaleh • Ilan Hirschfeld • Tom Hoberman • Scott Maier • Sharyn Maggio • Bruce Mulford • Jerry Newler • Randy Paulikens • David Politziner • Henry Rinder • Michael Saccomanno • David Smith • Barry Sziklay • Larry Thoma • Stacey Udell • Jeff Urbach • Alan Winters

About the Author

Kal Barson, the founder and shareholder of The BARSON GROUP, PA, is a CPA licensed in both New Jersey and New York. He is a graduate of Lafayette High School in Brooklyn, New York and received his Bachelor's of Science in Accounting from Brooklyn College. He is accredited in Business Valuation (ABV), a Certified Fraud Examiner (CFE), and Certified in Financial Forensics (CFF). Kal has over 30 years in accounting, virtually all of it working with small to medium-sized companies and individuals, emphasizing tax and financial planning, managerial controls and business profitability. For most of the past 30 years, he has concentrated on investigative accounting, business valuation and litigation support services.

In the forensic accounting and business valuation niche area, Kal has extensive hands on case experience, covering matters such as divorces, shareholder suits, partnership dissolutions, business interruption claims, fraud and embezzlement, and various other accounting type services involved in financial litigation matters. He has investigated the financial operations of an extremely varied range of businesses involved in various services, retail, wholesale, distribution, construction, manufacturing and the professional service sectors. These investigations and valuations have included complex multi-entity cases, minority stockholder suits, insurance losses, and funds flow tracing. Perhaps too often, the services also include determining the real income of a business operation, including addressing concerns as to the possibility and extent of unreported income.

Kal has often been an expert witness, and has testified in court and depositions numerous times. He has also been called upon as a consultant regarding the financial and tax aspects of settlement options. While many cases involve working for one side or the other, Kal has had numerous court appointments and joint stipulation assignments. He has also been appointed as a fiscal agent and discovery master.

Kal has authored several texts in the investigative and valuation arena, as well as several mini-books. The texts include:

- "Investigative Accounting" – Techniques & Procedures for Determining the Reality Behind the Financial Statements (Van Nostrand Rheinhold) – 1985;
- "Investigative Accounting in Matrimonial Proceedings" (Prentice Hall Law & Business) – 1993;
- "Investigative Accounting in Divorce" (John Wiley & Sons) – 1996;
- "Income Reconstruction – A Guide to Discovering Unreported Income" (Editor) (AICPA) – 1999;
- "Investigative Accounting in Divorce" – 2nd Edition (John Wiley & Sons) – 2002.

The mini-books, typically between 40 & 60 pages, targeted to the judicial and legal communities include:

- "Divorce Taxation – the Basics" – 2004;
- "Business Valuation – the Basics" – 2006;
- "Financial Issues in Divorce Practice" – 2007;
- "Reading & Understanding Tax Returns & Financial Statements" – 2008;
- "The Majesty & Glory of Unreported Income" – 2009;
- "Divorce – It Can Get Personal" (lifestyle analysis & related matters) – 2010.

Kal is a frequent panelist/lecturer/instructor – having spoken on behalf of the AICPA at various national conferences, as well as on behalf of the NJ Society of CPAs, and to a number of other accounting associations and groups. Kal has also frequently lectured to various legal associations – including the New Jersey Judicial College, The Institute for Continuing Legal Education (NJ), The American Academy of Matrimonial Lawyers (NJ), and others.

In perhaps a somewhat unique vein, Kal also formed a peer group (informally titled Divorce Services CPAs) about 15 years ago. This is an informal group of fellow CPAs who do investigative and valuation work in the divorce arena, and who get together approximately four times a year for friendly open discussions on a wide variety of issues impacting their practices.

Kal is a member of the Board of Directors and the past president (for 8 years) of CPA-USA Network (formerly National Associated CPA Firms). He is also of course a member of the AICPA, and of the New Jersey Society of CPAs – where he has been very active in matrimonial and litigation services committees and sub-committees, having chaired some of same. Kal is also a member of the Association of Certified Fraud Examiners.

On a personal level, Kal is a long time Board member, and member of the Executive Committee, as well as the past President, of the Jewish Federation of Somerset, Hunterdon & Warren Counties (NJ). He is married over 40 years to his high school sweetheart Janet. Their two daughters, Rebecca and Emily (& Emily's husband Matt) live in Washington, DC, where they are actively involved, and employed, in the social services and political arenas.

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Richard Iglar

Richard F. Iglar, Esq., is a partner at Skoloff & Wolfe P.C. in Livingston, New Jersey. He has been certified by the Supreme Court of New Jersey as a matrimonial law attorney. He is a Fellow of the American Academy of Matrimonial Lawyers (AAML), the preeminent organization in the nation for family law practitioners. He serves as the secretary of the National Test Committee of the AAML and on the board of managers and board of examiners of the New Jersey chapter of the AAML. He has published a number of articles in the *New Jersey Law Journal*, including "The New Secret Weapon: Retroactive Counsel Fees" and "The Rules of Engagement." He has frequently provided legal commentary for New Jersey News 12 and the radio on a variety of family law topics, including custody matters, father's rights, the development of New Jersey family law and high-profile cases. He graduated from Rutgers College (cum laude and Phi Beta Kappa) and Boston College Law School. He has been recognized as a super lawyer by *Law & Politics* and *New Jersey Super Lawyers* magazines.

Preface

To lighten the atmosphere and satisfy my sense of humor, each chapter (including this introduction) will start and end with carefully selected anecdotes from my experiences. All are true, with just certain identification matters altered to protect the absurd.

> *Accounting for Fun and Games—This involves one of the most egregious situations in which we were ever involved or could even imagine. We were investigating a family business, modest in size but not insignificant, and our procedures included testing various expenses related to the postings that created those expenses. This also extended to testing certain banking transactions and getting a comfort level about such things as reported revenues and the accuracy of expenses on the tax returns. We expected that this would be easier than most situations because the company's accountant was a professor of accounting who moonlighted on the side for some local businesses, keeping their books and records. What we encountered caused us to question the value of an accounting degree from the college at which this professor taught.*
>
> *What we found was that the tax returns did not remotely agree to the internal recordkeeping (which was via QuickBooks) and that we couldn't reconcile any of the expenses on the tax returns to the underlying QuickBooks records. Recognizing that there could be reasonable explanations for this and that we were dealing with no less than a professor of accounting, we reached out to him to help us understand his system. It took us several repetitions of our discussion to make sure that we understood him correctly. As he explained to us, he ignored QuickBooks, figuring that the software probably had mistakes in it. Instead, he summed up all*

the disbursements as run through the bank statements and then made an educated guess about an expense allocation for various expenses. That is, by way of example, if he felt that it was reasonable for office supplies to be 15 percent of expenses, that's exactly what he would do: take the total expenses that he tallied from the bank statements and assume that 15 percent of the expenses were for office supplies. That is how he created each and every expense that was recorded on the tax returns.

As if this piece of lunacy wasn't enough, we asked him for his supporting workpapers, so that we could at least trace what he did and figure out why, in the aggregate, the numbers didn't agree. As you might imagine, for someone whose concept of accounting was as perverted as this professor's, his response to us was that he maintained no workpapers or records, but rather (and this is a virtual quote), he jotted down his notes on scrap paper and then discarded the scraps.

The fields of investigative accounting and business valuation (which, in my world, for all intents and purposes, constitute one field) have been very good to me as a professional; in the relationships developed; as an educational tool; and, of course, financially. It is an interesting niche that, despite the various aggravations and areas of tension (what would business and life be without some of those), makes accounting, at least to me, an interesting and challenging field. I got involved in this field over 30 years ago and have never regretted it and never found it to be boring or lacking in challenge. I wrote my first book in this field over 20 years ago, and at that time, I believe it was the only book truly focusing on the hands-on aspects of investigative accounting of closely-held businesses.

As I previously mentioned, this field has been good to me in many ways, including financially. One unfortunate aspect is that you come face-to-face with a lot of misery: divorce is no fun. The further reality is that a lot of that misery is aimed at, or realized by, the wives and children. I know there are plenty of husbands who suffer miserably, but because of simply how our world has evolved, relative power positions in general, and relative physical strength positions in general, there is no question, at least in my mind, that, in the aggregate, the wives suffer greater than the husbands. Presumably, nobody would challenge that the children also suffer greater than the husbands. Thus, in some sense of giving back, all the royalties generated by this book have been assigned to the following three charities that focus on women and children:

- Planned Parenthood of Greater Northern New Jersey (Morristown, NJ)
- Wider Opportunities for Women (Washington, DC)
- Women Aware, Inc. (New Brunswick, NJ)

Thus, if you have gotten this far in reading, I suggest you urge whoever you know to buy multiple copies of this book; besides making me, as the author, feel good about the number of copies, it would also be to the benefit of three very worthy charities.

I have written this book for an audience who I expect to be fellow CPAs and accountants, particularly those focusing on divorce practice, but also those who might want to get a better sense of what is involved in various aspects of investigative accounting and, in particular, handling a divorce engagement. Also, I see this book being of great benefit to the legal practitioners who practice family law. It should help them better understand the process that we accountants go through and why our services are relevant in virtually any divorce of substance in which serious money or a closely-held business is involved.

In regard to my fellow CPAs, particularly the experienced ones, I would expect that this book is going to be a combination of topics that you already know and a reinforcement and refresher of certain topics that you may not think about each day. Hopefully, somewhere, I provide some interesting, valuable nuggets; an approach or thought that you find helpful; something you had not considered before; and maybe something that gives you one of those "Aha!" moments. If you experience one of those moments while reading my book, I will consider my efforts to be a success. If it is not clear what I mean, it is something special that stands out. Think about walking down an aisle in a supermarket, past the odorless, pasty, nondescript white bread, and coming across a wonderful surprise: an aroma-filled loaf of seeded rye. I will consider this book a success if it provides you with one of those wonderful moments, an idea, a concept, a reaffirmation of an approach, or a contradiction of an approach and if it gives you an idea of how to view something differently, which, in turn, will save you some time, aggravation, or money.

We work in a wonderful field, and it truly gives us the opportunity to provide very valuable and tangibly valuable services to our clients. It is not the ho-hum financial statement or tax return services, both of which, although required by the government, are somewhat perfunctory. Rather, this field gives us a chance to truly help people who need the help, even if they oftentimes accept that help begrudgingly or outright reject or resist such help. We still provide help knowing that on the other side, someone likely considers us not much better than crawling leaches, although that extent of venom is usually reserved for the attorneys.

I would be terribly remiss if I did not thank Laura Johnson of my office, without whom this book never would have been completed. Special thanks go to my wife, Janet, who also works in (runs) our firm, for completing the Herculean proofreading task and for the assistance she provided to Laura. Also a thank you to my contributing authors: Richard Singer, one of our state's leading divorce attorneys, and Paul Lewis, a standout in the computer forensic field.

I truly hope that you enjoy reading this book and that it provides real value to you and your practice. I invite your feedback, suggestions, and comments. You can reach me by phone at (908) 203-9800 ext. 101 or by e-mail at kal@barsongroup.com.

> ***It's the Little Things That Count***—*This one is my absolute favorite and absolutely true anecdote that falls under the rubric of "truth is stranger than fiction." I was involved in a particularly difficult divorce matter in which I represented the wife of a very arrogant and obnoxious doctor. She had been browbeaten for years and, arguably, had some emotional issues. We were in court on a regular basis, and at this stage, we were involved with the trial. My client showed up one day in court with an elegant but small velvet pouch that was only large enough to hold maybe one or two apples. She walked over to her husband and handed him the pouch. Not even looking in it, he took*

that pouch and handed it over to his attorney. The attorney looked inside, blanched, and then immediately brought it to the judge.

You can imagine what was going through my mind, as well as the wife's attorney's mind as this process was evolving. The judge looked inside, and that is when the proverbial "s…" hit the fan. What followed was a truly unique discussion on the record. In that velvet pouch was a sheet of paper with a poem written on it, something about birds and love. However, the essence of this whole situation was that also inside the pouch, wrapped in that paper, was my client's stool sample. As she explained (because the judge insisted on some kind of explanation), she had recently come back from a vacation in Mexico, was not feeling well, and was urged by her doctor (not her husband) to have a few tests taken, including, of course, having a stool sample analyzed. My client felt that rather than spending several hundred dollars for such tests, because her husband was a doctor, he could take care of them either directly or through his connections. The judge immediately institutionalized my client.

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Parameters of the Inquiry

SAY WHAT? There are many different styles of conducting business, and a sense of humor is often helpful. That was carried to a bit of an extreme in one of our cases that involved investigating a business that sold parts and supplies. The husband ran what he considered an informal operation, which was rather manifest on some of his billings. After detailing what was being sold with prices for each item, the bill listed a subtotal and reflected adjustments. The exact quote was as follows:

> *1% more handsome than me discount, rarely given; 1% smarter than me discount, more rarely given; 1% better built than me discount, never given.*

As accountants, we are pretty much all ready to jump in and start an investigation of a business. However, particularly in litigation, and in divorce matters, it is prudent to have an understanding of many of the related issues that are not necessarily directly involving accounting services in the traditional sense. Rather, there are numerous aspects for us to appreciate the potential morass into which we are stepping, and issues that we will be expected to handle. This chapter will provide us with that kind of opening understanding, providing some insight into issues that we will run into on a regular basis. As examples, this would include, recognizing the importance of economic as contrasted with tax concerns when we are doing a financial investigation; dealing with concerns of unreported income; the practical concerns of valuing a small interest in a large company; the particularly divorce-oriented concerns of active versus passive, as well as cut-off/as-of dates. Also addressed in some depth are concerns having to deal with tax fraud – which is an area that simply must be considered (perhaps more accurately cannot be shunted aside) in a divorce matter.

It is critical, as early on in the involvement in the matter as possible, to truly understand the parameters under which we are working. Certainly, it tends to be a given that if we have a business to investigate, we are going to look for whether personal expenses have been run through the books, the trends, and so on. However, those are the easy givens; a number of issues exist that may be very important to grasp, so that we can proceed efficiently and effectively.

Big Picture Issues

Consider the most important big picture considerations when faced with an investigation engagement:

- *Economic versus tax.* Typically, the businesses that we run into report their numbers on one form of a tax basis or another. Obviously, for the smaller businesses with no financial statements, the only financial document that really provides the key information would be the tax returns. Those tax returns are almost always done on a *tax basis*, which, for our purposes, means that taxes have been minimized to the extent possible. When financial statements exist, particularly if they are at a higher level (think in terms of audit and, possibly, review but not compilation), we may be blessed with a financial record that is expressed in economic terms. However, with the exception of some audit situations, expect that even with financial statements, tax motivation has been predominant.

  A couple of simple examples would be depreciation and meals and entertainment expense. For tax purposes, depreciation can be almost everything that is purchased during the year—and for most small businesses indeed everything. So, as an example, for many businesses, if the business purchased $400,000 of long-lasting equipment during the year (for example, machinery and equipment or furniture), the tax law allows immediate upfront initial-year write-off of the entirety of same. It is pretty obvious that those types of write-offs do not represent economic reality. For our purposes, we will need to restate that depreciation, along with the book value of the assets, to bring it in line with economic reality. On the other side, let's say that a business has $50,000 of meals and entertainment expense in 1 year, and let's assume, for the moment, that it is all legitimate and for valid business purposes. The tax laws only allow the write off of 50 percent of that expense. Thus, in that sense, the taxable net income would be overstated by $25,000. Once again, that is an item that requires us to make an adjustment to bring tax numbers into economic reality. When we are looking to determine what is going on in the business, especially when we are looking to determine income and value, economic reality trumps tax reality virtually every day.

- *Unreported income (URI)*. Is there or is there not URI? This is potentially a very big issue from a number of perspectives. If we have reason to believe (and it is important to know this at the very beginning) that the existence of significant URI is a real concern, then it tells us that (more than is typical) less reliance can be given to the books and records. It also tells us—and this is very important from many perspectives—that to do the job right, the fees are going to be much higher; performing investigative accounting for the determination of URI is a time-consuming and expensive process. It also, therefore, dictates how we intend to approach and attack the books and records of the business. It may tell us that more emphasis than normal has to be given to the lifestyle of the individuals. The key issue is that if we believe or know that URI is a serious issue, our approach is going to be different and, in many ways, more intensive.
- *Major perquisites and benefits*. In a sense similar to the preceding regarding URI, it is important to get a grasp as early on as possible about the extent of very heavy perquisite use (benefits received from the business). To cut through the fine points, let's simply call this "running personal expenses" through the business. Many (perhaps most) businesses do that to a degree. After all, it's hardly a shock to believe that a business might have deducted a couple of meals that were not really business expenses. Or perhaps the owner of the business took out an ad in a local community journal because a friend sold the ad, rather than because there was any business benefit from it. However, in many situations, the perquisites are extremely substantial. In one case we investigated, we saw a check for $15,000 made payable to a well-known university, running through the books as cost of goods sold. It was the college tuition of the business owner's child, and it was being treated (buried) as if it were a business expense. Knowing that perquisite use likely helps set the stage in advance for understanding how much work is involved in the investigation and for directing us in terms of how we intend to approach the investigative phase of our services. When we are looking to flesh out the assignment to get a sense of what level of staff we need, how many hours are involved, and what kind of fees the client should anticipate, it helps tremendously to have a grasp on these types of critical aspects.
- *Normal versus atypical and aberration*. An often overlooked issue is trying to attain an understanding in advance about whether the subject business has gone through, or been subject to, certain unusual situations, swings, or positive or negative growth over the past several years. Doing so helps us evaluate the nature of the job and determines

how we are going to approach the investigation. Appreciating the extent of the work that we need to do is very different when we look at a five-year spread of a business and see that the sales revenues have been in a fairly narrow range or gradually increasing or decreasing, in comparison with a situation when sales have fluctuated wildly or significantly increased or decreased. These two types of situations are very different, and although the skill set is the same, the attitude, approach, and plan of attack are going to be different. This is also the case when we look at a several year spread of expenses. It is a different concept and approach when the expenses are fairly consistent from year to year and at a level that strikes us as reasonable (assuming an experienced CPA who understands what the numbers should be), in comparison with various expenses fluctuating dramatically from year to year or various expenses being out of what we would consider the normal range. Usually, we are concerned with expenses being too high, though occasionally even too little raises our eyebrows. Once again, the approach and intensity of what has to be done are different. At the risk of redundancy, greater intensity means more hours; a higher level of inquiry (think partner or manager versus staff or junior partner); and, thus, more fees.

Valuing a Small Interest in a Large Company

One of the challenges that we come across every once in a while in divorce valuation is when, whether it is our client or the spouse of our client, we are asked to value a small interest in a large operation. Think in terms of a partner in a law firm that has hundreds of partners, and the interest being valued is 0.5 percent. Putting aside valuation methodology and the usual type issues, there are a number of interesting issues to be addressed:

- Does this business or practice have a buy-sell agreement (or stockholder agreement or partnership agreement), and if so, has it been used with some degree of frequency in the past few years? If no such agreement exists, then we are most likely free to proceed with the more typical valuation processes. However, if there is such an agreement and if it has been used regularly, then, in many jurisdictions, we either will be restricted to the terms of that agreement or have a substantial obstacle in our way to do anything other than use the terms of that agreement. It is probably a bit trickier if an agreement is in place, but it hasn't been used or has been used only infrequently.
- Do we attempt to perform a forensic analysis of the entire business or practice, or limit ourselves to what is only directly applicable to the interest being valued? The latter is really not that simple. How do we know that we are limiting ourselves to what is directly applicable without access to the entire business or practice? However, just how practical is it to be performing a forensic analysis of a substantial-sized operation to look for hidden perquisites of one individual out of many, especially if that one individual does not control things? Even with control (which is a relative term in an entity of this size), it is likely that there are procedures and controls in place, so that the books, as they relate to any one particular individual, are relatively clean.

- Does it make sense to try to look at the whole for the bigger picture games that may have been played or adjustments that would appear to be warranted instead of perquisite adjustments for one individual? Even if we felt that was the case, to what extent does it make sense when we approach the value, especially in this example of 0.5 percent interest?

In a law firm; professional service operation; and, possibly, other types of entities, another way to approach the concept of value is to consider the possibility that the individual owning that interest being valued has the potential to walk away with his or her book (equivalent of book) of business. As an example, New Jersey is generally considered to be a state where, as a matter of public interest, there can be no restrictions on an attorney and his or her clients. Therefore, an attorney can leave a practice and take the book, assuming that attorney has such a book. So, assuming we are confronted with this type of situation, perhaps an approach would be to not worry so much about valuing the overall entity (and very likely we may be restricted to the terms of the buy-sell agreement) but, rather, hypothesizing what this individual can do with his or her book of business. Although an interesting approach, it brings in various hypotheticals and assumptions, including whether the individual has the ability to walk away with that client base, the expenses incurred in setting up a practice, perhaps some time value issues, and so on. Also, just how portable is a book? By way of example, if that book requires a team of 20 attorneys to serve it, will this individual be able to walk away with another 19 attorneys from that firm to establish this practice that we are hypothesizing can be made out of the book that has value? Or is it practical that even without such a team, the attorney at issue can bring that book to another firm where there is a team and an infrastructure available to service that client? (This is similar to what stockbrokers do when they leave one brokerage house for another.) If so, how does that affect what we are trying to accomplish in regard to determining value?

Finally, does it matter what level of power this individual has within the firm or business? In a sense, this raises the question of the ages. Is any 0.5 percent interest the same as any other 0.5 percent interest? Does it matter and is there a difference if the 0.5 percent interest being valued is owned by just any rank and file attorney partner versus the managing partner or head of the compensation committee? No answer will be attempted to be addressed here; the question is being raised for its interest.

Cutoff or As-of Date

One of the more basic items that we need to know when we get involved in the investigation and valuation of a business is the as-of date, as well as the time span for the investigation. The latter is usually less of a concern because it tends to be one that we determine that by using our professional judgment. However, there are many exceptions such as when a client expresses concerns that during a certain timeframe or certain number of years ago, the spouse might have been doing things or there is reason to believe that things might have been going on (for example, a diversion of funds) that warrant special attention. Putting that aside, though, the timeframe tends to be our call. However, the as-of date is critical and not ours to decide.

Is the valuation date, say, June 4, 2011, or July 30, 2011? Depending on the state, the valuation date might be the date of filing of the divorce complaint, a moving target going much closer to trial, or some other date. In any case and in all likelihood, we are going to do some analysis beyond, let's assume for the moment, the typical December 31, 2010, previous year-end cutoff. Obviously, the extent of the case and complexity of the issues all come into play in terms of how much analysis will be required. The previous year-end cutoff is a convenient date and one that provides us completed tax returns, a closed set of books, and the like. However, if the as-of date takes us into the middle of the year, we very likely need to perform some level of investigation into that year. On the other hand, if the valuation date is January 25, 2011, or perhaps December 7, 2010, then barring any unusual circumstances, we can assuredly rely and focus on a December 31, 2010, cutoff date. These illustrations assume a typical calendar year-end.

In some cases, it will be important to focus on as precise a date as possible because of possibilities such as the movement of substantial sums of money from one place to another, which might have been done (intentionally or unintentionally) a couple days before or after the complaint date or valuation date. That might represent an asset of substance that cannot be ignored. Also, depending on the jurisdiction, there may be a very stringent, regimented, and enforced cutoff date issue. Let's say that we are dealing with a December 5, 2010, as-of date, and to simplify matters, intend to use December 31, 2010, as the company's year-end. It would not be too much of a stretch to believe that in some situations, attempts will be made to preclude us from looking at any transactions of that business beyond December 5, 2010. These attempts might go so far as to try to prevent us from having a copy of that business's tax return for the year 2010. I would imagine that such efforts would be unsuccessful, but it is an item to keep in mind and one to pursue as soon and vigorously as possible. These concerns tend to be amplified in the valuation phase of our services.

Now, let's add some complications to the cutoff and as-of dates considerations. How about a recession? We had some pretty nasty changes to our economy in 2008–10, and who knows how long it will carry forward. Regardless of which side we are on, whether for the good or bad of the company, it is possible that there could be major changes in economic conditions. We are not concerned here with the typical relatively minor year-to-year fluctuations but, rather, something of substance. For instance, let's say we are investigating an automobile dealership with a 2009 as-of date. Perhaps the easy one is if it's a Pontiac dealership. That's too easy; it's questionable whether its financial history is relevant at all because an expectation exists due to the fact that the dealership closed.

Instead, assume it's a Hyundai dealership—one with fairly strong fundamentals. How much are we going to rely on the past few years when we are performing our forensic analysis (keep in mind that I am not addressing the issue of valuation here)? Part of the purpose of this forensic analysis is to determine a normalized level of net income. How much do we take into account a recent recession? Is that recession going to continue for a while (who knows), and how much does that matter when we are looking at a long-term situation? How relevant is that recession as to the numbers we are working on today? If the business has been around for say 20 or 30 years and if it's a fairly long-term marriage, how relevant are 1–2 years of poor numbers? How much of a difference does it make if it's 1–2 of good numbers? This is not only an intellectual issue for the forensic accountant to deal with both in the forensic as well as valuation process, but it is one whose resolution may very well depend on the rules of the jurisdiction.

However, in these situations, maybe we are called upon to do a bit of projections. Typically, our forensic analysis does not rise to the point of doing a projection; rather, it establishes a normal level based on history and then an assumption about a level of growth going forward (which is generally only a valuation issue as contrasted with determining normalized net income). However, it would not be far-fetched to consider that in some situations, we may be asked to make some form of a projection going forward for purposes of litigation, such as when a recession has taken a toll on this business or, perhaps, when certain recent, favorable events have atypically improved the operations of this company. That is an area fraught with a whole new range of problems for the forensic accountant. Just how far into the bowels of the business do we immerse ourselves, and to what extent does that rise to the level of providing, in effect, management-type advice that may be beyond scope of what we are truly expert in doing? That is not to say that we couldn't render this type of service with the assistance of management and some serious investigation; rather, that tends to be outside the range of what we do as investigative accountants in a litigation matter. Besides, it would bring a whole new dimension to the professional fee area.

In addition to the issue of dealing with past history in times of major economic changes, we have to deal with how far forward we can peek. This is not just a valuation issue where it's fairly well-established that we are not allowed to use subsequent events (let's put aside certain practical issues and jurisdictional concerns). Instead, let's deal with the forensic issues and extend that into an area where we know information that we simply cannot ignore. How much of that subsequent information are we allowed to use, and how do we use it? To give an example in a litigation case where the author was involved, we had a business that was rather profitable, and one of the areas of contention during the trial was the growth rate to be factored into the development of the cap rate for valuation purposes. The issue here was not so much value, but more basically, had this business substantially peaked (and would it only grow in accordance with inflation), or did this business still have some serious room for growth in its future?

Because the two valuation experts had significantly different growth rates factored into the development of their cap rates, this was a lot more than merely a theoretical question. The case dragged on for a while and went to trial a couple years after the complaint date. The business's tax returns for the two years subsequent to the valuation date were entered into the record and used by one of the experts. There were the usual objections for bringing in postvaluation financial data, but the judge allowed it, with the proverbial admonishment of "I'll give it the appropriate weight." It turned out that in the year following the valuation date, the business grew by over 20 percent, and then, in the following year, it was stagnant at that new higher level. How much of that new information (which no one could possibly have known at the time of the valuation date) can be used in the work we do? Is it strictly to help support or refute an assumption of growth, without giving it the strength and weight of directly affecting the value?

Directly connected to this type of issue is one of the business's cycles, assuming that can even be defined. It is generally accepted that most businesses have cycles, but that's not definite nor are they easily determined or defined. Assuming there is a cycle, is it a couple years, several years, or long-term? If that could at least be determined, then the issue of the extent of reliance on the past few years in the face of dramatic changes in economic conditions can be better addressed. Often, particularly for small businesses, that's not practical or feasible.

Generally, we have flexibility and some latitude in how we handle cutoffs when we are concerned about an as-of date. What I mean by that is let's say that we have a complaint date (a valuation as-of date) of January 25, 2011, in a case that involves the investigation and valuation of a closely-held business that has the customary December 31 year-end. In probably 95 percent (or even more) of our cases, we would be very comfortable in stopping our investigation at December 31, 2010. We have closed books, it's a natural time to stop, and the difference of a few weeks will not matter. That is virtually a guarantee about value (putting aside the possibility of some unusual or extraordinary events happening).

However, keeping in mind that this is divorce work, it may not be as simple a break on the personal aspect end as it is on the valuation end. For instance, let's say that in the first couple weeks of January (just after the year-end that we used as a cutoff for valuation), a bonus or distribution was paid to one of the spouses. That might make a big difference in either direction. Perhaps the distribution was in the form of a large bonus to a minority owner of the business when that amount of money would not otherwise have been in the pot. Or let's assume it's an S-corporation, and the value of the business as of that date was inclusive of that pot of money, but now, it has been distributed and is in the bank account of the individuals and was counted as part of their marital and personal balance sheet. As a result, there may be, in effect, a doubling up, particularly if that sum of money was significant and relevant to the valuation and is now also reflected as a bank account asset of the couple.

On the other side of the fence, maybe we've got a cutoff date of December 5, 2010, and we perform the valuation as of December 31, 2010, as a practical matter. Perhaps the business had some issues, and there was a significant capital infusion toward the very end of the year, with part or even all of that infusion coming from the parties being investigated (divorced). Perhaps a marital balance sheet is prepared as of the December 5, 2010, date of complaint, one that obviously includes these funds that were used a couple weeks later as a capital infusion for the company. However, the valuation of the company was done as of December 31, 2010. Assuming that this infusion made a difference, once again, we could have the effect of doubling up an asset. This area is more complex than this simple illustration might suggest, but the concept and concerns remain the same.

Active Versus Passive

One particular issue that can make a big difference in the extent and direction of our work is the passive versus active argument, or the issue of separate versus marital assets. As a general statement, if an asset (think business) was acquired during the marriage other than by gift or inheritance (or possibly as the direct consequence of an asset that existed prior to the marriage), then that asset is in the marital estate (in the pot), and the issue of active versus passive tends not to be relevant. However, it is hardly unusual to be involved in a divorce matter in which one of the spouses has an interest in a business, and that interest was either in existence prior to the marriage or came about through a gift or inheritance from family during the marriage. In most, if not all, jurisdictions of which the author is familiar, in such a situation, a critical question is the extent, if any, of appreciation in that asset during the marriage, provided that asset is considered an active asset. Generally speaking, if the asset is a passive asset (for example, a block of publically traded stock), then any appreciation (let alone the underlying basis) is not in the pot, and during the divorce process, the other spouse has no claim to that asset. If we are indeed talking about a 100-share block of publically traded stock, then the answer is rather simple and obvious. However, it can be much more difficult if the asset at issue is an interest in a closely-held business.

If we are dealing with an interest in a closely-held company, and especially if that interest is a minority interest, we may very well need (want) to address whether that valuation interest is active or passive. This is clearly a case- and individual-specific situation. The first question to address and the first issue to resolve is to what extent, if any, the individual whose interest we are valuing is involved in the business. This question is easy to answer when the interest was gifted or inherited, the individual at issue does not work in the business at all, or the individual lives in a different state. Barring something unusual (for example, classic telecommuting from a different state), this is definitely going to be a passive asset situation. In that case, the entirety of that asset, including any appreciation during the marriage, is out of the pot.

In many ways, the other extreme is just as obvious and easy to answer, such as when the individual at issue is employed full time by that company in an important role (for example, CEO, plant manager, head of sales, and so on). This is almost always going to be an active asset situation (there certainly can be exceptions, but only rarely). In that case, the appreciation during the marriage would be in the pot.

This area gets a bit more interesting when we have someone who is in between these two easy extremes. Fairly recently, we represented a spouse in a divorce case who happened to have an interest in a family business and got that interest via gifts. Further, the timing of the gifts was fairly close to when our client got married, which was a number of years earlier. Therefore, we had a long history of our client owning the stock, but clearly, the source of the stock was a gift, which constitutes separate property. The first issue addressed was that of employment; in this case, our client was gainfully employed full time in this family business in which our client had an interest. Thus, we started off with at least one strike against us. By the way, in New Jersey, the burden of proof of establishing an asset as separate property falls on the one who is looking to claim that status (burden of proof can vary from state to state).

The next issue that we had to address was the nature and extent of the involvement of our client in this business. This is where we were successful in clearly establishing the nonactive (passive) nature of this stock interest in the hands of our client. Even though employed full time for years, our client was not a decision maker and filled a noncritical, back office, paperwork filing type role. The job clearly was one that could be filled by hiring a clerk or bookkeeper, both of whom are generally readily available in the open employment market. Furthermore, the compensation that our client received over the years was in line with that type of job. To help further, our client had relatives in the business, and they filled more vital roles and were paid accordingly and substantially more than our client. Thus, we were able to establish in a fashion able to withstand challenge that the stock interest of our client was one of a passive asset; thus, the entirety of the value (original gifted value, as well as appreciation during the marriage) was out of the pot. The steps that we took included visiting the premises, observing our client and client's relatives in their respective roles, and interviewing various relatives of the client who worked in the business. By far, forgetting the fancy issues of valuation, this was the critical point; winning it meant that the value was irrelevant. By the way, because we didn't know which way the judge would rule on this issue, we nevertheless had to proceed with valuation, even though it ultimately turned out to be unnecessary.

Gift Tax Return

When dealing with gifted interests in a business, we have found that it is often the case that no gift tax returns were prepared. Sometimes, that's actually preferable to gift tax returns having been prepared, depending on which side of the fence we are on. Let's first deal with situations when gift tax returns are prepared. On one level, they at least provide us with a foundation for the value at the time of the gift. There are at least a few issues with that:

- Was a real valuation performed? Sometimes, for fee expediency, a so-called valuation is prepared for a gift tax return that would fail the relevant standards that we hold ourselves to when performing a real business valuation. Maybe no backup exists for the number expressed on the gift tax return because it was placed there by an accountant or attorney with no existing support. Perhaps the valuation was performed based on the company's book value, or maybe a lower level valuation was performed just to get something on the record. When these situations exist, what kind of reliance can be placed on any such expressed value?
- Valuations for gifts and estate purposes are performed at fair market value. This means that, when appropriate, discounts for lack of control, as well as lack of marketability, are applicable. Depending on the jurisdiction, when it comes to divorce, value might be the fair value standard rather than the fair market value standard. Typically, this would mean no discounts. Refer to the previous bullet; depending on the quality, or at least the depth, of the available records used for the gift return, we may or may not have a fair value starting point for determining value in the divorce case. If it is

clear that certain discounts were taken, they can be undone, or more likely, for our purposes, we can revert to the starting point in the gift valuation before discounts were taken. However, what if a number is expressed without the supporting detail? Can we assume that discounts were taken? Even if we can, what were the percentages of the discounts?

- Even if a full valuation was performed, and we have the report, what if we disagree with the valuation? What if the quality of that appraisal was not the level of work that we would demand in our practice or demand for valuation purposes in a divorce? How strong is our position in ignoring that valuation? Are we going to be in conflict with the gift tax return that was filed and, possibly, passed an IRS exam? Will our attitude be different depending on which side of the case we are working?

What if there was no valuation for the gift? Yes, we all know the rule that there should be a valuation for any gift above a certain level. However, let's for the moment accept that no valuation was performed, or at the very least, no record exists of any valuation being performed. Further, no gift tax return was prepared. Some might argue that in the absence of a gift tax return, with the burden of proof being on the one claiming the separate property element, we fail that proof, and the interest in the business cannot be considered separate property. But is that really fair or reasonable when, using this as a hypothetical, the tax returns are available for the last 15 years, and 12 years ago, we see a change in the listed ownership percentage? In addition, one or perhaps both litigants acknowledge that there was a gift, family members indicate that there was a gift, and maybe even other family members outside of this divorce recall the gift. Further, let's assume that there is no record of the stock interest ever having been paid via marital funds. Is it reasonable or even logical to try to take a position that in the absence of a gift tax return, one party cannot claim the separate property aspect of that interest? Furthermore, what if the argument is that when the gift was valued at fair market value (even though there is no trail to prove this), the conclusion was that it was worth less than $10,000, and at that time, no gift tax return was necessary? As an aside, in New Jersey, there has generally been an acceptance that this issue will not rise or fall based on the existence or absence of the gift tax return. Rather, unless there is sufficient evidence otherwise, the reality of a gift having been made can be accepted.

Tax Fraud

I don't know about you, but when we get down to it and cut out the niceties, I come across the possibility of tax fraud, if not every day, at least every week or month in the work that my firm and I do in this field. Whether it's URI or egregious perquisites, routinely, we see things that may rise to the level of tax fraud. This raises the issue of how best to handle tax fraud, including our responsibilities, the client's and attorney's responsibilities, the effect on valuation, and so on. There are a myriad of issues to be concerned about, all of which are considered grey areas within our field and open for much debate—although some might take the position that there are really no issues, and others might take the position that there is only one approach to take when dealing with tax fraud. The intent here is to outline the various considerations we should account for if the possibility of tax fraud exists in an engagement. Regardless, let's address some of the concerns in this area:

- What constitutes tax fraud, at least to the extent it concerns or affects the work that we do in a divorce arena? Should our concerns start and stop with a technical definition of fraud involving an understatement of income by at least a certain percentage or dollar amount? How bad does URI have to get until we consider it tax fraud (see chapter 7 for in-depth discussion of URI)? Further, unless we have the proverbial second set of books, anything we do to determine URI is going to be an estimate. How strong is our belief about the accuracy of our estimate?
- The extent of tax fraud is only substantial perquisites. Assume for discussion purposes that URI is not the concern, but rather, we find evidence of the business having expensed as a business expense, for example, the college tuition of some of the shareholders' children, cars provided to multiple family members, home furniture, and so on. Let's call these egregious perquisites. Economically and functionally, they are essentially identical to having a like amount of money simply not deposited and being handled as URI. However, many people look at URI very differently (and much more harshly) than they do perquisites, even egregious perquisites. Do we feel there is a difference between the two, and are we going to treat them differently? How many egregious perquisites are necessary in order for them to rise to the level that raises a concern about tax fraud?
- What are our responsibilities in this area? It is a delicate matter to consider, to be sure, and one open for much debate. Let's accept for the moment that there is no question, at least in our mind, that tax fraud exists. We could refuse to work on the case any further and fire our client or we could turn our discoveries over to the IRS. However, my suggestion is that if either is your approach, you are in the wrong business. Walking away from work is always an option, but the practicality of doing so must be weighed. I don't profess to be an expert in the area of law, but IRS reporting may very well constitute a breach of professional ethics. After all, you have come across this very highly confidential financial information in your role as an accountant, and you have a certain client confidentiality obligations. Disclosing this information voluntarily (versus disclosing this information via an IRS or other subpoena) could violate those obligations. On the other hand, you could be concerned that not disclosing this information in some way violates your ethical obligations. A difficult dilemma that we all must deal with in our profession. What I can share with you is that among the CPAs who do this work and with whom I regularly converse, the essentially unanimous feeling is that we have no legal obligation to voluntarily report this information to any authorities. That is, this information should stay within the confines of the case.
- The court process and trial are essentially legal concerns, but many times, the attorney will look to us for the right insight to help him or her make the decision about how far to pursue a case involving tax fraud. For example, in New Jersey, at least in theory, if a judge in a divorce action is presented with convincing evidence of tax

fraud, the judge is obligated to halt the trial and submit the matter to the prosecutor's office or the IRS (see previous bullet point and chapter 7 discussion regarding our roles in such matters). Thus, when faced with the possibility of tax fraud discovery, in our area, it is possible to hire a private judge (that is, a retired judge) or an attorney who will do mediation or even binding arbitration to prevent the case from going to court. Again, tread with some caution and consider working with client attorneys when faced with such matters.

- What if the tax fraud or URI involves our regular business client? Assuming here that it's the business owner(s) committing the fraud (as contrasted with employee fraud), what are we going to do about it? First, if you're involved as the expert for a regular business client in a divorce investigation, you probably made a big mistake, but this issue will be discussed further in chapter 7. More likely, the expert engaged particularly and specifically for the divorce has come across tax fraud. We have found out through that specially engaged accountant that this beloved client of ours has for years been guilty of tax fraud. I think the consensus is fairly straightforward—we need to have a face-to-face discussion with the client and address this touchy issue. We also need to recommend to the client that amended tax returns be prepared and filed to reflect the right amount of income. Another issue to consider is to make sure that our client understands that we cannot accept this behavior anymore going forward; we want the client's assurances that the past is the past and that the client will no longer engage in such tax fraud in the future. Regardless of whether we believe such representations and the steps we take to confirm the client's future actions are very much a personal decision and not the subject of this book.
- Well, now we have a leverage tool, which is a very interesting and potentially dangerous concept. Now that we know tax fraud exists, perhaps we have a weapon—a leverage tool—to secure a better result in this case. I have certainly seen that considered and attempted (never by the accountant); however, that causes some problems. For one, I have seen a lot of businessmen who have gotten away with this type of fiscal gimmickry for years and have even survived IRS examinations, and they are not about to change their ways or be bullied into a settlement they do not like simply because we got the goods on them. Furthermore, in most cases, it is that tax fraud that has enabled this couple or family to sustain their current lifestyle. If you blow the whistle, you have an excellent chance of cutting off the source of the funding for this family; as well as potentially damaging or destroying the business. Do you really want to do that? Does your client want to do that? It sounds in most ways rather self-destructive. Finally, if I understand the process, tax fraud is a criminal act. I don't believe it is allowed to try to use a criminal act as leverage in a civil action (divorce). That is a legal issue, and (again) I'm not an attorney, but it's an item for consideration. The very idea of proposing this type of leverage in practice may itself be a crime.
- If we have made a determination that tax fraud exists, and have the usual situation where the parties have always filed joint tax returns, we have to give consideration to discussing this situation with our client and counsel. This is particularly an issue if we

are representing the nonbusiness spouse, the one who would most likely qualify as the innocent spouse. Even if our role does not involve any direct tax work on behalf of either party and even if we are not going to be doing the nonbusiness spouse's tax return, we certainly need to consider emphasizing the tax fraud concerns to our client (and counsel), so that our client has the opportunity to reconsider the historical joint filing. (You may even have an obligation to emphasize these matters to your client and client's counsel.) Arguably, the innocent spouse defense is weakened, if not eliminated, once the nonbusiness spouse knows that URI has been discovered and joins in on the filing of a joint return. It would not be inappropriate for us, as investigative accountants, to emphasize that kind of concern and strongly suggest that separate returns be filed. It is also important for counsel to be aware of this matter from various perspectives, not the least of which may be dealing with the court system that doesn't fully understand this matter and questions why now, all of a sudden, we have a spouse who is refusing to file a joint return, which is probably going to cost the parties more in taxes. We don't want our client tagged with that extra tax bill just because he or she is exercising prudent caution relevant to tax improprieties. In short, it can be a tricky matter that deserves input from multiple parties.

When faced with tax fraud, we often have conflicting concerns if we make the discovery. Those concerns only change somewhat when we hear about the tax fraud instead of discovering it. Let's deal with some practical issues coming from each of those vantage points:

- *We discover the tax fraud, and it involves a litigation client.* The situation here is a typical retail store or medical professional who doesn't like depositing the copays. It is our client who runs the business, is clearly responsible for reporting the income, and has defrauded the government. It is important that such a discovery be followed as soon as possible with a sit-down conference with our client and client's counsel. Give the counsel a heads up about the purpose of the meeting, so that the counsel has an opportunity to avoid the meeting if he or she believes that might be the best way to handle this from a litigation point of view. However, it is this author's opinion that sitting down with the client and, preferably, the client's counsel is generally important, so that everyone understands that there is a potential or real problem, or both. A related issue is whether to advise the client's regular company accountant or ask our client to advise his or her accountant. Frankly, I'm not sure of the exact protocol, but presumably, as forensic accountants, we should not be directly contacting the company's regular accountant to advise him or her of this problem unless we have been given written permission by all parties to communicate everything and anything with the company accountant. Even then, it might be best coming directly from our client. Most of us who do this work, and I say this based on numerous discussions with many peers, believe that we have no further responsibility or any personal exposure on this issue. However, it is generally incumbent on us to advise our client (and possibly our client's attorney) of the problems and what should be done to correct the past and avoid the same problems in the future.

- *We discover the tax fraud, and the client is, arguably, the innocent spouse.* What I previously indicated about meeting with our client and client's counsel holds true (putting aside any issues relevant to the company accountant), even in regard to the counsel being involved in the meeting. After all, it is (hopefully) not our client committing the wrongdoing; rather, the client is someone we believe would qualify as an innocent spouse. As an aside, exercise caution in this area. Although the IRS tends to be lenient about the determination of an innocent spouse, it is a complex area, and unless your engagement extends to tax consulting for the potential defense as innocent spouse, I strongly suggest you not go too far in giving any assurances regarding your client's nonexposure. Regardless, have a face-to-face meeting to discuss what this discovery means from a litigation point of view, as well as a tax exposure. See also, discussion of joint returns in this section.
- *We did not discover the tax fraud (in this example, URI), and it involves a litigation client.* Here, the posture may be more defensive and even angling to see what type of redemption can be done. After all, it's only someone else's opinion that URI exists; maybe he or she made a mistake. Nevertheless, it certainly calls for a sit-down meeting with our client, and this time, our client's counsel should be present because you are only at the allegation stage of URI, and the allegations are not ours. Try to press your client into admitting that URI exists or holding fast to his or her position that URI does not exist or that it's either minor or grossly overstated by the other expert. In any case, our client needs to give a definitive answer about URI. If it exists, let us deal with it and see how much we can counter as part of our client's defense; if it doesn't exist, then disprove the other side. If our client acknowledges the existence of URI, then try to focus on its magnitude and reduce the amount of URI determined by the other expert. If our client denies the existence of URI, and we set out to disprove the other expert but, instead, prove his or her allegations, then we know our client lied to us (perhaps not the most earthshaking event in your life), and we'll have to deal with our client accordingly.
- *We didn't discover the tax fraud, and it involves one of our regular business clients.* This one really hurts because it involves a regular client who is not "just" a litigation client. This may be somebody whose business and personal returns we have handled for years, and now, all of a sudden, we have become aware of tax fraud or, at the very least, serious allegations of URI. We need to have a sit-down discussion with our client. The divorce attorney may not be important or relevant to our discussion because we are not directly involved in the litigation—at least not yet. We probably need to discuss our client's reaction to these findings and find out if our client agrees with the findings. If not, obviously, our client needs to do something about countering those allegations, whether with us or a financial expert engaged specifically for the divorce. Until that aspect is resolved, we probably do not have to do anything other than monitor the situation. If the matter is resolved by that other financial expert (or perhaps you—more about that later) who concludes that there is no support (or inadequate support) for the allegations of URI, then it would seem that we can rest easy.

On the other hand, what if we conclude that the allegations are correct, even if the magnitude is perhaps somewhat less than originally thought? Or what if our client acknowledged at the beginning of the investigation that URI exists? It seems to me that we effectively have two choices: either we fire the client (always a distasteful situation), or we advise the client that he or she needs to file amended returns for at least a number of past years and has to promise never to do this again. How much we believe of that is a separate issue. As far as filing amended returns, we cannot force our clients to do that, we can only recommend that they do so. If the client refuses, how far do we carry our insistence? Some might say that in that case, you have to fire the client; however, that judgment call is entirely up to you.

Let's briefly discuss an item I previously referenced: as part of this issue, your client asks you, the regular accountant, to take up his or her defense and investigate the business. Although we may be more capable than most to conduct this investigation due to our intimacy with the business, allow me to raise a serious caution. If we accept that engagement, we have now immersed ourselves in the divorce action, and we may not be well-equipped to do so, and may truly regret it. Also, what if our conclusion agrees with the other expert's conclusion that URI does in fact exist? Now, we have a client who asked us to come to his or her defense, and we have proven that URI exists or, at a minimum, agreed with the other expert that URI exists. Because of our conclusion, we will probably now lose this client. Words of wisdom: stay away from any such assignment.

Nonowner Employee Client

When it comes to financial investigations, our first thought relevant to a W-2 nonowner employee tends to be that there isn't much for us to do. After all, if indeed we are dealing with a nonowner employee, for the most part and with limited exceptions, the W-2 speaks for itself. (We assume here that the owner is not the father or mother of the nonowner employee and that we are truly dealing with an arm's length situation.) However, we certainly may have tracing-type issues, and the W-2 may be significantly complex.

In regard to tracing-type issues, these are particularly relevant with high earners. The reason is because if someone is making just enough to cover the bills, then there probably isn't much we need to do in the tracing area. However, let's assume we are dealing with a high earner—someone who earns several hundred thousand dollars per year or even several million dollars per year. Typically, in that environment, more money is being earned than is needed for the basic lifestyle; therefore, we may be called upon to do a tracing to find out how the money is being spent. This may include concerns about spending on luxury items, wasting marital assets, saving marital assets, and so on. The key here is taking the W-2 and subtracting the withholding taxes from the gross income to arrive at what would be considered, for our purposes, the net cash flow from the W-2. That is what we should see being deposited into the checking account. Putting aside fancy issues such as splitting the check, cashing some of it for pocket money, and the like, what we are dealing with here is that if, after withholding taxes, the net pay for the year is $500,000, we should be able to see $500,000 being deposited into one or more known accounts. If we do, then that aspect of our concerns has been laid to rest, and now, we have the relatively easy task (most of the time) of determining how the money was spent.

Of greater interest to us, using this hypothetical as an example, is if we only see $350,000 deposited. Now, we know we have a $150,000 mystery. A typical explanation for that mystery is that the money was deposited into another checking or savings account that we don't know about. Another possibility is that the money went to a checking or savings account that nobody else knows about. Think in terms of a well-paid executive whose paycheck is direct deposited into the family checking account. However, once per year, this executive gets a very sizable bonus. None of this causes a URI problem because it's all on the W-2. Just make sure that bonus also goes into the checking account.

Sometimes, our concern is not the cash flow but, rather, getting a thorough handle on the benefits received by this employee. This will typically require a thorough analysis of the W-2, as well as the year-end paystub or pay sheet, and making a serious inquiry into the benefits package enjoyed by this individual. Here we look for things such as deferred compensation; restricted stock units; stock options; a thrift plan; a cafeteria plan; and, possibly, a wide range of additional benefits. To what extent do these benefits come directly out of the employee's gross pay, and to what extent are these benefits that don't directly cost the employee anything? One area that may highlight a concern would be looking at box 5 (Medicare wages) of the W-2 in comparison with box 1 (taxable wages). A 401(k) plan is simple; to the extent that there were elective contributions, they would have been removed from the wages listed in box 1 but not from those listed in box 5. However, maybe there is a very big difference between the two boxes (for example, $100,000) because some form of deferred compensation was picked up as taxable for Medicare purposes now, but it is not immediately taxable income. When we observe these types of differences, they trigger the need to go further to secure all the details, so that we can properly serve our client.

BUT I SHOWED YOU ALL THE PAPERWORK— Typically, when we receive documentation, we have a closed transaction, but every so often, it's not quite that simple. In one service business that we were investigating, we noted a significant number of invoices from various vendors marked as being paid in cash, with checks being drawn against the company to reimburse the owner for paying those invoices in cash out of his own pocket. The invoices were typically for several hundred to a few thousand dollars each time, several times each year. It was explained to us by the owner that this was done because certain suppliers and *vendors required cash for special or rush jobs; therefore, he paid for those jobs personally and then reimbursed himself for these expenditures. Our review of the personal bank records, surprise of surprises, showed no such cash ever being withdrawn from the bank or any possible source of cash to pay these invoices. Yet, we had these invoices, and they were paid. What we had was a series of phony invoices. The business owner took what were, in some cases, legitimate invoices, made changes to them, copied, manipulated, etc., and created phony invoices. In some cases, he went a step further and created a phony supplier. What gave one invoice away was that he misspelled the town in which that phony supplier was allegedly located, as well as he got the telephone area code wrong. He didn't stop there, though. In reviewing charge account statements, we noticed instances of eight charges, one after the other, for the same flights. Obviously, several people were flying together. We were advised that this was a business trip and that the business owner we were investigating paid for all these flights because they were for business and referral sources. What he failed to mention was that he was paying for several of his friends' flights, so that they could all go on a golfing vacation. He also neglected to mention that each of his friends reimbursed him in cash.*

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Practical Concerns

WHAT'S YOURS IS MINE AND WHAT'S MINE IS MINE—Although most if not all states have done away with the long outdated and sexist title ownership issues in divorce, title is relevant in other elements in our lives. In one of my divorce cases, a surgeon placed all the assets in his wife's name as a measure of liability protection. He also had a habit of playing doctor with various women. It got to the point that his wife filed for divorce. What a beautiful example of role reversal; the husband and business owner-operator had literally nothing in his own name: not a bank account, not a savings account—nothing. Of course, his now estranged wife had no intention of making life easy for him and refused to cooperate in giving him access to any financial resources. It took a few months before he was able to get the court to order at least a temporary assignment of a chunk of their assets to him.

I have no doubt that the readers of this book by and large are proficient, perhaps very proficient, in forensic accounting. That is all well and good, but doesn't necessarily get us to where we want to go, doesn't necessarily cover all the important aspects of working effectively in the divorce litigation arena. The purpose of chapter 2 is to provide some insight and suggestions on a wide variety of practical concerns that will impact how we handle cases on a day-to-day basis. These areas include dealing with a small case, particularly in the face of our current standards, under SSVS; walking into a situation where the records are a mess, and how to try to address that in some efficient sense. Also, I try to do justice to helping all of us in the ever-present and very problematic area of our fees; as well as what often becomes an interconnected service for us in a divorce matter, and that is handling certain tax concerns of our client that weren't originally part of the deal.

Statement on Standards for Valuation Services No. 1 and the Small Case

In some ways, the creation of Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, vol. 2, VS sec. 100), didn't really change how those of us who believed in a quality product did our work. We already had our standards, demanded certain quality from ourselves and our staff, and produced well-done and credible products. At least in regard to a "full" (or nearly full) valuation job, for those of us who always did the job right, nothing much changed other than we now have the ability to point to our standards and the enhanced ability to challenge those in our communities who do less than good work.

However, the very practical issue of the small job became, in many ways, much more difficult. Before SSVS No. 1, when we got one of these small jobs, and we knew the fee couldn't stand a real valuation, we nevertheless brought quality to the work product; we just took judicious corner-cutting moves and shortcuts to get the job done in a practical, efficient manner and provide a service to everyone. Now, along comes SSVS No. 1, and although our hands are not tied, they are certainly a bit more restricted than prior to publication of that statement. What we have done in the past and what we think and know to still be a quality job and one that meets the realities of a tight budget now presents us with a number of concerns and issues. The reality is that if we set the stage correctly and make maximum use of the scope limitations allowed us under a calculation of value in accordance with SSVS No. 1, we can still proceed with these practical approaches. However, getting that across to the attorneys and judges, let alone to lay people such as our clients, can be a daunting task.

As a general statement, judges, attorneys, and clients are interested in the final product (clients and attorneys are also interested in cost) and rarely interested in the theoretical nuances with which we have to live each day. Assume for the moment that we have been engaged to handle a divorce case involving a typical small business, such as a professional practice grossing a few to several hundred thousand dollars per year or a retail or service business grossing a few hundred thousand dollars per year. We all know—and it's important to make the client and attorney know—that doing the right forensic and valuation job on a small business costs essentially the same as doing one on a midsized business (allowing for a certain degree of flexibility and margin for error). Sometimes, if a small business has a poorer set of records, the valuation job might even be more difficult and, thus, more expensive. The point is that a certain amount of time is necessary to investigate records and perform the right valuation work, regardless of whether it's a business doing annual sales of $300,000; $1 million; or $2 million.

So, if we are engaged to investigate and value this classic type of small business, depending on the local market, to do the right job and do a full (conclusion of) valuation, we can easily be looking at $20,000 and more in fees, which probably would be considered unacceptable by the clients (certainly, at least, the business owner) and, likely, the attorneys as well. In the "old days," we could pretty much determine what kind of shortcuts we wanted to take, cut the right corners, and still do a credible job. Now, with SSVS No. 1, sometimes, we have to clearly lay out what is effectively the scope limitation of our job in advance, so that we can qualify it as a calculation of value under SSVS No. 1. The easy part is the litigation report exception; we can make the report as brief as we want because the litigation exception allows complete flexibility in the degree of the report and even permits an oral report. However, it is my experience that in divorce litigation, even when we are as informal as possible, the attorneys, as well as the client, want something in writing for their files. What we need to do is have a sit-down meeting with the client and client's counsel to explain the limitations that we are going to impose and that they are going to accept in order for this job to be credible and, at the same time, remain in conformity with our standards. This process gets a bit more difficult when we are jointly stipulated or court appointed and need to sit down with both sides and convince everyone of what has to happen. To compound the situation, taking this time to explain this process is either nonbillable or adds cost to what has already been determined to be a cost-sensitive situation.

In order to make our fees more palatable to the litigants and their counsel and to remain in compliance with SSVS No. 1, it is suggested that the following are at least some of the areas we typically need to push for (or impose) agreement about limiting our scope:

- *Forensics*. Typically, especially in a smaller valuation job, forensics can easily exceed the fee for the valuation process. The problem here is that the forensics are often more important than the valuation, but it's the valuation that dictates our standards.
- *Unreported income (URI)*. If there are no concerns about URI, terrific. However, if there are concerns, an absolute big money saver is for the litigants to agree on an approximation of the amount of URI. This can be a very difficult area to get a concurrence because the business owner will often mightily deny virtually any URI and only begrudgingly acknowledge a modest amount. On the other hand, the nonbusiness spouse may be knowledgeable (or think that he or she is knowledgeable) and have a big number; imagine a big number; or, very often, truly have no real idea about the number. When faced with that situation, how can we expect the nonbusiness spouse to agree to something about which he or she has virtually no knowledge? Yet, in that one area alone, if we do not come to an understanding, the forensics will easily be a significant fee. One suggestion is that maybe if there is a commonality of under-

standing about the approximate level at which the couple or family were living, perhaps the difference between that level and the reported income can constitute a URI figure for purposes of our analysis. For additional discussion on URI, see chapter 7.

- *Perquisites*. Perquisites are a bit easier to deal with than URI, but they can still prove to be challenging, and the uninvolved spouse may really know little about them. Try to come to some understanding about the magnitude of perquisites. Once again, the parties have differing needs, goals, and levels of knowledge.
- *The business owner*. If we are representing the business owner, we are in a quandary on this one. How much are we going to accept at face value simply because our client told us, and yet, at the same time, try to do the right job for that client? We know that if the matter goes to trial, the more we have accepted at face value, the weaker the position. The situation is not much better representing the nonbusiness spouse. Just how much does that person really know about the business, and therefore, how much information can we accept from that person in trying to limit our role? When jointly engaged or court appointed, at least we can maybe get them to sit down together and hammer out some level of agreement. Frankly, that's the exception to the rule.
- *Valuation approaches*. Here we at least we have an opportunity to get the parties and counsel to agree on limitations. It is often not all that difficult to convince them that we can eliminate the cost approach because the case involves a profitable business. We can agree to eliminate the market approach because it can add a lot to the fees, and it is likely not going to be the best approach (more about that elsewhere in this book). Thus, get them to agree to some kind of an income approach. We might also be able to get them to agree to a common knowledge, rule of thumb approach, with or without an income approach to back it up. If it's a type of business in which the market approach can be easily performed from reference sources (this does not mean public company comparables and guideline companies), then maybe that also can fit into the budget.
- *Economic and industry background*. This should be easy to shortcut if there is fee pressure. Dictate that we will not be performing any general economic background (macro or micro) nor will we perform industry background. Instead, we will use what we already know and what we can glean from the clients themselves. This can be a big time saver.
- *Words of caution*. Tread carefully, and get everything in writing. Frankly, do not trust anyone on this. If we are going to shortcut the process, which inevitably has to be done in a calculation of value and might have to be done when there are fee pressures, make sure that the engagement letter, or something along the lines of an engagement letter, lays out the shortcuts, scope limitations, and so on, and get both sides to sign off on it. Maybe even get their attorneys to sign off on it and acknowledge that these limitations were agreed to as part of the assignment. Do not leave it simply for the report letter or, worse, an oral report. Assume from the onset that the litigants will have short and selective memories, particularly regarding anything viewed as adverse to their interests.

One final word of caution relevant to these scope limitations and performing a calculation of value: when calculating that value, give serious consideration to making one of the limitations on our work that we will not testify in court about the calculation of value. This is particularly the case if we are being engaged by only one side, as contrasted with being neutral or court appointed. In the latter situation, perhaps with the appropriate restrictions, we might agree to testify in a "friendly" situation by presenting the points to put them on the record in a form other than that of a classic cross examination. Even then, a word of caution: we may get boxed into a situation we don't like. However, if we are representing only one side, getting put into a situation of testifying when we've performed a calculation of value and the other side has performed a conclusion of value is kind of the equivalent of bringing a knife to a gun fight.

A final, final word of caution: in general, it is hardly unusual that after we present our findings, one or both sides are disappointed or have questions that we simply can't answer because, after all, we only performed a calculation of value and restricted forensics, as well as valuation approaches. So, they agree (or if we are working for just one client, the client decides) to expand the scope to either make it a bit more of a detailed calculation of value or, perhaps, even go the full route to a conclusion of value. The good news is that we've got more work and more fees and an opportunity to do the type of job we prefer.

However, we also have a problem: we've already expressed our (please excuse the choice of words here) conclusion about the calculated value. To a degree, we've almost put ourselves in a position where, for the most part, the outcome of the newly expanded scope of services has been predetermined. Forget all the theoretical fine points and justifiable accounting explanations. The reality (let's face it, we are in a litigation environment) is that we arrived at a calculated value of X. Now, whether for one client or jointly, we've raised the level of our service and eliminated some or even all of our scope limitations, and our job is to come up with a better supported calculation or conclusion.

Be honest with yourself—how much different can you afford this new number to be from the old number? Remember, you're the only expert; everyone else is a layperson, including the attorneys. They are not going to really understand (or even want to understand) why what was once X is now perhaps two or three times X or one-half or one-third of X. We know that if we have a variation like that, and are a neutral expert, one of the parties is going to be furious with us. If we are working for just one side, and the new number is to our client's favor, then, ultimately, we are open to challenge when discovery brings out our first calculated value figure. If the new figure is contrary to our client's interests and desires, then explain that one. Especially because our work product is always discoverable (at least from my experience as an expert in divorce work), if we've got a major swing or variation of note between one calculation and another, one side or the other is going to be interested in the reasons for the change, and one or way or another, we will probably be grilled and made uncomfortable. No matter how good and technically or theoretically well-presented our explanation, remember that everyone else does not understand.

The Records Are a Mess

What do we do when the records are a mess? We have all seen this on a personal level, such as when we are performing a lifestyle analysis, and on a business level, especially if it's a small business. Checkbooks, statements, and canceled checks are missing, and sometimes, the business records are maintained manually in what turns out to be a two-write version of a one-write, except one of the twos weren't written. Fill in your own horror story situations in this space. We want invoices in support of various checks, but they are not available. What do we do about these situations? We can consider a few angles here, none of which are perfect and are sometimes mutually exclusive:

- *Don't do the work.* A tried and true resolution to many problems. Depending on how bad the situation, this may be the best answer. Certainly, this is a case-by-case call.
- *Make the client understand.* Tell the client that to do the job right, it's going to cost a lot of money because there are going to be elements of record reconstruction. This is probably my personal favorite, but only works if the client understands and has the money to back up that understanding. Moving forward without that understanding and, in most cases, moving forward without an increased retainer or level of payment, is likely an invitation to fiscal disaster.
- *Tell the client to go back and fix the records.* This works sometimes, but what makes us think it's going to work when the client has not done it before? Why should we make a difference now? We might, but this probably will not be a successful strategy.
- *Hire a bookkeeper to do the work.* This also works sometimes, and although it entails expense, it is probably a more efficient and cost-effective way to proceed than us, as accountants, doing the job. The assumption here is that the business does not have a bookkeeper, so bring in an outside bookkeeper. Besides, if the business did have a bookkeeper, look at the mess that it is in now. Do we want to risk the process with a bookkeeper who hasn't gotten the job done before? If this involves personal records, because we have a client who simply is not into record keeping and bookkeeping functions, bring in that outside bookkeeper. Sometimes, we might be able to do it within our own office via a paraprofessional. The concept here is that under our direction and control, the books will be done (redone?) at a less-than-accountant level. I suggest that this be a separate engagement apart from the litigation. Also, depending on the type of litigation and the particular jurisdiction, it might almost be a necessity to use an independent bookkeeper and maybe even one who will bill separately from our firm to maintain true independence and arm's length.

One of the problems we sometimes run into in this area (more so when it involves personal financial records) is that it can be very expensive to get copies of the front and back of cancelled checks from the bank. Nevertheless, many times, we have no choice. Having a bank statement detailing each and every check and deposit is nice on one level, but as we all know, it doesn't tell us anything about what the checks were for. We can make this process a little less painful, a little faster, and a little less expensive by narrowing the demand for cancelled checks to those above a certain threshold that is appropriate for the matter at hand. Don't forget that depending on the bank or institution from which we are seeking these records, we can be looking at weeks or even months before those records are produced.

For some purposes, an imperfect resolution of a recordkeeping morass is to use benchmarks. Keep in mind that this is subject to many shortcomings, and by definition, benchmarks only represent averages. Benchmarks are rarely useful in reconstructing a business's operations, but sometimes they apply to certain limited areas such as determining a gross profit (and even then great caution is urged), and they can be useful in trying to reconstruct the lifestyle of a family. Be careful that you are using benchmarks that are either appropriate for or have been adjusted for the regional differences in which you are working.

Sampling

We know that many things can be done properly through a sample and that sampling, in many ways, is a science with statistical validity that is well-established based on certain parameters. Take an adequate random sample, and we have something that could be expanded and extrapolated to the total universe that may have statistical validity and be scientifically accurate. However, we are appealing to a judge, not a statistician. It is important that we get across the message that what we have done is valid, and even though we only tested, for example, 20 percent of the transactions (which very obviously means that we did not test 80 percent of the transactions), what we did was scientifically correct, acceptable, and within the standards of our professional community. As an example, it might be helpful to point to political polling in which samples of less than 1 percent of the voters with a margin of error of, for example, 4 percent are considered a statistically valid sample. Here, we are testing 20 percent, and our margin of error is probably less than 1 percent. If necessary, be prepared with a statistics textbook with the right pages flagged, so that you can point to an authoritative source that backs up the legitimacy of what you have just done.

Also, keep in mind the trade-off between the quantity of transactions and the dollar value of the transactions. Statistical samplings work well when we have a large volume and no particularly large outliers. In a small volume, statistical sampling is less reliable. When there are significant dollar outliers, we may need to look at the large ones separately from any sampling simply because of the likely distortion their omission would bring to our analysis. Also, perhaps in the area we are investigating (for example, a general ledger account), there are 100 transactions totaling $100,000—the obvious arithmetic average being $1,000 per transaction. If our random sample of 20 transactions only totals $5,000, recognize that although we have taken a 20 percent sampling of the number of transactions, we have only taken a 5 percent sampling of the dollar volume. Even if that were statistically valid, it is not going to cut it in a trial and is going to require that we expand our sampling to make sure that we do justice to the dollar amount involved.

If, for the particular case we are involved in, this part of our investigation represents an important and substantial aspect, consider not taking a sample (regardless of whether it is statistically valid) but, rather, performing a far more substantial analysis, possibly even 100 percent. Of course, that is a judgment call, but the caution here is that if the numbers are large, think of the need to defend your approach on the stand and what the cross-examining attorney may argue was "left on the table." What might taking only a sample mean in defending implied shortcomings of our conclusion?

Copies Versus Originals

The issue of demanding to review originals as contrasted with copies is not what it used to be. The quality of copiers nowadays, as well as having many documents prepared by computers, often means that the quality of the copy is every bit as good as the original, or the original, being computer generated, can be replicated as an "original" multiple times over. Thus, the presence of too many copies as contrasted with originals, which was a standard concern in a fraud examination and a related-type issue in performing most forensic examinations, is no longer a concern. For almost anything that is internally generated by the target company (for instance, a sales invoice), this angle of attack virtually does not exist anymore.

However, this is still a relevant issue for some outside-generated documents (for instance, supplier invoices). Perhaps the target company is purchasing a wide variety of items, and those purchase invoices coming from another company are to be examined. In that case, we would expect to have originals. That is not to say that those companies could not also be internally generating their sales invoices (the target company's purchase invoices) on a plain vanilla computer system. In such a case, we will face the same issue. However, at least in that instance, if we believe we have something worth looking at, we might even (and tread carefully here) attempt to gain a copy directly from the source (forgive me, I know we were supposed to be talking originals).

Fees—Are They Unreasonably High?

Before our readers go off on a tangent wondering whose ox is being gored, the issue being addressed here is something we have all heard on more than one occasion: legal and expert fees are sometimes too high. Perhaps there is truth to that; sometimes the fees are too high. However, that also leaves us with the fact that sometimes the fees are not too high, and sometimes, they are only too high in the sense that the process and system made them that way. Speaking from the perspective of the financial expert, fees sometimes get out of hand because of matters having nothing to do with our abilities, conscientiousness, quality of work, and so on. Rather, they are endemic to the system and arise as a consequence of those who abuse the system.

Discovery is a common problem. Imagine how much time and fees would be saved (both the expert's and legal counsel's) if discovery were readily forthcoming and if both sides respected what is supposed to happen. Unfortunately, all too often, requests for discovery get ignored, backburnered, and so on. We have to follow up repeatedly, we have to perform an inventory because we are not getting the appropriate cooperation or records are simply dumped and we are faced with the classic "he said, she said." Think how much time and money would be saved if, at the very onset of the case, the side with control of the records simply had copies of the financial statements and tax returns made, organized the records, and had them ready and available to be inspected. Assuming there is no separate agenda and assuming that, ultimately, the process works, what is the justification for not immediately and completely cooperating? Yet, we all see this far too often, and in an average matrimonial matter involving a business, this easily can add thousands of dollars to the fees.

In a somewhat related vein is the general concept of cooperation between counsel and, of course, between clients. Many times, when fees are higher than expected, part of the "blame" can be attributed to a serious lack of cooperation. Based on a number of years of doing this type of work, it is my observation that the lack of cooperation that causes extra fees is rarely the direct fault of the experts and not usually that of counsel. Strong counsel will see to it that the litigants don't interfere, at least to the extent that they can direct them. Nevertheless, it is hardly unusual to experience delays, obstructions, and other lack of cooperation aspects that cause extra discussions and correspondence between counsel; between counsel and experts; between the experts; and, of course, with the litigants. Inevitably, this results in extra fees.

Another factor is often the lack of enforcement by the judiciary of its own orders. We have all seen cases in which despite numerous orders, whether it be for discovery or virtually any other aspect of the litigation, one or both litigants blatantly and repeatedly ignore the judge's orders. Typically, at most, all that happens is a dressing down by the judge or perhaps a slap on the wrist but nothing of any real consequence, which encourages delays and a lack of cooperation. Also, the mere need of having to make appearances or to file motion after motion obviously adds fees.

From an expert's point of view, the investigation and valuation of a small business costs approximately the same as investigating what might be considered a midsized, closely-held business. The reason is because that regardless of size, if we are asked to determine the real income because of concerns of personal expenses (perquisites) being paid through the business or cash going unreported, the processes we have to go through and the amount of work involved are pretty much the same, regardless of whether the business is grossing \$200,000 or \$500,000 or even \$1 million. The fees can be curtailed, but that requires a level of cooperation and forthrightness from the clients and a willingness to cooperate from counsel.

To illustrate, if it is pretty much understood, if not quite formally agreed, that significant perquisites exist or a certain level of URI exists, perhaps it is possible to have the parties (with counsel's cooperation) stipulate (for certain limited purposes only) a level or, at least, a certain range of said perquisites or URI. Granted, many times, this cannot be done; many times, the nonbusiness spouse simply doesn't have a solid handle on that number and is at a distinct disadvantage. However, even then, a reasonable range can be accepted (for instance, the number is between \$30,000 and \$50,000 per year). If the litigants can agree on at least some reasonable range, regardless if one expert or two, a fair amount of fees can be saved. Of course, if the matter goes to trial, both counsel have to accept that the forensic examination was truncated by mutual agreement.

Sometimes, whether because of time or fee pressure issues, we are asked to take shortcuts to speed up the process. Shortcuts are almost always an option but can be misleading depending on just how much work is involved, the complexity of the situation, and whether any financial shenanigans are esoteric. Shortcuts can also leave one or both parties feeling like something is lacking, and if the matter goes to trial, they can often prove dangerous for the expert and his or her client and inadequate for what is needed at trial.

Experts always have the concern that when there are shortcuts, even when we are told to take them to help move the case along, the potential exists for those shortcuts to backfire. For instance, even with the case going toward a settlement, many tense negotiations and sessions occur and many questions are asked, and it's not unusual for the expert to be challenged about certain numbers. If we accepted certain numbers based on agreed representations, they may not be right, and we may not have strong support, but it was within the ground rules under which we worked. Worse, the matter doesn't get settled and goes to trial. Typically, we have made it clear at the onset that when we perform shortcuts, we can't be expected to testify about them with the degree of certainty that we would normally express had we been allowed to do a full job.

Another fee-related concern is the extent of a report to be produced for a business valuation. What it essentially comes down to is whether one or both of the parties wants (needs?) a full report or some reduced level of report. Certainly, a full report, which for many business valuations can easily run 40–60 pages, takes more time and costs more money. Many times, it is desired to have an abbreviated report to save on both time and money. This is certainly something virtually all experts have experience with and can handle, but what we typically emphasize is that these abbreviated versions are not suitable for trial. The idea is that if we can provide a report that helps the parties settle the case without the need of a full report, then all is well and good. However, the abridged version does not have the depth of analysis and detail of a full report, and it doesn't require us to necessarily have all the information and verification that we would have for a full report; thus, the abridged report is inappropriate for trial, and it would be dangerous (to the expert and one or more of the litigants) to expect it to be used in that fashion.

It is often suggested that with a reasonable degree of client cooperation and especially when we are a court-appointed or neutral expert, in lieu of a full report, we provide an exit conference (typically from one to two hours) during which we explain what we did and our approach and conclusions, and follow that up with a short (a few pages) letter summarizing that exit conference. This provides the attorneys with what they typically need to complete their files and make a record for their clients and, at the same time, avoids a lot of extra time and cost.

One of the more common refrains is that the fees were out of proportion to the magnitude of the dollars involved. Sometimes, that is a legitimate complaint, but more often than not, the fees could not be avoided because of the system and what was referenced previously: the investigation of a small business takes approximately as much time as the investigation of a midsized business. By way of illustration, if we are faced with a one-man business reporting gross revenues of $200,000 per year and reflecting a net income of $50,000 per year but supporting a family lifestyle of $100,000 per year—and if there is no trust or agreement between the parties on any of the issues—one or both of the attorneys or one or both of the litigants is going to insist on an investigation. We will need to provide a comfort level that virtually beyond question will cause an extent of work that, after the fact, may prove to have been out of proportion to what is actually involved.

When we are asked to perform forensics and a business valuation, the same work will be involved, regardless of whether the reported net income is $50,000 or $200,000 or $500,000. The volume of transactions needed to be reviewed typically will not vary all that much between businesses within a reasonable range. Furthermore, if allegations of URI exist, then it clearly does not matter that the business under consideration is small, with a very modest net income, because a lot of investigative analysis will be necessary to address the concerns of URI.

It is probably safe to state that all experts and counsel who have been in this field for several years have experienced situations that have simply surprised them. This is the case when by all appearances and information available at the beginning of the investigation, there was a belief that the numbers couldn't be all that big and URI or perquisites were probably modest, but after the work has been completed, extreme levels of perquisites or URI were discovered. These levels were simply unknown and unforeseen and would have remained unknown and undiscovered were it not for the forensic analysis. By way of example, I have seen outrageous expensing on company books for such items as college tuition and real estate (treated as an expense of operations). I have also seen URI well into six digits. Where do we draw the line, and as experts can we be reasonably confident about the extent, depth, and accuracy of our work, particularly when we are always faced with the prospect of a trial that magnifies any shortcomings?

Social Security

Something to keep in mind, which you probably already know but could be very relevant in a divorce case, is that 10 or more years of marriage entitles each spouse to get benefits based on the other spouse. However, even 1 day short of 10 years fails this test, which can make a huge difference in terms of retirement entitlement when a divorce is in the works. The date that counts is the date of the divorce, not when the divorce complaint is filed. Thus, we will have the opportunity to assist in this way. As an example, if our client (typically the lower-earning spouse, who is statistically more often the wife) files for divorce after 9½ years of marriage, it may be very prudent and practical to see to it that the divorce is not put through for at least 6 months in order to achieve 10 years of marriage. Do not take this item lightly.

Final Tax Return

No, we are not talking the tax return of a deceased individual but, rather, the final return while the couple is still married. We can expect that in any number of cases in which we are involved, particularly as the case drags on, we are looking at the couple finally getting divorced in short order but having to address the filing of the prior year's tax return. As an example, perhaps it is March or April 2012 or even the middle of 2012, and they have not yet filed their 2011 return. Let's further assume that there is a good chance that they will be filing jointly for 2011 as always. Assume here no URI or other issues that would cause us to prudently advise our client (or the other client) not to file jointly. We can expect the following concerns about this final joint return:

- If a tax balance is due, who is going to be paying it? This comes up all the time, and the liability can be allocated in any number of ways. The issue is to make sure that the liable party is defined.
- If there is a refund, who gets the refund? Refer to the prior item; this happens all the time and needs to be clearly defined. However, for the refund issue, think about the following point.
- In most marriages, the address on the tax return is the marital home. Once the parties split, whose address is on the return? Typically, it is the dominant party, which often means the person in business or the main breadwinner; however, that does not mean it is right or appropriate. This takes on importance more than just on image and impression but as a practical matter. Whoever physically receives the refund has a major leg up in terms of disposing of that refund. I don't know about you, but I have seen husbands and wives signing checks for the other as a routine part of life. Notwithstanding the fact that the refund check is made out to both parties, whoever gets the check is going to be able to do whatever he or she wants with that check, no matter the obligation. Thus, maybe we need a neutral address on the tax return, such as our office or the office of one of the attorneys. Think here in terms of providing your client (or it might be the other client) with comfort rather than a technical answer.
- This is going to be one of those returns that everybody is going to want to have a hand in. This final return needs to be reviewed for the safety and benefit of both sides, as any of the others in the past should have been reviewed. We may be called upon to perform that review, or we may be the ones in the middle helping interpret and explain the review to one or both sides.

Tax Advice and Return Preparation

I find that rather frequently I am asked by a divorce client (and just as often by that divorce client's attorney) to provide tax advice, to review the joint tax returns that are being prepared by the couple's long-time accountant, or to step in and take over the tax return preparation for my client currently going through the divorce. Typically, my engagement letters do not specifically call for such tax services as part of our engagement. Frankly, there is little to no way of knowing that we will provide this service when we are engaged because it almost always has nothing to do with the purpose of our engagement. However, as with so many other aspects of business life, things just simply evolve.

Almost always, when I am involved and working on a case, I will agree to provide tax advice and even, on occasion, prepare a married filing separately (or if there are children, a head of household) tax return. Often, I will accept such a request or assignment even when it is likely that once the case is over, this client will not be the type that fits my practice client profile. Nevertheless, while the litigation is ongoing, I am the obvious and logical choice simply because of my involvement and intimacy with the finances.

Typically, if there is no reason for the couple to file separate returns, I will discourage them having me do so and, rather, encourage that they continue with whomever they have been using in the past and simply have me review the return before it is signed by our client. When I am the neutral or agreed-to expert, that is even more emphatically the case; I generally do not want to be put in the position where I am taking tax return work away from someone who has served them well in the past and when there is no reason of which I am aware for that person to be removed from that position of tax preparer. Obviously, every case needs to be looked at and considered on its own merits.

However, in at least one general situation, I will push for and encourage the filing of a separate return, regardless of whether I am going to be the one to prepare it (sometimes it is best if I make no effort to prepare it and, in fact, decline that role). That situation is when I have determined that URI exists, and am representing the nonbusiness spouse—the one who would be classically the innocent spouse. In that case, I might even argue that I have an obligation to urge the filing of a separate return, and as a protective measure, probably should put that in writing by sending such a letter not only to the client but also to his or her attorney.

After all, if we take a situation involving the typical retail business, and we have determined that approximately $100,000 per year of URI exists (which is hardly an unusual situation), and we are working for the nonbusiness (innocent) spouse, it may be our obligation to insist that the client no longer file a joint return. Obviously, we cannot dictate to or force our client or control the issue, but certainly can forcefully express our opinion and commit that opinion to a letter. If for no other reason than protecting ourselves, it is something that we should be doing. Yes, I know that our engagement in this matter was to investigate and value the business, not provide tax advice; however, when the chips are down, and a somewhat innocent spouse goes forward with a joint return when he or she should have known better and regardless of the adverse tax consequences, it is hardly a stretch to believe that we could turn out to be the victim of a malpractice action because we did not suggest or advise the filing of separate returns. Even if we are not going to be the ones to prepare the return and even if we do not want to prepare the return, I do not see any downside (only upside) in making this concern known to our side.

When giving this advice and helping our client take this position, be prepared for the almost inevitable complaining and griping from the other side. The typical responses are asking why now, stating that they have always filed joint returns, and stating that he or she always knew what was going on in the business. That knowledge of wrongdoing in the business may or may not be true, but that is not our concern right now. The argument may also go that filing separate returns is going to cost thousands of dollars more than filing a joint return. Again, that very well may be true, but that is not the issue, at least in regard to our client. It may become an issue in front of a judge, but if the judge is made aware of the fact that serious concerns exist about the propriety of the reported income, it is unlikely that the judge will hold it against the spouse for insisting on filing a separate return, even if it costs extra. This also likely means that no withholding tax or estimated tax has been paid on behalf of that person toward his or her current tax obligation. The other side of the coin is that depending on whether that person also works or has independent income, that person may have no income or tax obligation. Notwithstanding that fact, file or press our client to file that separate return to go on record that there was a specific intent by our client to file separately. Do not allow a de facto joint filing to happen.

One final concern on this issue is that in the situation in which the business owner is objecting to the filing of separate returns, it would not be unusual for that person to offer to indemnify our client for any tax problems. I am assuming that I do not have to tell you that the value of an indemnification is not very much. The indemnification is an agreement between the husband and wife; it is not an agreement with the taxing authorities (federal or state). If the IRS or a state comes after our client for taxes because of URI, all that indemnification agreement is going to entitle our client to do is go after (sue) his or her former spouse. That is not worth much because, after all, the taxing authorities typically go after the easiest route for collecting their taxes—the low-hanging fruit. If our client is the low-hanging fruit, what kind of real practical benefit is there in that client having the right to sue his or her former spouse?

Even if there is going to be a successful innocent spouse claim, we typically will not know that as a fact, so a bit of gambling is going on there. It is possible there could be much aggravation and thousands of dollars spent in professional fees in getting our divorce client in this type of tax arena to the point of the IRS agreeing to the innocent spouse claim. Why go through all that if we can eliminate that whole issue with the relatively simple step of not filing a joint return? Remember, this is not only for our client's own good but, potentially, to protect us, even if our client does not follow our advice.

THE GOOD NEWS AND BAD NEWS CONUNDRUM—Although in doing our work, we are experts in valuation, we are not always experts about the specific company or business being investigated. We don't have to be—we're applying business knowledge and theory, and as long as we know what we're doing, as every expert will tell you, that's sufficient for the job to be done right. However, if we are truly experts in any particular business, it's our own accounting practices. This is especially the case when you've been in the field in excess of 20 years, have run your own accounting firm, or have had a hands-on involvement in the management of an accounting firm. We were engaged as the neutral experts in a divorce involving the husband's accounting practice, he being one of several partners in that practice. It became *clear to us that his firm was very poorly run and mismanaged. To make matters worse, or at least more ticklish, the husband was the managing partner. Thus, when we sat down for the settlement conference (with both counsel, as well as the litigants), we had the somewhat unenviable task of telling the husband that we had good news and bad news. The good news was that the business wasn't worth much; the bad news was it that wasn't worth much because he didn't know how to run an accounting firm. The husband was conflicted; he didn't know whether to smile or glower, so he alternated. The wife had the same problem; she was clearly unhappy about the value numbers, but she was very happy about the peer disrespect she heard about her husband.*

3

Dealing With the Client

FOOL ME ONCE, SHAME ON ME; FOOL ME TWICE ...—Sometimes, you get a flavor for a case at the very beginning and a true appreciation of some of the difficulties you're going to encounter. We had that with a very pleasant gentleman but one who had some difficulties providing us with routine discovery. Despite our repeated requests, we were unable to get such basic records as general ledgers, disbursements and receipts journals, bank statements and cancelled checks, and the like. Rather than continue with the back and forth of correspondence, we dropped in on this prominent community businessman and asked him why we were having such difficulties getting basic records. As he explained to us, straightforwardly and with total candor, "A few years ago, the IRS reviewed my records, and I got convicted for tax fraud. There's no way I'll make it easy for them to do it to me again."

There are some in our field who, somewhat tongue-in-cheek, would tell you that this is great work if we only didn't have to deal with the clients. Not fair of course, but telling as to some of the tensions and frictions that arise within a litigation/divorce matter. The goal of chapter 3 is to help you with some basics of dealing with the client: how to best and most easily interact with them and the importance of interviewing your client. Checklists are provided to help you with the interview process—particularly relevant where a business is involved. Also provided are some (allegedly) words of wisdom relevant to concerns about unreported income, as well as the occasional issue of filing jointly versus separately.

However, humor aside, one of the critical elements in doing this work correctly and efficiently is coordinating, to whatever degree is appropriate, your efforts with the client. This is true regardless of whether the client who hired you is one of the litigants, you have been jointly engaged or stipulated by both litigants, or you have been court appointed for both litigants.

Interacting With the Client

The interaction with the client over the course of our service will likely entail in-person meetings; telephone conversations; written correspondence; e-mail; and, possibly, some new technologies that will open up other avenues for interaction. In most situations, it is very helpful and sometimes even irreplaceable to have an initial face-to-face meeting with the client. Whether it is a matter of a lifestyle analysis, consulting of some form, a financial investigation, funds flow tracing, business valuation, or something else, we usually really need to hear it from the client. It almost always helps to have had an opportunity to receive tax returns (certainly personal and, many times, also business) in advance of any such meeting, so that we can better understand at least the surface financial parameters. Generally, if the case involves a business investigation, the practitioner should meet with the nonbusiness spouse first (usually in our office or the attorney's office) and then the business spouse second (usually at the place of business).

Meeting with the client serves multiple purposes, such as the following:

- Getting to know each other, and particularly for the nonbusiness spouse, the need for that spouse to establish a level of comfort with us and what we are going to try to accomplish.
- Opening a dialogue for future communications and procedures in terms of talking to each other and accessing documentation.
- Finding out how much that spouse knows about the business, marital funds, sources of income, and so on.
- These meetings often involve the attorneys, so here's a suggestion: always invite that client's attorney to be present at the attorney's and client's option.
- To make clear what types of records to which we expect to have access, the need for cooperation and disclosure, and so on.
- Addressing certain obvious questions or issues, particularly if we have had the opportunity to review tax returns in advance of such a meeting.

It is important not to get drawn too far into the client's set of beliefs and understanding. We need to maintain a critical and objective independence, even when we are working for one side. Our professionalism dictates that we do the job right and advocate for our opinion, not that we simply accept the client's word for things. When litigation occurs, such as divorce, it is reasonable to expect that each side will have its own spin or interpretation and that, in some cases, either or both sides may simply outright lie in order to further their particular goals. Thus, we need to be skeptical and challenge whenever we, in our professional judgment and based on our experience, recognize the need for independent verification and support of various statements or representations made by our client. Sometimes, it's a matter of not being afraid to directly challenge a client's statement. Emphasize and impress upon the client that our challenge is not a matter of not believing or disrespecting the client; rather, it is for the client's own good that we are able to independently support any such representations in order to buttress them and have them withstand cross examination. When a client still balks at providing, or allowing us to seek, such verification and support, the warning signs are clear, and most likely, things aren't quite as represented by that client.

Meeting With and Interviewing the Client

It is my experience that when I am engaged by the nonbusiness spouse, most of the time, I am not precluded from meeting with, and talking to, the business spouse. It is simply the most efficient way to proceed, it tends to save everybody money (fees are almost always an issue), and it clearly expedites the process. It also best serves everyone in a factual sense because having the opportunity to directly discuss matters with the business spouse tends to improve everyone's knowledge and the quality of the product. It is also my experience that most of the time, the business owners have no qualms about talking to me; even when they perceive me as the enemy, and they know there is an agenda, they are still willing to talk. Of course, the language may be a bit stilted, and we can expect them to hold back certain information, as well as slant (and sometimes simply outright distort) other information. Nevertheless, few things can substitute for a discussion with the business owner.

Once in a while, we might run into an attorney who, whether out of insecurity or simply a bad attitude, will prohibit us from having any such interaction with the business owner. Because interviewing the business owner as part of understanding a business when we are performing a business investigation and valuation tends to be important, this obstacle may force us to make certain assumptions that we would prefer not to make had we had better access to the business owner. It is important that when and if we make any such assumptions, we state them very clearly and state that our report unequivocally references the restrictions placed on us by one of the attorneys and our concern that the restrictions may have an impact on our report conclusions.

One way around this and a way that creates extra fees for everybody is to interview that business owner through the deposition process. This now entails having both attorneys, a court stenographer, us and perhaps another expert, and the business owner and perhaps the other spouse present. Further, because the accountant is usually not allowed to be the one asking the questions, it also requires us (as accountants) to prepare a script for our attorney who will be asking the questions. No one is served well by this process, and a lot of extra money is spent. By the way, when we interview the business spouse (actually, this applies regardless of who you are interviewing), we will take notes and keep them. If we record the conversation, obviously, we would keep the recording. Alternatively, if we are taking notes, it is strongly suggested that the appropriate practice is to in some way transcribe those notes (for example, through dictation that is then transcribed). Typically, the notes are needed anyway for a report as part of the company background. In addition, it is good practice to keep our notes; it might even be spoliation if we don't. The following pages contain example interview checklists for clients in business valuation, medical practice, veterinary practice, and legal and accounting firms.

Initial Financial Disclosure

Most if not all states have some form of required financial disclosure for parties going through a divorce. For instance, in New Jersey, it is called a Case Information Statement. Typically, this takes the form of some general background information, such as names, addresses, and the like; some current and recent history of employment and compensation; a form of a budget detailing lifestyle expenses; and, usually, a form of a balance sheet. Recognize that this rarely is in accountant-developed form; therefore; we accounting purists should be prepared to be offended by what many times we know from an accounting perspective is simply not good form. Nevertheless, it's a document with which we must live. Generally, these documents need to be prepared early on in the case, sometimes even at the very onset. It is helpful to the forensic accountant to secure a copy of such disclosure, typically from both parties. This will help put into perspective the parties' viewpoints of certain financial issues, even if they are distorted or dishonest. The key point is that we get to understand a bit about where the clients and, depending on attorney input, the attorneys are coming from.

Also, assuming that the disclosures are fairly well-developed, they will provide us with a sense for the level and style of living (which lends itself toward getting a rudimentary understanding of income or at least one or both parties' version of income), as well as what is sometimes a decent (and other times terrible) presentation about the assets and liabilities. Even when, as is often the case, the value of an asset is stated TBD, knowing that asset exists, or that one of the parties to the divorce believes that it exists, is useful information. It is also recommended that we compare what is presented on the disclosure statement with the personal tax returns of the parties. Two basic questions are as follows:

- Does the alleged lifestyle comport with the reported income?
- Does the alleged balance sheet make sense in respect to both the income as well as the sources (such as interest and dividends)?

If, in our preliminary overview, we receive an immediate "No" answer to either of these two questions, then it certainly puts up warning signs to us that the income may be other than as reported and other than as it seems on the surface and also, possibly, that there may be hidden assets that raise questions.

BUSINESS VALUATION INTERVIEW CHECKLIST

This is intended to ensure coverage of all relevant areas and topics. It is expected that notes will be taken separately. It is a guide; each matter will have its own unique points.

Name of Company: ______________________ Name of Client: ______________________

- ☐ Who is being interviewed and when and where?
- ☐ Who else is present during this interview?
- ☐ Company website address.
- ☐ Entity form (i.e. corporation, LLC, etc.).
- ☐ Who can we contact for access to records and information?
- ☐ Who else on the company staff is aware of our work, and do we need to keep the nature of our work confidential?
- ☐ Describe or list the owners of the company, their percentage of ownership, how long they've owned the company, and how much they paid for their interest in the business.
- ☐ If any of these people paid to buy into the business, get all supporting documentation for such buy-in.
- ☐ Describe what the company does.
- ☐ What are key dates and events in the company history?
- ☐ Describe all locations of the company, including the purpose(s) of any locations in addition to the main location, and whether they are owned by a related party or leased from an unrelated party.
- ☐ If locations are owned by a related party, detail who, the form of the ownership, the amount of space occupied, the rent paid, and whether there is a lease. Get a copy of the lease. We will probably need the tax returns of all related entities.
- ☐ If the location is not owned by a related party, who owns it, what's the square footage, what's the monthly rent, when does the lease expire, and are there options to renew? Get a copy of the lease.
- ☐ If relevant, describe the area surrounding the business location, including its community and whether the immediate area is dominated by one employer.
- ☐ Detail all related entities (location, business function, and percent of ownership by each related person and entity), and describe what activity or business is conducted between these related entities.
- ☐ Who is management and who are key members of the company? Include name; position and title; age; health, if available; years with the company; job responsibilities; and approximate number of hours worked weekly or monthly.
- ☐ Are there any particular concerns about any of the key personnel (for instance, retirement, health, etc.)?
- ☐ What is the compensation arrangement with key personnel? In particular, describe any contingent- or commission-based compensation arrangements or any personnel who have a profit-sharing arrangement.
- ☐ Does any employee (particularly key personnel) have an employment contract? If so, we need a copy of each such contract.
- ☐ Are there any shareholder or partner agreements (draft of signed)? If so, we need copies.
- ☐ Is life insurance carried by or paid by the company on behalf of any key personnel (other than de minimus group term insurance)? If so, we need full details, a copy of key pages of the life insurance policy, etc.
- ☐ How is the company governed? If it includes a board of directors with outside or independent personnel, we need full details.
- ☐ If relevant, include a breakdown of sales by product line, including a brief description of each, approximate percentage of sales, and approximate gross profit percentage of each segment.
- ☐ What is the size of the market for each of these products, and what is the company's market share?
- ☐ How reliant is the company on just one or two suppliers? If so, describe the situation.
- ☐ How does the company promote and advertise its products or services? Obtain samples of brochures and marketing material. Be sure to check the website.
- ☐ To what extent do government regulatory bodies routinely affect how the company operates? Provide details, including the regulatory bodies and copies of reports made to those bodies.

- ☐ Does the company have any foreign operations, and if so, are there any particular issues because of the foreign exposure?
- ☐ Are foreign sales significant, and if so, are there any concerns (i.e. currency or political)?
- ☐ If the detailing is relevant, who are the major competitors of the company, where are they located, do we know their sales volume, and do we know whether they are public or privately held? Obtain whatever information we can about these competitors.
- ☐ Is there anything particular about the products or services of the company, or are they generic and essentially the same as everyone else's?
- ☐ If sales are cyclical, explain.
- ☐ Explain any restrictions or limitations on the company's ability to distribute its products or services.
- ☐ Discuss the ability of the company to grow. Is capacity an issue, and if so, how?
- ☐ How are sales collected? Cash, check, or charge; by whom and where?
- ☐ If any collections are in cash, what internal controls are in place relevant thereto?
- ☐ Describe the typical customer, including the nature of the operations, size of the customer, geographic area of customers, etc.
- ☐ Detail any customer representing 10 percent or more of sales in any of the past 3 years. Provide information about the customer, the sales volume, or percentage of sales. Also, describe any special issues involving such major customers.
- ☐ How is customer loyalty, and how price sensitive are the customers?
- ☐ How does the company determine what to charge; how competitive is pricing?
- ☐ To what extent do bid jobs represent percentage of sales?
- ☐ To what extent are sales to governmental agencies?
- ☐ Are sales in any way connected to political positioning or who is in power? If so, provide details.
- ☐ Is the company facing any anticipated substantial capital expenditures? If so, describe them and how they will be financed.
- ☐ How up to date and adequate is the company's management information system?
- ☐ Does the company have a credit line or other borrowing facility, and if so, what is the extent of the credit line? If not, was the credit line declined? If there is a credit line, get a copy of all financial documents submitted to the lender in order to secure the credit line.
- ☐ Are any company assets or liabilities nonoperational?
- ☐ Is the company or any of its key personnel involved in any litigation? If so, to the extent relevant, describe the litigation.
- ☐ What are the major technological trends within the industry, and to what extent, if any, will they affect the company?
- ☐ Does the company have any proprietary products, patents, or special technology? If so, describe. If there are any patents or copyrights, secure documentation relevant to them.
- ☐ Are there any environmental concerns for the industry or company?
- ☐ Describe any significant research and development being done by the company.
- ☐ To what trade organizations does the company or its management belong? Provide details about the locations of the trade organization and appropriate contact information.
- ☐ Are there any major threats to the company's continued operations?
- ☐ What are the expectations for the company's financial performance for the next few years?
- ☐ Does anyone have any options, stock rights, or entitlement to purchase into the company? If so, we need full details.
- ☐ If the company has a history of paying dividends, we need the details.
- ☐ Within the last five years, have there been any oral discussions or written proposals relevant to selling part or all of the company? If so, provide full details.
- ☐ If any portion of the company was sold or acquired within the last five years, we need all details of sale or acquisition.
- ☐ Who are the professional advisors for this company (i.e. accountant, attorney, consultants, etc.?
- ☐ Make sure to do a walkthrough of the business operation.
- ☐ Sign and date this checklist, and attach it to the notes.

Prepared by ______________________________ Date____________________

MEDICAL PRACTICE VALUATION INTERVIEW CHECKLIST

This is intended to ensure coverage of all relevant areas and topics. It is expected that notes will be taken separately. It is a guide; each matter will have its own unique points.

Name of Practice: ______________________ Name of Client: ______________________

- ☐ Who is being interviewed and when and where?
- ☐ Who else is present during this interview?
- ☐ Practice website address.
- ☐ Entity form (i.e. corporation, LLC, etc.).
- ☐ Who can we contact for access to records and information?
- ☐ Who else on the practice staff is aware of our work, and do we need to keep the nature of our work confidential?
- ☐ Get a copy (often online at the practice's website) of the doctors' credentials and resumes.
- ☐ Describe the type of practice, giving particular attention to any specialties.
- ☐ Get a list of owners or shareholders, with percentages and history of ownership.
- ☐ Get details about the compensation packages for each doctor in the practice.
- ☐ If there have been any buy-ins or buy-outs in the last five years, get full details. Keep in mind that many times, this is done via salary offset.
- ☐ List all locations, activity or services performed, and whether ownership is with a related or unrelated party.
- ☐ If ownership is with a related party, we need details about respective ownership interests, the form of the entity, square footage, and we will probably need to get copies of that entity's tax returns and other financial data. Get a copy of any leases.
- ☐ If ownership is with an unrelated entity, get a copy of the lease and details about the amount of space, rent, options on the lease, square footage, etc.
- ☐ If relevant, describe the area or neighborhood around the office, including the community in which the practice is located.
- ☐ Are one or two major employers in the area that would likely affect the patient base?
- ☐ Provide historical information about key dates and events in the practice's history.
- ☐ List all related entities and affiliates, providing information about their names, interrelationships, percentage of ownership interests, and the relationship between these entities and the medical practice.
- ☐ For each doctor in the practice, if relevant and if only a few, get his or her name, professional society memberships, board certifications, hospital affiliations, and nature of work. It is possible that the doctors' resumes will provide all that information?
- ☐ Who are the key employees, what are their job functions, how long have they been with the practice, and what are their typical working hours?
- ☐ What hours are the practice open? Have details about the number of hours that the various doctors (especially the one being investigated) work, and compare that information with the operating hours.
- ☐ Describe any specific and particular concerns about any of the key personnel.
- ☐ Discuss compensation arrangements for each of the doctors, as well as the key personnel. Get full details of any compensation plans and calculations.
- ☐ Get details regarding staffing, including the number of full-time and part-time nurses, assistants, billing or insurance processors, office personnel, etc.
- ☐ If patients are seen other than during the general operating hours of the practice, indicate that fact.
- ☐ If applicable, what are the typical hours for hospital rounds and servicing?
- ☐ Describe the relationship and numbers regarding existing patients, new patients, frequency or number of new patients per month, etc.
- ☐ How many patients are seen in a typical day or week, and what is the length of the typical appointment?
- ☐ Describe the typical patient.
- ☐ What are the most common types of procedures?

- ☐ If this is a surgical practice, how many surgical procedures are performed each week? Get details about whether the procedures are major or minor, etc.
- ☐ Are patients seen once, or are follow-up visits common?
- ☐ What is the approximate demographic mix of patients (men, women, children, etc.)?
- ☐ If emergency visits are part of the practice, approximately how often are they experienced?
- ☐ What is the number of active and inactive patient files?
- ☐ What are the sources of new patients (i.e. the doctors, patients, marketing, etc.)?
- ☐ Does any referral source account for more than 5 percent of practice revenue? If so, explain and provide details.
- ☐ Get information about the practice's typical fee structure for existing and new patients.
- ☐ What is the typical copay, and how many of them are there on a typical day or week? Note that this can be a very important item, particularly if we are concerned about unreported income.
- ☐ Is a copay received for each patient visit? If not, explain.
- ☐ How is the receipt of copays handled and processed?
- ☐ Under the assumption that nearly all medical practices accept insurance, is this practice any different? If so, explain.
- ☐ What is the internal system for processing insurance claims, and how frequently are they processed? Note that the more modern practices are doing it instantaneously online.
- ☐ We need to get accounts receivable detail, and we also need to get a sense for the extent of unbilled insurance-based revenues.
- ☐ What type of management information system does the practice have? Get printouts of complete detailed reports for the past few years.
- ☐ Get information about collection history, bad debt write-offs, and the like.
- ☐ See if we can get information about the approximate percentages of collections that are represented by check, cash, credit card, insurance payment, and the like.
- ☐ Does the practice sell any products? If so, describe the products and the frequency of sales.
- ☐ If products are sold, make sure to get details (this may be routine within the general ledger) of purchases, costs, and the like, as well as details of what kind of records are maintained for such sales.
- ☐ What kind of marketing does the practice maintain?
- ☐ What is the overall condition of the practice's equipment, and are any significant expenditures anticipated soon?
- ☐ What is the approximate value of the drugs or supplies on hand?
- ☐ Are there any shareholder or partner agreements (draft or signed)? If so, get copies.
- ☐ Is life insurance carried by or paid by the practice on behalf of any key personnel (other than de minimus group term insurance)? If so, we need full details, a copy of key pages of the life insurance policy, etc.
- ☐ Describe any litigation in which this practice we are looking at has been involved in during the last five years, including any current litigation.
- ☐ Has the doctor ever been sued for malpractice, and if so, has any such suit been successful?
- ☐ What are the expectations for the practice's financial performance for the next few years?

THE FOLLOWING ARE SPECIFICALLY FOR VETERINARIAN PRACTICES

- ☐ What types of animals does the practice treat, and what is the approximate percentage of business each type of animal represents?
- ☐ Does the practice board animals? If so, describe arrangements.
- ☐ How many animals does the practice see in a typical day or week?

Prepared by ______________________________ Date____________________

LEGAL AND ACCOUNTING FIRMS VALUATION INTERVIEW CHECKLIST

This is intended to ensure coverage of all relevant areas and topics. It is expected that notes will be taken separately. It is a guide; each matter will have its own unique points.

Name of Practice: ______________________ Name of Client: ______________________

☐ Who is being interviewed and when and where?
☐ Who else is present during this interview?
☐ Firm website address.
☐ Entity form (i.e. corporation, LLC, etc.).
☐ Who can we contact for access to records and information?
☐ Who else on the firm staff is aware of our work, and do we need to keep the nature of our work confidential?
☐ Get a copy of each professional's credentials and resume.
☐ Describe the type of practice, giving particular attention to any specialties.
☐ Get a list of owners or shareholders, with percentages and history of ownership.
☐ Get details about the compensation package for each owner.
☐ If there have been any buy-ins or buy-outs in the last five years, get full details. Keep in mind that many times, this is done via salary offset.
☐ List all locations, activity or services performed, and whether ownership is with a related or unrelated party.
☐ If ownership is with a related party, we need details about respective ownership interests, the form of the entity, square footage, and we will probably need to get copies of that entity's tax returns and other financial data. Get a copy of any leases.
☐ If ownership is with an unrelated entity, get a copy of the lease and details about the amount of space, rent, options on the lease, square footage, etc.
☐ If relevant, describe the area or neighborhood around the office, including the community in which the firm is located.
☐ Are one or two major employers in the area that would likely affect the client base?
☐ Provide historical information about key dates and events in the firm's history.
☐ List all related entities and affiliates, providing information about their name, interrelationships, percentage of ownership interests, and the relationship between these entities and the practice.
☐ Who are the key employees, what are their job functions, how long have they been with the firm, and what are their typical working hours?
☐ Describe any specific and particular concerns about any of the key personnel.
☐ Get details about staffing, including the number of full-time and part-time paraprofessionals, office personnel, etc.
☐ Is life insurance carried by or paid by the firm on behalf of any key personnel (other than de minimus group term insurance)? If so, we need full details, a copy of key pages of life the insurance policy, etc.
☐ Describe any litigation in which this firm or the owner we are looking at, or both, has been involved in during the last five years, including any current litigation.
☐ What are expectations for the firm's financial performance for the next few years?
☐ Keep in mind that legal and accounting practices almost always have work in progress (WIP), and it can be substantial. Make sure to get information about WIP as of the end of each of the past few years and as of the valuation date.
☐ What are the typical hourly rates or range of rates for each level of personnel in the firm, including paraprofessionals and administrative and clerical staff?
☐ Does the firm bill for secretarial services?
☐ Does any one client represent 5 percent or more of firm revenue? If so, get details for each of the applicable years.
☐ In regard to the firm's key clients, get information about how long they have been clients, the age of the decision makers in those client bases, and the general exposure or security of those clients remaining with the firm.
☐ Are there any shareholder or partner agreements? If so, get a copy.

- ☐ In regard to those agreements, do restrictions exist about taking the book of clients (for example, in NJ it is not allowed to have such restrictions on lawyers)?
- ☐ What are the major referral sources for this firm (for example, accountants or lawyers, insurance personnel, bankers, existing clients, etc.?
- ☐ Does any one referral source represent 5 percent or more of firm revenue? If so, get full details.
- ☐ In regard to WIP relief and billing, how often is that done, and is it monitored?
- ☐ How are receipts and payments from clients received and recorded and by whom? Does any concern exist about unreported cash income?
- ☐ Is the approximate percentage of revenues received in the form of check, cash, credit card, and so on determinable? If so, get the information.
- ☐ Is the firm involved in any kind of prepaid plan through an employer or group of employers? If so, get full details, and be sure to determine the extent of revenues that represents and the profit margins from that form of business.
- ☐ Does a standardized procedure exist for determining the collectability of receivables and WIP? If so, get full details. Regardless, we need aged WIP and receivables.
- ☐ Describe how the firm markets itself.
- ☐ What is the overall condition of the firm's equipment, and are any significant capital expenditures anticipated soon?

Prepared by ____________________________ Date___________________

Much of dealing with the client is not a matter of technical expertise but, often, the classical bedside manner. It is advisable to have a solid idea in advance about what types of questions we want to ask, the areas of concern or areas that are suspect to us, and how our time should be best spent. It is important to try to read the client as the discussion or interview is progressing, so that we understand how the client responds, how much of his or her responses we think we can accept, whether we need to change the nature or tone of our questioning, where we might have to back off, and so on. Unlike going through a set of books to come up with a financial statement, in this work, we are dealing far more intimately with the client, trying to understand what the client knows or thinks he or she knows and how to mesh that with our role.

Unreported Income

If the business that is involved is one in which unreported income (URI) would be expected or at least not surprising if it were to exist, then by all means, broach that subject during interviews with both of the litigants. The nonbusiness spouse will probably have an accurate sense that URI exists (assuming for the moment that it does exist) but might have no usable or reliable sense about the magnitude of URI. On the other hand, plenty of spouses are very informed about what goes on in the business, may have even kept a set of books, and may have an excellent and concrete idea about the magnitude of URI; however, proving that may be a totally different issue.

When talking to or interviewing the business spouse, expect that person to be on the defensive if asked about cash, but by all means, ask if cash is received in the business (let's assume for the moment that it is received) and then ask if it's all reported. Many times, we will hear either there is no cash (if we know better, we simply know that this is not true), or we'll hear there is cash but control procedures are in place, and everything gets reported. Be sure to ask whether everything gets reported, and then, get into the accounting system, so that the flow of funds can be determined. For instance, through how many hands does the cash flow? Recognize that checks payable to an individual can be just as good as cash.

If the front desk collects all the money, and the owner never touches it at that level, and on that basis representations are made that no URI exists, recognize that the story is not complete. For instance, although the front desk may collect the money and even prepare a deposit slip, what does it do with that money? Often, it goes to the business owner who then goes to the bank to make the deposit. I believe that a phrase that we have all heard on police shows is "chain of evidence." Just because an employee prepares the deposit slip and then hands it to the business owner going to the bank does not mean that what gets to the bank is exactly what the employee prepared. On the other hand, particularly in the larger and more professionally run businesses, regardless of the cash being collected, the owner may take pains to have controls in place, so that the business does not get ripped off by employees. Most likely, that owner is willing to accept the need to be honest with the reporting (and get the advantage through perquisites) in order to preserve the integrity of the numbers and also to either prevent or minimize the extent of employee theft.

Joint or Separate Tax Returns

Although approximately 98 percent of married couples file jointly, we all understand that filing jointly is elective on the part of both parties. Filing jointly is not a requirement simply because one is married. Typically, people file jointly because it tends to save money on taxes; it means filing only one tax return instead of two; and because of the almost uniformly mixing of family expenses, it is simpler from a logistics and paperwork point of view. However, filing jointly makes each party jointly and severally liable for the entire filing, and that means responsibility for taxes, interest, and penalties.

One of the issues that comes up, not infrequently, is that all of a sudden, during the divorce process, one spouse (the nonbusiness spouse) "discovers" that he or she could not have been living on the reported income, and it is the fault of the business spouse. As a result and with good recommendations from professionals, that spouse now demurs in regard to the filing of a joint return. In a nondivorce context, other than as a source of friction between the spouses, that would be the end of the discussion. Each spouse has that right to refuse to file jointly, and no authoritative body is going to interfere with that decision. However, with a divorce, we have seen that an effort is sometimes made to use the system to have the judge order the recalcitrant spouse to file jointly. This then sets up a clash between the power of a state judge in a divorce action to order a spouse to file a joint return and the federal tax laws that make it clear that a joint return is elective for both spouses.

Rather than force the filing of a joint return, it is suggested that a very reasonable compromise would be to have the tax calculated based on both separate returns and joint returns. Assuming it is found in some fashion that the spouse who was refusing to sign was unreasonable in that refusal, penalize that spouse for the extra cost (assuming there was any) for filing the tax returns in such a fashion via an adjustment against equitable distribution or perhaps even against alimony payments. That would accomplish the court's goals without putting it into potential conflict with federal tax laws and, at the same time, without jeopardizing the spouse who did not want to sign by making him or her jointly and severally liable for a return with which that person might have found some fault. However, if the matter does not go to trial (and most don't), there will likely be no actual ability to determine if the refusal to sign was reasonable.

Finally, it is suggested to those of us representing a spouse who was perhaps forced to file a joint return and then gets tagged in an audit to consider that possibly (no guarantees here) the order of the judge that forced our client to sign a return that he or she made clear that he or she did not want to sign might be considered the return having been signed under duress. That might be good enough to get the IRS to agree to an innocent spouse claim.

WHEN IT'S TIME, IT'S TIME—Having a sense of humor is usually a good thing, although it can backfire. Sometimes, you take your chances and hope that your sense of humor, combined with your own personal perception of the situation, will leave you in good stead. I was being interviewed by a man going through a divorce who was also interviewing other experts in an attempt to decide which expert to hire. His business was of substance, and it made sense for him to go through this process, which included having both his corporate and divorce counsel, as well as his company controller, present during these interviews. My interview was just about over when the husband looked me in the eye and said rather emphatically that it was his desire that this case be moved along quickly and brought to an end in as short a time as possible. In turn, I looked him in the eye and, with a slight smile on my face, asked him if his concern over time was because he had a pregnant girlfriend. Now, you know, that's either going to make or break getting hired. The good news was that he looked at me, laughed out loud, said "Yes, and welcome aboard."

4

Dealing With the Target Company

IT'S A SMALL WORLD, BUT IT WAS A BIG HIGH SCHOOL—One of our cases involved representing the husband who had a business across the Hudson (from New Jersey) in the Big Apple, near the Holland Tunnel. After spending several hours with him discussing the business and reviewing financial records, I mentioned that I would be leaving and going back to New Jersey. He offered to provide me directions to get from the parking garage to the Holland Tunnel. I explained to him that it wasn't necessary because I was familiar with the area, having originally come from New York and was raised in Brooklyn. He smiled and said, "Me too." Of course, whenever that happens, the next question is, "What high school did you go to?" The response was, "Lafayette High School," and the counter response was "Me too." That left one more question: what class? The response was, "19xx" (let's leave this one alone), and the counter response was, "Me too." Yes, he and I were in the same class in high school, and we had no idea who each other was. For those of you from most parts of the country that probably seems incredulous; for those of us from the big city, when you *consider that there were 1,750 students in my senior class in high school, you realize how that could be possible. Besides, he was a sports guy, and I was on the math team.*

Most of the divorce cases in which I have been involved, and I venture similarly for most of us who do this work, involved a closely-held business, in which one or both of the litigants had an interest, sometimes a 100 percent interest. The goal of chapter 4 is to help you deal with the target company—whether you are working for the business owner, or for the spouse of the business owner. This includes an example of a document production request letter that might help you in terms of covering all bases and asking for records. This chapter also provides some very practical suggestions about the protocol of who you are dealing with, and dealing with aspects while at the company being investigated.

Typically, when we are called in on a divorce action (this also applies to a commercial divorce such as a partnership dissolution or shareholder suit), and a business is involved, we are asked to either perform a forensic analysis about the business's income generation (the income and benefits enjoyed by the owner who is party to this divorce) or determine the value of that business (the value of this person's interest in that business). It is this author's experience that it is unusual to be asked to value the company without first addressing the forensics. However, consider the following broadly stated situations:

- It's a fairly large company with audited financial statements. In such a situation, we may indeed be asked to only perform a valuation, with everyone reasonably satisfied that the forensics are not relevant.
- Almost regardless of the size of the company, let's assume that the person of interest has a very small ownership interest (for example, 5 percent) and is known to not be among the group that controls the company. Once again, we may be asked to only value the company (this person's interest therein), and everyone may be satisfied that forensics are not necessary.
- Let's assume that it has been agreed that the business is separate property, and the value is not an issue. However, the forensics may be very important and relevant to what this person is actually earning because of support-type issues. Even in the jurisdictions where the business interests may be off limits to the marital estate, the income generated is almost always never off limits.
- Perhaps the person of interest has no ownership interest in the business (it could be owned by his or her parents), but once again, his or her earnings, certainly inclusive of benefits and perquisites, are an issue.
- As a cost reduction factor, an agreement limits either or both the extended forensics and the degree of valuation necessary. A word of caution: make sure any such limitations are agreed to in writing and that our engagement letter or other written evidence strongly protects us. When it comes to these types of scope limitations, a number of our peers will refuse to use those results at a trial and will insist that they only be used

for a negotiated settlement. When the scope of what we have done has been severely restricted, it is often considered too much of a risk to allow the matter to go to trial.

One comment regarding the magnitude of the case and the resulting fees: in many situations, the forensics are far more time consuming and, thus, far more expensive than the valuation phase. It is hardly unusual to have to spend 30, 50, or 100 hours or more on the forensics, but the valuation aspect might be done in only 10 or 20 hours (obviously, these are very broad generalizations).

Getting Started

Typically, one of the first elements of dealing with the target company is to simply get the past several years (typically five) of tax returns and financial statements. Certainly, every business has tax returns (put aside the chuckling right now about those businesses we know break the rules), but not every business has financial statements. When financial statements exist, they should be received in addition to the tax returns. Further, generally speaking, we would give more reliance and credence to the financial statements than the tax returns. As we know from many small businesses, they are going to be the same. However, in larger situations or when the financial statements are on an accrual basis as contrasted with cash-basis tax returns, as a general rule, we will always use the financial statements because they tend to be more accurate and relevant to financial performance.

It is amazing how much angst and grief can be avoided in the process of trying to get documentation if we can simply get records that the attorney already has. Too often, the attorney has a volume of records but either doesn't think of handing them over to the accountant, or the accountant does not ask for them. Instead, what happens is the usual stream of correspondence from the accountant to the attorney asking for a wide volume of financial records. A sample document request letter can be found on the following pages.

Once we get those documents, it is critical to put them on some form of a spreadsheet, so that we can perform a basic visual analysis. Look at five years of revenue and expenses, and see if there is anything that appears unusual or out of line. Have sales been within a reasonable range, and has sales growth been reasonable, give or take what one might expect? Do many expenses seem to fluctuate dramatically from year to year, particularly if that fluctuation is not in sync with the sales? The idea here is to help set the stage for the forensic examination we are about to perform. Although the preparation of the spreadsheet can almost always be done adequately by even a junior-level staff person, the analytical determinations about what areas, if any, should be attacked via the forensic process must be left to a senior-level individual or us as partners or owners. By the way, sometimes we find that nothing looks out of line; therefore, nothing by itself merits investigation. That itself may be a warning. One of the areas that we should look at first is the gross profit. Assuming it is relevant to the type of business at hand, if the gross profit does not look right, then we know we have something to attack. In a cash business, if the gross profit looks right, then we should be just as suspicious because maybe cash income is being used to buy items for cash to keep the margins in line. We will deal more with that issue later.

SAMPLE DOCUMENT PRODUCTION REQUEST LETTER

Re: _______________ vs. ________________

Docket # _______________________________

Dear______________________________:

We have been engaged by ___________________________ to assist in his or her pending divorce action. To that end, we will need access to, and copies of, various business and personal financial records.

In regard to (business), please have the following items available for our inspection or copies for our files where so indicated. Unless otherwise stated, the records requested are for the period____________________.

1. Copies of all internally and externally prepared annual and interim financial statements.
2. Copies of federal and state income tax (or information) returns, including all K-1s (if applicable).
3. All books of original entry, including detailed general ledgers, disbursements, receipts, sales, and purchase and payroll journals.
4. If accounting or bookkeeping records are maintained on a software program (such as QuickBooks), provide us a disk (not password protected) with detailed general ledgers and supporting schedules.
5. Copies of accountant's year-end worksheets, including journal entries and supporting schedules, along with supporting documents used to prepare financial statements or tax returns.
6. Cancelled checks, checkbook stubs, deposit slips, and bank and broker statements.
7. Payroll records, including payroll returns, W-2s, and Forms 1099 and 1096.
8. Purchase and expense invoices, paid bills, and charge account statements and slips.
9. Copies of loan documents.
10. Appointment diaries.
11. Copies of year-end aged schedules of accounts receivable and payable.
12. Sales invoices.
13. Inventory records.
14. Copies of all papers, closing statements, tax returns, agreements, and contracts related to the sale of ________________.
15. Copies of schedule of equipment (fixed assets), including motor vehicles and depreciation thereon.
16. Corporate and directors' book(s), including minutes of board meetings.
17. Stock register book(s) (since inception) or equivalent for partnerships and LLCs.
18. Copies of insurance policies, including property, casualty, liability, and officer life.
19. Copies of any revenue agent's reports.
20. Copies of any pension, profit-sharing, and other employee benefit plans and the related records, statements, tax returns, and transaction information.
21. A list of all subsidiaries, joint ventures, or other affiliates with common ownership, including a schedule of all related party transactions.
22. Schedule of lease and rental payments, including premises, facilities, equipment, and automobiles, with applicable agreements.
23. Copy of resumes or curriculum vitas of all individuals with an ownership interest.
24. List of patents, copyrights, trademarks, and other intangible assets.
25. Note and collateral documents relating to notes receivable and payable.
26. Real estate appraisals.
27. Schedule of owners or shareholders, including percentages of ownership and when interests were acquired.
28. Copies of shareholder, member, or partner agreements; buy-sell agreements; and employment contracts.
29. Copy of prior business valuation reports.
30. Copies of legal documents relating to purchases and sales of company interests.
31. Significant contracts, such as covenants not to compete, franchise agreements, customer or supplier contracts, and labor contracts.

32. List of contingent assets and liabilities, including pending or threatened litigation, with related legal documents.

In regard to the personal financial records of ________________, please have the following available for our inspection or copies for our files where so indicated. Unless otherwise stated, the records are for the period___________________.

1. Copies of any financial statements, including, but not limited to, statements used for financing (business or personal), mortgaging, and tax shelter and investment qualifying
2. Copies of personal federal and state income tax returns, including K-1s and Form 1099
3. Savings account statements and other indicia of savings
4. All statements, checks, and other indicia of the use of equity lines
5. Stock brokerage monthly transaction sheets
6. Copies of closing statements on any real estate purchased or sold
7. Copies of real estate appraisals
8. Cancelled checks, bank statements, deposit slips, and check registers
9. Copies of loan applications
10. Copies of support for alleged liabilities to _______________________
11. Copies of automobile, boat, and plane registrations owned individually
12. All charge account statements and receipts (detailed annual summaries provided by the credit card company are acceptable in lieu of monthly statements)
13. Copies of any revenue agent's reports
14. Records in support of rental property income and expenses
15. Copies of all December or annual statements from banks and investment and other brokerage accounts, including retirement accounts
16. Property or casualty insurance policies
17. A schedule of property acquired by gift or inheritance, including the date of the gift or inheritance and value at that time
18. Life insurance policies, including cash surrender values and loan information
19. List of personal safe deposit boxes, their locations, and exact contents at the complaint date
20. Copies of original and amended Case Information Statements of the plaintiff and defendant [in some states]

In addition, because of what appears to be significant and frequent financial activity (that is, issuance of checks) between _____________and __________________, we expect we may need access to the financial records of those individuals or businesses.

The preceding list may not be complete. Additional items may be requested as our inspection progresses.

Very truly yours,

____

Financial Statement Review

In getting started, one of the early analytical processes is to review and analyze tax returns and financial statements. Let us deal here with the financial statements because they can have information that essentially would never be on a tax return. Reference here is to when we have (*a*) a full financial statement, including footnotes or (*b*) a management report (because the bank needed it) discussing the operations and referencing various items within the financial statements. Footnotes can be a goldmine, and they need to be reviewed carefully. It is suggested that although we might have a low-level staff person create the spreadsheets that compare several years from the financial statements, do not relegate the review or digesting of the footnotes to anyone lower than an experienced senior-level staff person. In fact, as a partner (or whatever high level is appropriate here), we very well might want to do that ourselves.

Scour those footnotes for information that might be useful or relevant to the investigation. Knowing that the company depreciates its assets over a certain period of time and in a certain style might be a required item in a footnote but may not be relevant or important to the work we do. On the other hand, a footnote evidencing related-party transactions, litigation, covenants in a financial statement, and the like can be crucial to getting a better understanding of the business and can be extremely important in doing our jobs right, regardless of our side. Whether the information in the footnotes is good or bad (based on our perspective of high value or low value), those are items we've got to pay attention to and items we cannot ignore. Depending on what those footnotes reveal, we certainly may wind up expanding our discovery needs, possibly even insisting on having access to the company's accountant's work deck. Do not forget those work decks—think of your own. Sometimes, they contain a lot of useful information that might prove quite revealing, including comments, side notes and the like.

We are probably at a point in technology in which the majority of businesses have websites. Some have just a bare-bones website with essentially a name, an address, some contact information, and a few words or a couple pictures about the company. Those websites are there simply because somebody felt it was important to have a presence on the Internet, but nobody bought into making it a useful tool for the business. Basically, those companies went along with what other companies were doing. On the other hand, some websites are simply terrific in the extent and depth of information they provide. They include information about the company's services and products, its employees, what it is doing, what it hopes to do, and its far-flung operations and links to subsidiaries and organizations or groups in which the company is involved or links related to its operations.

When we get engaged to investigate a business, one of the first steps in that process (perhaps even before bothering with the tax returns and financial statements) should be to access the Internet and see what information is out there about that company. We are not just talking just a website. What information is in the public domain about this company? At the same time, use the search engines on the Internet to find out more about the person we are investigating, the person or people who run the company, the team members of the management staff, and the board of directors of the company. Essentially, find out whatever you can about the company and any people involved with it. Although, in theory, this should be applied to everyone, so that the job is done completely and correctly, if we are on the attack (that is, we represent the spouse not involved in the business), the Internet might inform us about how many customers the company has served well, what the public thinks of it (those wonderful testimonials), and the generally rosy picture portrayed on the Internet (with perhaps a bit of puffery). All this helps in developing not only our understanding of the business but support for a position about the possibly favorable future facing this company. It can be difficult for a company, ownership, or management to proclaim a poor outlook and adverse conditions when we are able to point to their own online literature that essentially posits that this company is the best thing since the Industrial Revolution.

Protocol

Protocol is a funny thing in our field. The best way to proceed in these cases is to reach out to the targeted business; deal with the owner, controller, or bookkeeper; and get what we need to proceed with the job. Typically, that works fine if our client happens to be the business owner. When our client is the nonbusiness owner spouse and even sometimes when the client is the owner of only a small percentage, protocol issues have to be followed. Often, they are appropriate and merely slow us down a little; sometimes, they are truly obstructionist in nature, and that obstruction is created by the business owner, or his or her attorney, or both. Unfortunately, sometimes, this protocol requires that we submit our discovery and access needs in writing to the attorney representing our client, who then in turn submits it to the attorney representing the business owner, who then in turn submits it to the business owner, who then in turn may even submit it to corporate counsel. Depending on the level of sincerity in regard to cooperation, a simple request to, for instance, have access to the 2010 general ledger might take one month or more to put into action. Whenever possible, try to deal directly with the company people who will enable the job to move smoothly and efficiently because, frankly, everyone wins in that process. However, some hard-headed business owners and overly combative attorneys don't see it that way.

At the Business

Unless precluded from doing so, at least part, if not all, of the forensic analysis should be performed on the business's premises. That's where the records are, that's where the people are who can answer questions, and that's where the action is.

Assuming we get the opportunity to perform at least some of our forensic analysis at the company, use that opportunity (provided we are not absolutely precluded from doing so) to talk to some of the employees and get to know a little bit about them, particularly those in the financial department (such as the bookkeeper). Putting aside any agendas we might have, the simple reality is that if we have at least a decent working relationship with the bookkeeper, we have a much better opportunity of getting our work done reasonably efficiently. Besides, it never hurts to be on a good talking relationship with someone who has access to the books and records and who may know a lot more than the books will tell you on their surface. Oftentimes, even long-time bookkeepers don't necessarily have all that much loyalty to the owner or business, and they are willing to open up and talk to us. Also, even when they do have loyalty, remember, their thought processes and agendas are not the same as ours. They may very well open up and share information with us in a normal chitchat fashion—certain golden nuggets that we cannot find elsewhere. This can be particularly the case when they don't get the opportunity to talk with anyone else during the day; they will welcome us. We may be the bright spot and highlight of their day.

The bookkeeper is not the only person with whom we might interact and not the only person who might be able to provide information. Let's face it, many times, the bookkeeper is ensconced in the financial aspects of the operation; he or she may not be involved in various other aspects that would be of help to us in proceeding with a good investigation. Therefore, keep your options open, and make reasonable attempts to have open lines of communication with as many people in the target company as possible. In larger situations in which return visits are common, I have even heard of some of our peers bringing in coffee or donuts in the morning to ingratiate themselves with the company employees.

Most of the time, it is rare that we will get the same type of cooperation or chitchat from the company accountant that we possibly got from the company bookkeeper. After all, put yourself in that person's shoes. If the roles were reversed, just how open would we be to chitchat and making it easy for the person who is digging into our valued client's records to come up with the "dirt"? Thus, although we are all entitled to expect professional courtesy and civility, do not expect anything more than that.

Nowadays, more and more, we are able to do an increasing portion of our work offsite. In the "old days," when we were going to review the books and records or go through the general ledger, journals, and so on, that was obviously done only at the place of business. A decent-sized investigative case would take you perhaps a few to several days, and sometimes, that would be with you and an assistant working on the case. Thus, much time spent at the target company, with ample opportunity to get a run of the place and meet and talk to people. Over the past number of years, this has changed to more and more remote-access situations. Particularly for small and even midsized businesses, it is no great effort to get, for instance, QuickBooks or another software program on a disk that gives us multiple years of the detailed general ledger, receipts, disbursements journals, and so on for the target company. We are then able to work more efficiently at our desk in the office, with greater ability to manipulate (no adverse implications here) the data in order to perform a better analysis of the data. It should be kept in mind this does not mean that we are no longer going to be spending some degree of time at the business.

There are reasons why this will continue are as follows:

- Simply, it is virtually an absolute necessity to be at the company at least once to perform a walk-through or inspection and see what's going on. Also, if possible, use that opportunity to interview one or more key people.
- Even in this day and age of a substantial amount of the accounting or bookkeeping records being on a software program that is portable, supporting details, such as bank

statements, cancelled checks, sales invoices, and paid bills, are often not so readily accessible outside of the company premises. Thus, although we are able to do a number of basic analytical procedures in the comfort of our office desk, when it comes to verifying certain transactions and looking at documents, most of the time, we will need to be at the company.

- As referenced, visiting the company is a crucial step in virtually all of our investigations, especially when a valuation is required. Arguably, if the only purpose of our investigation is the determination of income, testing various transactions, and the like, perhaps a visual of the company's operations is not that important. Likely, we would still want to see the company, but generally, a case can be made that it isn't all that necessary. However, when a valuation is part of the assignment, it is the exception to the rule when a visit would not be appropriate; helpful; and, perhaps, even necessary. If it is a public-type situation (for instance, a retail store), then visiting it is a rather easy task and can and should be done before the employees know you. Go there as just any other customer, take our time, walk around, and make some very good mental notes. Immediately after leaving, commit those mental notes to paper, dictation, computer, or whatever works for you. Having those types of contemporaneous notes can be invaluable. Also, they go a long way toward building and supporting credibility when and if those issues come to the fore in court.

  Be observant about the company's operations. What is the condition of the office, store, or the like? As appropriate, are the shelves full? What time of day or week did we go? If relevant, what was the weather like that day? If the location is important (it usually is for retail), is the company on a main street; in an industrial complex; or on easily accessible streets, roads, or so on? Is it a new building or one that is falling apart? We do not have to be a real estate expert to make valuable observations and comments relating to the physical condition and operation of the company. Are the company's machines idle, and if so, is that staged for our benefit? Does the place look clean or is dust piled up everywhere?

  A related comment: I recall a situation in which my adversary made a number of comments in his report relating to interviews that he had with various key people. However, he retained no notes of any form that would be considered contemporaneous and, in fact, had nothing more in his file (allegedly) than the recitation he presented in his report. That cost him a number of credibility points at trial.
- Many times, the businesses we are investigating are not open to the public but, rather, might be a distribution center, factory, professional office, and so on. In those situations, it is unlikely that we could just simply stroll in and look around. That does not mean we should not try (keep everything in reason) nor does it mean that we couldn't do a degree of looking. For instance, assume it is a doctor's office. Although we are not going to get behind the scenes without permission, we can certainly make a preliminary visit to see what it looks like on the outside, as well as the inside of the waiting area, reception area, and so on.

In the vast majority of cases, as a practical issue and recognition of not wasting people's time and money, it is not a big deal to get access to the company property and even an escorted or guided walk-through. Ideally, that walk-through would be with someone high up in the company who can talk to us and explain various things, answer questions, and so on. Once in a while, we will come across an attorney on the other side (assume we are working for the spouse who has no involvement in the business, and we are viewed as the interloper or enemy), representing the business owner, who will work to make life difficult by precluding us from doing the basic rudimentary walk-through under normal circumstances. Sometimes, this is done with a reasonable business approach to the litigation; sometimes, it is done to simply waste time and, perhaps, create higher fees. Regardless, you want that walk-through. During any such walk-through, taking notes is perfectly normal and routine, and even dictating notes should not be objectionable; however, think twice before dictating notes that are within earshot of other people, except when those notes are benign and simply straight, objective observations. Even then, certain observations can be interpreted in different ways.

Knowing the Business

As accountants, one of the advantages we bring to many investigations is that we have a wide range of experiences (assuming you are somebody with a decent number of years of experience). Unless we have been pigeonholed into one particular field, the odds are, especially for small to midsized firm practitioners, that we have probably seen a large number of different types of situations. That helps us learn a little about a lot of businesses and, sometimes, a lot about of some of them. Now, we are investigating a business, most likely to determine its value. Depending on how much we know already about that particular business and industry, it is time that we learned a lot more. Have no illusions: you will not be a true expert in that business nor is that expected of you. We are experts in forensics and valuation; that is not the same as being an expert in a particular business.

However, we need to have a basic working knowledge of more than just the fields of forensic and valuation. Most businesses have a significant amount of generic and industry information readily available in the public domain. This information might be available through trade magazines and journals, trade groups, other clients of ours, the target company itself if we are on good terms or if it is actually our client, the spouse with whom we are working (take a lot of things with a grain of salt), and even the Internet. Just make sure that you understand the operation. We do not have to worry ourselves that we are going to be challenged that we are valuing a business that the owner knows better than us; the owner will always know the business better than us. Hopefully, we will always know valuation better than the owner! This raises an interesting question: what if our job as part of the divorce action is to value a firm that performs business valuations? A conundrum, but us leave that for another day.

Part and parcel of learning about the business and its industry (specifically, the business being investigated) is to learn what we can about its internal flow and processes. How are sales made, and how are the funds collected? Who handles the funds? How many employees does the business have, and broadly speaking, what are their functions? How far do the hands of the business owner reach into the various parts of the business? This tends to be more of a concern in small to midsized businesses (especially when there is cash) than in larger multilocation operations. How are checks cut, who authorizes them, and what kind of documentation backs them up? Yes, to a degree this sounds like an internal control review, and in fact, to a degree, it is an internal control review. But the purpose of course is different, and generally, the depth that we have to plumb is nowhere near as significant as an internal control engagement.

Multiple Companies or Divisions

An area that can present fascinating complexities and really test our insight is when multiple companies are involved in the investigation. Multiple divisions can also create issues, but if they are merely divisions of one company, and all the reporting for the operations is contained within one set of books, then, in theory, multiple divisions should not matter. However, if we are talking about multiple companies and different ownership interests therein, our job has just become so much more interesting and complex. Before we get carried away with our enthusiasm, put the magnitude of the issues into context, particularly fees. A $20 million dollar operation is a lot easier to investigate than 3 interrelated $7 million dollar operations. The totality is the same, but we could easily double the fees in trying to investigate the latter versus the former. Will the case sustain that, does it warrant it, and do we expect an appropriate cost-benefit relationship? Indeed, it is very difficult and perhaps impossible to make that judgment before we have an opportunity to sink our teeth into the operation, spend some significant time on the investigation, and spend a significant amount of our client's money.

When dealing with multiple company operations, first we need to address ownership. The easy part is when the ownership is the same. This is the case when an individual is the only owner of two or three companies. Generally speaking, those situations are conceptually simple because they often constitute one extended family. Also, what goes from one company to another can be considered to not be at arm's length and approached accordingly. Far more difficult is when we have, for instance, three companies with three owners, and their ownership interests vary from company to company. In such a situation, we may be starting with the assumption that the transactions among the entities are at arm's length because different ownership interests compel each of the owners to be cautious and handle things appropriately. That may be the case when we start, but it is by no means an absolute certainty.

After all, for those of us who have spent some time in the trenches working closely with clients, it is hardly unusual for some clients with multiple shareholders to have a side deal (sometimes called a yellow sheet or a true-up sheet) or whatever is needed in order for them to track what each of them has taken or benefited to the exclusion of the others. Then, depending on their style, at year-end, they even it up among themselves in some fashion. It is a good possibility, particularly if we are on the outside, that we will never know the full extent of the deal and see those sheets, unless our client's spouse had the opportunity, wherewithal, or soundness of mind to grab a copy at some point in time. Barring that type of situation, different ownership interests in multiple operations forces us to at least seriously consider that those intercompany transactions are legitimate.

Assume for the moment that we have multiple companies, and for whatever reason—if only because the same ownership percentages are involved—we suspect that games may be being played. We need to look at a number of things to provide us with a better sense about whether games are being played and whether something needs to be addressed in a little more detail. However, first, recognize that unless something is unusual or of particular concern, does it really matter if one entity has incurred unnecessary expenses for the benefit of another entity? If we are talking about the same pair of pants, does it matter if more money is in the right pocket than the left pocket or back pocket? Thus, don't get carried away about suspicious activity among entities if the net of any such activity and the net of any potential corrections leave the combination unchanged. This is not to say that there may not be manipulations among companies, perhaps to make a very successful company appear less successful for purposes of valuation, but generally, that would not be the situation because generally, financial movements are tax motivated.

If we do have concerns about the validity of transactions among entities and are convinced that there is an end result merit to these concerns, then consider the following:

- Do their respective tax returns or financial statements correlate with each other where they should? Assuming a similarity in product or service, do the respective percentages and financial positions make sense? Do intercompany balances among them reconcile?
- Do they report on the same year-end? This could be a flag. If they report on different year-ends, the ability to play games increases by creating, in a sense, a permanent deferral by having income and expense moved among the companies to maximize the play among them in respect to when income is recognized.
- Who owns what? As previously mentioned, as a general rule, if the ownership is the same, then this exercise tends to not be all that important, especially if all the entities are owned by one individual. However, assume that we have varying ownership interests. It's very important to understand who owns how much of each of the entities. It's also important to know if that ownership is real or simply a substitute or proxy for someone else. Generally, that information is also relevant in regard to relative power positions. For instance, putting aside the legal nuances (remember here that we are accountants and looking at this from a financial perspective), assume that we have a bunch of companies set up by the parents and they have distributed ownership interests to various of the children. Mom or Dad or both may still control everything, and regardless of the different ownership interests, they may dictate everything that goes on. Thus, recognizing again that legal issues are involved that are outside our ken, we may look at this as one big pot rather than several distinct and separate entities. We need to make our case, show transactions among the entities, and show that these transactions are not at arm's length. That is going to be a key factor if we are to overcome the situation in which the defense is that different ownership interests exist, and therefore, they have to be at arm's length. As a general rule, that's a pretty serious obstacle to have to overcome. Also, perhaps we've got some very minor interests at

stake. As a general statement, these tend to be irrelevant in regard to any true input or control, as well as to having any ability to direct benefits.

Recent Changes

When a divorce action is initiated, depending on who is directing it, it is not that unusual for a business to all of a sudden acquire that nearly fatal disease known as recently acquired income deficiency syndrome (RAIDS). We also know that although it's immediately suspicious on its face, sometimes, there really is a downturn somewhat contemporaneous with a divorce filing (the classic coincidence). Often, an important role that we need to play is to try to make the determination about whether a company's recent adverse performance is merely divorce planning or truly reflective of recent financial reality. We need to look at things such as sales deferrals, the possibility of other companies being established, unusual expenses, and whatever seems out of line or atypical for the past.

Did the company lose a large customer? That would be particularly suspicious if it was a long-term customer. On the other hand, what if the loss was because of a contract that was up for bids, and this time, the company we are investigating simply didn't come up with the right bid? Barring collusion, that's probably a legitimate situation. Just how suspicious are we, and how suspicious is our client? Is it possible that the bid was lost intentionally to a friendly stand-in? Is the relationship with the customer very good, and the company simply agreed to forgo a year to look bad, figuring that it will make up the revenue in the future? These are not easy areas to attack.

Possibly, we can look to see what is happening in the industry in general and if the target company's current shrinkage is consistent with industry or regional experience. If it is, all the more support for the legitimacy of the decline. If not, well, our job just became a little bit more difficult. With counsel's assistance, we may need to consider subpoenaing various people; we have to tread carefully because our enthusiasm and attack posture may possibly create estrangement with business relationships and succeed in damaging that business (perhaps more than it's already damaged). It might also open us up to a lawsuit if what we did in any way could be argued to have been done in bad faith and, perhaps, as a deliberate attempt to damage the operations. We all know just how far-fetched some people can go with their reaching, so once we go outside of the comfort of the four walls of the business by probing customer and supplier relationships, some degree of caution and cynical perspective is necessary.

Another area of concern is when the case has dragged on for a couple of years, and the business is still hurting and still below where it was during the happier phase of the marriage. When a business has gone through a couple of years or more of a downturn, barring thoughts of financial suicide, we are probably witnessing a real problem. It is one thing to create a temporary problem within the company (figuring the company will recover pretty soon) because very little is risked and lost. It is another thing to carry that on for two or more years. Therefore, when we see that length of a downturn, we've got to give more respect to the legitimacy of that adverse situation. Just how many business owners are going to purposely hurt their business for a couple of years, lose hundreds of thousands of dollars or more (relative to the size of the operation), and risk permanent damage to their operation just so the value of the business and his or her income comes in somewhat lower, meaning less has to be paid to that miserable spouse? After a couple years, even if it was intentional and it succeeds in lowering the business's value, odds are that probably as much was lost in real money as was gained in reducing the value for allocation and distribution purposes. That is not to say that this approach isn't logical or that some particularly embittered spouses would go that far. After all, we all know the newspaper stories about a husband or wife taking a bulldozer and knocking down a house or sawing the house in half, so that the other spouse doesn't get to enjoy it.

Realistically though, if we really believe that games are being played and have been played for a couple of years, we must recognize our greater burden to prove such suspicions. In cases like that, it is strongly urged that we do whatever possible to search out other financial connections and avenues for that business owner. Were side businesses or other operations set up? Were relatively new accounts established and not disclosed? Do what you can to search out business formations, registrations, accounts, credit references, and the like. If indeed we have cause for suspicion that the past couple years are a false façade, hopefully, something else will prove our argument. Face it, it's a pretty weak argument if nothing has been diverted, and indeed, the adverse situation is real, even if it has been intentionally created.

CHARLTON HESTON WOULD BE PROUD—
Sometimes, you don't know whether you should laugh, cry, or run. I was performing a financial investigation of a garbage company. The husband had an interest in the company, along with his family, and I was representing his wife. The company was in an old-style wood building, with modest offices lining both sides of the long hallway. I was in a small conference room on one side of the hallway working with the company accountant and going over various items. While doing my analysis, I kept hearing "click, click, click." My curiosity got the better of me, and I looked through the open door to see if I could understand where the click was coming from. Diagonally across from the conference room was the husband's office, and I saw through the open door the husband sitting at his desk cleaning a rifle; the rifle's chamber was making the "click, click, click" sound. I gave a gentle elbow to the company accountant (let's call him Bob) and said to him, "Bob, what's with the rifle?" Bob took a look over his shoulder, looked back at me, and calmly responded, "Don't worry, he might shoot his wife, he might shoot her attorney, but he'll never lay a hand on an accountant."

5

Analyzing the Balance Sheet

BE CAREFUL, THAT'S A GIFT—Some lighter moments are not really intended that way but kind of evolve. We were holding an all-parties settlement conference in our office on a case in which we were the neutral expert. On one side of the table sat the wife and her attorney, on the other side sat the husband and his attorney, and at the head of the table sat yours truly. We were fairly well along in our conference when something particularly piqued the wife's ire, and she reached into her bag, pulled out a package, and flung it across the table at her husband. He ducked, not that it would have mattered because it was only women's clothing. The wife was particularly upset because even though the husband had been out of the house for six months at that stage, he had seen fit to order the clothing for his new girlfriend and had it mailed to the marital residence.

The first four chapters arguably got you to the point where you are now ready to employ some of the accounting skills that you have honed over the years. Chapter 5 deals with attacking the balance sheet. Included are recognizing the practical aspects of differentiating between accrual versus cash (remember, this is a divorce litigation, not an accounting standards course); and dealing with not only reviewing (which generally is the easy part) but with challenging such assets as accounts receivable, work-in-progress, and inventory. This chapter also deals with liability, though that tends not to be as exciting in an investigation as the asset area.

This chapter also selectively covers balance sheet issues that are of importance to the forensic accountant, and at the same time, it will look to avoid, as much as possible, overlap and duplication with the very fine detail provided in the recent AICPA publication *Forensic Accounting for Divorce Engagements* by Huber and Glenn. Thus, although there will be some degree of overlap, the intent is to either address only those areas not covered in that book or provide a different angle or view of a particular area.

Accrual Versus Cash

We are not addressing here a particular balance sheet account but, rather, a concept that, as accountants, we are certainly all familiar with: dealing with a set of books or records maintained on a cash versus an accrual basis. It is a given that the accrual method is the only "correct" accounting approach and one that would ideally be used. As a practical matter, particularly when dealing with professional practices, small service businesses, and even small retail businesses when inventory perhaps is not a real issue, we are often dealing with cash basis records. While that may be all well and good in a tax environment, keep in mind that we are working in a litigation environment (specifically divorce), with the goal of coming up with and developing as useful and reliable financial data as possible for a limited purpose. In addressing both balance sheet and income and expense areas, that means if we had our choice, we would want to express those on an accrual basis.

As a practical matter, in many situations, that simply either is not possible or would be so time consuming that it would be cost prohibitive. For instance, if we were to take a typical professional service business (for example, a doctor's practice), which is certainly maintained on a cash basis, and we were to attempt to restate five years of data on an accrual basis, we would instinctively know that it is simply not practical. Further, when looked at over a several-year period, certainly from an income and expense point of view, it's also likely not terribly important because the virtue of a several-year financial analysis is that aberrations and fluctuations from year to year tend to get eliminated or, at the least, minimized. If our target company has played games from year to year in creating income deferrals, or accelerating certain expenses, even if we do not adjust those from year to year, when we look at several years and average them, the impact likely is not significant. Forget for the moment the multitude of exceptions and variations; just allow these broad assumptions for illustrative purposes.

To illustrate, take a growing company or, perhaps, one not growing but in which a bit of divorce planning is occurring in the final year that we are investigating. Assume the typical situation that from year to year, we have had a hold back on deposits (the old classic sales deferral technique) that was typically between $20,000 and $50,000. However, in the final year, the hold back is $200,000 because of either growth or divorce planning, or both.

Because we are going to fix the balance sheet anyway, the extra magnitude of the deferral does not really matter; we are going to come up with the right numbers regardless. However, from an income point of view, that last year was probably $150,000 more profitable than it seemed. Whether that is out of line with the other years depends on the profitability of that year compared with the other years, taking into account the magnitude of the deferral for each year. The point here is that the outsized deferral overrides the leveling. Thus, at least to a degree, it can be very important to get a handle on the approximate magnitude of the sales deferral variation from year to year. Again, this becomes especially important if, instead of a straight average, our judgment call is (or would be with the right numbers) some form of a weighted average. Once again, a significant change as just described could have a dramatic effect on our ultimate normalized income to be used for valuation.

Although we will likely spend much time doing our normalization adjustments (making the numbers "real"), except when it is overly obvious and easily accessible, it's not likely worth spending all that much time trying to organize the numbers truly, year to year, on an accrual basis. We can leave that for the end and, generally, only for the balance sheet. Even when significant fluctuations are inconsistent from year to year, over a five year period, we have likely leveled the distortions to where they would not matter. Again, allow for plenty of exceptions, which are being put aside for the moment. Where the issue of accrual versus cash does need to be taken into account is typically only at the end point (valuation date) on the balance sheet. Thus, the effort in this area will be devoted to coming up with a good handle on accounts receivable, perhaps work in progress, maybe an inventory adjustment, accounts payable, and accruals for the date of valuation. Each of the prior four year-ends in our five-year analysis won't lend themselves to anything of value from the balance sheet perspective and, as briefly discussed, would likely entail too much effort in the income and expense area to warrant the work that would be involved.

Cash

It is important to get a good understanding of how cash is handled. The word *cash* here is intended to mean both checks coming in by mail and over the counter, as well as cash. The flow is important; don't let anyone ever tell us, particularly for a professional service business, that he or she does not receive any cash, and therefore, has no unreported income (URI). Think for the moment that our own doctor is the famous Dr. Smith who practices in a firm known as Central America Pediatric Services. Do we make the check payable to Central America Pediatric Services, or do we take the easier way out, especially because it's a personal relationship, and simply write Dr. Smith on the check? In turn, Dr. Smith can easily cash that check anywhere he or she banks, conveniently skipping the step of recording it in the practice's books. That is one simple example of how even a business that receives no cash can have URI. The point here is to understand the flow of funds in the business.

Sometimes, with a larger cash business, we might hear something along the lines of the owner does not really touch the cash because it comes in through the employees, they handle it, enter it into the system, and fill out the deposit slips. That may all be true, but who brings the money to the bank: an employee or the owner? More often than not, it's probably the owner. So much for internal controls from our point of view. Just because the employees correctly handle the funds and record the cash does not mean that the deposit is consistent with the recording or that the recording can't be changed later, overridden, or adjusted in some other way by the owner.

Depending on our level of suspicion and, perhaps, the concerns we may have about the flow of funds, we may also want to review the disbursements journal, looking for any and all payments to the owner or officer. It doesn't matter that these payments may be recorded correctly (that is, as compensation, expense reimbursements, loans, and so on); one of the things we are looking for here is the flow in order to trace the funds and checks to their ultimate disposition. Remember, a common concern in divorce services is not simply whether the business owner has been falsely reporting income or cheating the government but whether that person has been cheating his or her spouse. This can be done with perfectly legitimate income reporting by diverting the flow of funds to areas or accounts unknown to the other spouse. Be particularly vigilant if we see more than simply the usual payroll checks and, perhaps, an occasional expense reimbursement going to the owner.

Many, perhaps most, attorneys have trust accounts. A common concern we have in our forensic investigation is the use of those trust accounts for income deferral, such as holding back December income in the trust account and not recording it in the operating books until the next month. That's fairly routine not just for lawyers but for so many others. The real concern, which is fortunately the exception because it is outright fraud, is when the trust account is used to wash the income, so it never goes through the books. Think in terms of a client paying an attorney; the client's payment, as appropriate, goes into the attorney's trust account. However, instead of the money then going from the attorney's trust account to his or her operating account when earned, a check is cut directly from the trust account to that attorney, circumventing that attorney's operating account and books that are used for reporting income and expenses. Putting aside a truly serious income deferral, that's where the real action can be.

Accounts Receivable

This area generally does not produce much in terms of fireworks or forensic discovery, but every once in a while, it kind of surprises us. See if there is an unusual level of write-offs, though typically, the more effective way to look at that is through the bad debt expense category. Connected to that, perhaps we notice receivables being written off, but business continuing with that same customer. That could be as benign as a routine adjustment in favor of a client or customer, or it could be something such as the owner collecting the receivable in cash and writing it off but continuing to do business with this customer. Another consideration is if we notice large receivables that never seem to get paid off. Maybe we have some bad receivables that nobody wants to accept or recognize, or maybe a related entity with no need for paying receivables, and no one has disclosed that related entity before. Regardless, a longstanding accounts receivable warrants attention.

On occasion and generally only for the smaller businesses, we run into situations in which (allegedly) no system will provide us with the accounts receivable figure. Putting aside that this is hard to believe but being forced to work with the alleged reality, we can approach reconstructing accounts receivable in a few ways. Recognize that all of these approaches are imperfect, but at least they provide us with something and leave the other side with the burden of arguing that there is another or better way to do this in the absence of normal records. These approaches include the following:

- Reviewing two or three months (whatever would be appropriate for this type of business) of collections subsequent to the valuation date. Presumably, by correlating collections to invoice dates, we can make a reasonable approximation of what receivables existed at a point in time.
- Benchmarking averages. For many businesses, we can use industry norms or expectations (sometimes in a published form) to benchmark receivables.
- Combining observations of typical monthly billings or, more appropriately, the billings for the month or two immediately preceding the valuation date with either observations of that specific company or interviews with the owners about the average time to collect receivables. For instance, if the average outstanding receivable is 45 days, we can probably do a respectable job of estimating receivables by taking 1½ months of billings prior to the valuation date and assuming those constitute receivables.

Work in Progress

It is probably fair to say that we have reached the point in record keeping (typically in law and accounting firms) where rarely any excuse or justification is acceptable for not providing information on work in progress (WIP) when such a request is made. With perhaps the exception of the smallest of firms (truly the solo practice), the state of current record keeping and the ease of maintaining time records on software programs are such that it would be a rare occurrence that work in progress detail is not available. However, on the typical professional practice balance sheet, just as with receivables, we do not see WIP unless the records are maintained on an accrual basis (despite virtual universal tax reporting on a cash basis). However, just as with receivables, we know WIP is there.

When looking to develop a balance sheet of the net worth book value of a professional practice (typically less so when we are looking to determine income over a several-year period), it could be a gross mistake to overlook WIP. Depending on the billing habits of the firm, WIP is often the second largest asset (receivables being the first). Just as with sales, in a growing firm, we would typically expect WIP to be growing. From a true income perspective, having a year-to-year (end-of-year) WIP figure might make a significant difference in gross revenues per year. Even when the effect on year-to-year revenues is not of consequence, certainly, for our valuation date balance sheet, it is an item that is important to include.

Assume we are not provided with WIP; maybe the practice has it, but in our jurisdiction, discovery is not what we would like it to be, or a successful argument is made about client confidentiality. How might we determine it otherwise? As is almost always the case with the reconstruction of records, degrees of imperfection exist. Nevertheless, it is an exercise that sometimes needs to be done. Probably the best approach is to understand the firm's billing habits and determine the fee production or generation for a typical month. By the way, make sure we are dealing with typical months—think accounting firms in tax season, for instance. A less satisfactory alternative is to use benchmarking information, such as what the typical law firm or accounting firm of that size might have in terms of WIP. As a last resort, that would be one way to approach things but nowhere near as appropriate as having an understanding of the specific firm and how timely it relieves its WIP via billing.

Inventory

I don't know about you, but I have long considered inventory to be the most frequently abused item on the balance sheet, the easiest to manipulate, and the most difficult to calculate or reconstruct. For many small businesses, the inventory number is whatever the business owner (often in consort with the outside accountant) wants it to be at year-end in order to provide an acceptable extent of taxable profits (or losses). In theory, a business will count its inventory (even if only by a sampling) at least once per year and maintain that count (record) in some fashion. At least that is the theory. It's a safe bet that unless the nonbusiness owner litigant in the divorce matter (the spouse) happened to keep a copy (separate issue of how that person came across that copy), we will certainly never see such. Further, it's also a pretty sure bet that there are going to be representations that no copies are maintained—they count the inventory, they jot it down and give the number to the accountant, and so on. Further, the inventory changes every day; thus, it's very difficult to pin down fluid-type assets that have a direct dollar-for-dollar impact on profits, as well as the balance sheet.

Barring the client's willingness to turn us loose on the company's records, which takes up a lot of time and client's money, it is typically very difficult to get more than a broad comfort level that the inventory is somewhere near reasonable. For deriving that comfort of reasonableness, we might consider the following:

- *Turnover*. If we can zero in on a reliable turnover rate, then we might be able to back into what the inventory should be at various points in time. Many types of businesses and industries compile information that we can use for benchmarking to get a sense of what is the norm. The problem is that it's only the norm, which comprises companies doing better and worse. How would we know where the subject company belongs on that continuum?
- *Gross profit*. Once again, assume that we have a type of business that lends itself to either a benchmarked gross profit or, far better, a profit that we can test and determine on our own. We might be able to argue that the gross profit is far too low (if it's

too high, we have a completely different issue); thus, the inventory is understated or, perhaps, URI exists. We'll deal with that interconnected issue later.

- *Capacity*. This one tends to be more appropriate for retail, but it has possibilities. The concept here is that, for instance, we have a store in which the selling area (excluding the back office) is 15'×20', and we have a storage area that is 10'×10'. With that knowledge, we know the square footage. Putting aside the possibility of double racking and all other esoteric-type issues, with a thorough understanding of the costs of the inventory items and how much space they take up, we might be able to do reasonable justice to the amount of inventory based on the capacity of that business.
- *Outside inventory counting service.* Unless we are particularly expert in the specific type of inventory, perhaps we can bring in an outside inventory counting service to take an actual count and value of the inventory. However, that is much easier said than done. Among the not so minor obstacles would be getting permission and, probably to a degree, shutting down the business for the inventory count. In addition, any such count is done in real time, but we are valuing this inventory as of some point in time in the past. Also, the cost factor is involved.
- *Detailed analysis of purchases.* If the budget allows, we might be able to do a detailed analysis of purchases for the last two months of the fiscal year, along with the purchases for the first two months of the following fiscal year; combine that with a similar analysis of the sales during that time frame and what those sales meant in terms of relieving inventory. Further, additional analyses may depend on the type of inventory (not just the overall inventory) or by item or by group of items. In this fashion, we should be able to satisfy ourselves about whether the reported inventory at year-end was reasonable or even possible. If we are convinced that it's not, this type of testing should be able to prove our point.

When addressing concerns about the understatement or overstatement of inventory, one of the popular approaches is to look at the gross profit percentage and calculate an adjustment or correction to inventory based on what our tests of the gross profit reveal. One of the issues with approaching inventory in that fashion is that a gross-profit distortion could be caused by URI just as easily as it could be caused by understating inventory. Further, it is probably very difficult to make more than a crude approximation about the magnitude of any correction that needs to be attributed to understated inventory on one hand and URI on the other hand. It may not matter very much, though, because the net result is simply going to be an increase in income. However, as a practical matter, it may matter very much (think in terms of the judge's reaction) whether our $100,000 correction to the reported income is the result of concluding that inventory was understated by $100,000 versus inventory being understated by $80,000 and the existence of $20,000 of URI versus inventory being understated by $20,000 and the existence of $80,000 of URI. Besides the differences to the impact of the balance sheet, the visual and practical impact on the judge can make a significant difference to the outcome of the divorce.

Finally, a caution: if we do conclude that inventory is understated and that it's been understated for years, keep in mind that by way of simple example, to continually understate profits by $100,000 per year requires a $100,000 inventory reserve for the first year; $200,000 for the second year; $300,000 for the third year, and so on. In a growing business with presumably growing profits and, thus, the need to continually increase the magnitude of the reserve, after several years, our calculation could easily have millions of dollars of inventory in reserve. Be careful about getting carried away with this exercise. If we conclude along those lines, take a step back and make another evaluation about whether that is reasonable or possible; we may have more inventory by our calculation than the company can possibly have. Maybe we need to revisit our calculations.

Fixed Assets

A multitude of issues arise in this area, including value, annual depreciation, cumulative impact of depreciation, and the like. To make matters more confusing and difficult, over the last several years, the tax laws have been extremely liberalized in terms of the generosity of writing off assets in the year acquired. As a result, it is probably the exception to the rule to have a business in which adjustments to depreciation are not needed to arrive at economic income, and adjustments are not needed to bring fixed assets (book value) to more realistic economic value.

To a degree, the balance sheet tends not to be that important (in terms of adjusting for accumulated depreciation) in many valuation situations. If all our engagement calls for is to determine income, then once we define what we mean by income (economic, cash flow, and so on), in all likelihood, the balance sheet is not relevant to our assignment. In the more typical situation in which our engagement includes not only income determination, but a determination of value, in most situations, it is likely that we will conclude with an income approach to value. Thus, putting aside the possibility of the hybrid Revenue Ruling 68-609, to oversimplify, the balance sheet does not matter. Our goal is to arrive at an income figure that is then going to be capitalized, and as long as the business is reasonably profitable, such value is going to exceed (typically far exceed) book value and even adjusted book value. As a consequence, although there is probably always merit in making the appropriate fixed-asset balance-sheet adjustment, our emphasis is going to be on income.

When it has been determined that it is important to have a value for fixed assets that is superior to a tax-driven value, probably only two approaches are viable:

1. Generally, the easier approach and one that does reasonable service for the typical small business and even many midsized businesses is to determine what depreciation should have been the last several years based on readily accessible public domain information about the expected lives of various types of equipment. We can make those adjustments in the expense area, as well as make the annual and cumulative adjustment to accumulated depreciation and book value. Although we are not equipment appraisers, in many of our valuations, that does ample justice at a reasonable cost.
2. For larger cases and even midsized businesses with a substantial amount of equipment, it may be advisable to call in an equipment appraiser. When doing

> so, make sure we have a conversation with him or her, so that we both have a mutual understanding of what is needed. Although the appraiser understands the need to appraise the equipment, we might want to have more information about anticipated obsolescence and the anticipated need for replacement (time frames) and maybe even some help performing a retroactive adjustment to depreciation (other than the assumption of a straight-line adjustment for the differential).

Of course, as part of our forensics we have many of the usual issues, although with fixed assets, the average adjustment is probably larger than in many other situations. Besides obviously looking to see what was written off as a bonus and Internal Revenue Code Section 179 depreciation, because of the substantial liberalization of asset write-offs, extra attention needs to be given to areas such as supplies and repairs and maintenance. It would not be surprising to find fixed assets simply written off via those accounts rather than being set up as fixed assets to be fully depreciated. From a tax point of view, there is essentially no difference, so why bother getting fancy?

Every once in a while, we walk through a plant or business, and perhaps we see substantial assets that are not on the books or old assets that have been written off but are still used. Maybe we see assets that are clearly not being used even though they are on the books and being depreciated. Each of these situations requires us to consider what kind of adjustments, if any, need to be made. These adjustments may affect the amount of depreciation that we consider to be economically acceptable; they may also affect what we consider to be the value of the equipment. Once again, if the valuation is ultimately driven by income, any adjustments we make to the balance sheet are probably irrelevant.

Particularly in the area of vehicles (and, for the more exotic among us, boats and planes), the fixed-asset area can be very fruitful in our forensic analysis. Vehicles are a popular area for "gentle" abuse; sometimes, the abuse is not so gentle. We are going to want to make a determination about how many vehicles are being carried in the fixed assets, who is using each one, and the justification for use. It is hardly unusual to find not only the business owner (or two or three) having a car but also family members, such as spouses, children, and even parents. Adjustments here take the form of possibly removing assets from the books; removing depreciation from each year; and possibly also removing attendant debt, as well as interest expense, if these vehicles are financed. This applies in a similar vein when the assets are leased. In addition to all that, there is the simple, practical visual impact of these types of adjustments. Most judges don't get particularly excited or even interested in us making $50,000 and $100,000 adjustments because of accelerated depreciation. On the other hand, it's very easy to explain that the spouse and children have cars on the books and that the business owner abused the system. This is also a very easy visual for a judge to grasp, especially when the cars are nicer than the one the judge drives.

The area of fixed assets is another one in which a walk-through of the business is useful and, sometimes, important. However, finding anything particularly surprising or the so-called eye-opener is generally limited to the exceptions. Most of the time, it is going to be a boring walk-through, but pay keen attention to what we see. It may be helpful to review a detailed insurance policy in advance in order to see what assets are being covered. This is particularly useful when the insurance policy provides line-by-line and asset-by-asset detail. It is also helpful when the insurance policy states a value for each of these assets. Keep in mind that for our purposes, insured values may have nothing to do with economic value. Those values from the insurance company provide a guideline and may be helpful, but they may not be the final say in what numbers we are going to use. Again, if the numbers are substantial, give serious consideration to our client bringing in a machinery appraiser.

Notes Receivable and Payable

This is usually a boring area, and one that does not require attention. However, in regard to a note receivable, we may very well want to know why such a receivable exists, assuming the business we are investigating is not in the business of lending money. It might be because a questionable account receivable was converted to a note. In that case, we certainly have the concern about the collectability of the note, although logically, collectability is better as a note than as simple accounts receivable. Perhaps money was loaned to an inside party or a third party. Whatever the case, we want the details. Keep in mind that such a note receivable may very well qualify as a nonoperating asset, which will have potential significance in our valuation.

The other side of the ledger here is the notes payable, and some of the concerns are pretty much the same. We will want to know why the money was borrowed. What created that note payable? How was the money used? This may also involve tracing the flow of money into the business. Most of the time, it is probably just business as usual. Once in a while, we may come across a situation in which there was borrowing, so that the business owner could do something personal, and the money was washed through the business and handled in whatever way the business decided. Meanwhile, the business is writing off the interest expense. Again, an adjustment here will affect not only expenses but also the balance sheet; once again, we are looking at a possible nonoperating liability.

When we are dealing with notes receivable and payable and when the determination has been made that they are not operating assets or liabilities and, thus, have to be removed from the balance sheet, do not overlook that this will typically affect the personal balance sheet. Assume we are taking the position that a note payable was to secure funds that were not used in the business, and it is truly a personal note; thus, we have removed that note (and the interest expense) from the books of the business and our reconstructed and normalized balance sheet. Because we are dealing here in the world of divorce, what we have done is transfer this liability from the business to the personal balance sheet of the individuals. It works the same way for a receivable. This is an area that can take on significant importance because of our multifaceted role in dealing with the business, as well as personal finances, in the typical divorce situation. Also, consider the interest rates on the notes. Are they reasonable? This is usually not an issue, but once in a while, we will come across an unusual rate of interest that will warrant further attention. For instance, perhaps a related party has a note payable with a very high rate of interest. That high amount of interest is negatively affecting the business's operations and may be a way to divert funds to a related party.

One more item when we are dealing with these notes receivable and payable, especially a note payable: financing typically means that some form of financial package (at the very least, a financial statement) was submitted to the lender. For just about every small business and for many midsized businesses, that financial package includes a personal financial statement and the business statement. We are definitely going to want to secure a copy of those. See what the business owner put as the business's operations and worth, as well as his or her personal situation.

Intangibles

For most of our purposes, this means goodwill. Once in a while, it will mean other things such as patents or copyrights. A basic rule is that when we see an intangible on the books, we need to understand how it arose and how it got on the books of the business. If it goes back a number of years, it may have little to no relevance in terms of our valuation concerns. However, if it is more recent, then this could prove a fertile area for further examination. In that case, we are going to want the documents that support the reason for the goodwill on the books (typically an acquisition of some kind). From an expensing point of view, if goodwill is not amortized, in all likelihood, we will be making a normalization adjustment and treating the adjustment as a nonoperating expense. Don't overlook that when we are valuing a business that has goodwill on its books. If our valuation in any way takes into account book value, we will likely need to remove that goodwill because of a focus that is, in all likelihood, tangible oriented only. For larger company situations, because of the complex rules on goodwill impairment and depending on our personal level of expertise, we may actually have to call in one of our partners or associates or a fellow CPA who has that type of expertise.

When the intangible is a patent or copyright, once again, particularly if it is of recent vintage, we will need to know the details. Often, the reality of any patents or copyrights held by a small or midsized business is that they are not really worth anything by themselves. They are very often just another operating asset in a pool of assets that help contribute to that business's operations. However, there very well may be valuable patents or copyrights in the exception, and those situations may call for us to bring in an expert in that particular field. It is one thing for us as an accountant or appraiser to value a business's income flow; it is another thing for us to take a particular asset, such as a patent, and try to value it as a stand-alone. Unless that asset has a track record (royalties from third parties), it probably requires someone with that particular scientific or other field expertise within that specific technology to provide us with reliable valuation information. Even when a third party is paying royalties, it is quite possible that from a technological or item-specific vantage point, valuing the royalties is simply outside of our expertise. This is also the case with a copyright. How many CPAs truly know the expectations for copyrighted material?

Often, patents and copyrights are developed internally and, thus, may not even be on the books (other than perhaps stated at $1 and even then perhaps not). As a general and routine forensic approach but particularly when we have concerns that there may be patents or copyrights involved, perform a thorough analysis of the professional fees expense area.

Look to see if payments were made to intellectual property attorneys or if fees have been paid to the patent office. These can be obvious signs of the existence of such intangible assets or, at the very least, attempts to bring them into existence. Alternatively, look for the revenue sources reported by the business. Probably 99 percent of the time, nothing is going to be unusual here because the revenue is coming from our typical customer (typical for that business). However, perhaps royalty income exists. Obviously, that opens the doors for additional inquiries because we are going to want to see how the royalties are determined, what contracts exist, and so on.

Accounts Payable and Accrued Expenses

This area is generally not all that productive in the investigative process, but nevertheless, it has to be considered. By viewing the aged accounts payable schedule, as well as the equivalent of the aged accrued expenses, we may find items of note that are useful for the investigation. Have any accounts payable or accrued expenses been on the books for a long time? Does it appear they have never be paid? What we might have are payables that were set up on the books, often for legitimate purposes, in anticipation of a liability, and that liability (or at least the payment of that liability) never came about. Rather than reverse that accrual, which increases income, the payable is left on the books in perhaps a perverse sense of conservatism. Let's face it; if the payable is not paid from within six months to one year, it is typically not a real payable.

In regard to accrued expenses, they work the same way, but often, they are set up (particularly in smaller companies) by the outside accountant once per year at year-end. Review the journal entries and the support for those entries that established the accrual. Sometimes, we will find an accrual repeated from year to year, and that may be okay. If the prior-year accrual is being reversed because it was paid, we now simply have a similar item being accrued for this current year. Commonly, that might happen with accounting fees. The issue we need to address is when this accrual is never paid, and the liability is simply carried forward year after year. This area can also be productive in the sense that we might find payables or accruals that are unusual in size, term outstanding, and so on. That may lead us to investigate further, and in some situations, that can lead us to related-party situations that we did not know existed.

Loans and Exchanges

An oldie but a goody and a fabled dumping ground for almost anything. Usually, that is all it is, it tends to wash out, and we leave it alone. However, every once in a while, we might find something of interest—a little nugget of gold. Look in this account to see what kind of activities are running through it, keeping an eye on the more substantial items. Maybe it is serving as an area to wash questionable transactions. Maybe the owner of the business is flowing money in and out that, in the net aggregate, means nothing but when the pieces are viewed individually might lead us to other findings in other directions.

Officer or Shareholder Loans

We should not have to remind any of our readers that this type of account needs to be reviewed; however, it might be labeled loans, notes payable, and so on. We are looking for activity, although in some cases, a lack of activity can also be very telling. In regard to activity, where did incoming funds come from, and where did outgoing funds go? Assuming that our investigation involves a classically typical closely-held business, and we are doing work in a divorce context, unless our role is restricted, we are going to want to make sure that the flow of money involving an owner who is party to this divorce action is adequately reviewed and analyzed.

I am personally not a big fan of some of the less sophisticated arguments that suggest the owner taking money out via loans is receiving disguised payroll. We all know that as a loan, that money is not written off as an expense. Therefore, if indeed the money is intended in some fashion as a substitute for payroll, barring some truly unusual shenanigans, the result is going to be less officer compensation and, therefore, more net income. In virtually every case, we do not care as much about the actual compensation as the compensation plus net income. Nevertheless, typically, less sophisticated individuals make a claim along the lines of, "I am not even drawing a salary," and the reality is that loans are being taken instead of salary. Crude and elementary, but it happens. A related issue would include, for instance, whether interest is being paid or received on such loans, but once again, that often is nothing more than money from one pocket (the personal) to the other (the business).

Particularly when this area is addressed within a divorce litigation, we need to recognize that an owner or shareholder loan (in either direction) has its opposite but equal counterpart on the personal balance sheet of the litigants. If the business has a "loan receivable from officer" asset of $100,000, then a corresponding liability of $100,000 payable to that company (if done correctly) is going to be on that officer's personal balance sheet. One of the important elements that we need to keep in mind is not only the basic reality just expressed but that when we are performing our analysis, we need to analyze and correct any inconsistencies. Further, when we make any adjustments, we need to recognize the counterpart adjustment that is necessary on the personal side.

One more aspect of this loan area needs to be addressed, and it is sometimes a strategic issue within the divorce. If a loan (receivable or payable is not important here—the concept of the loan is the important item) is on the books of the business due to or from an owner or shareholder, we need to make a determination about whether that is truly an operating asset or liability of the business or whether it is a place where money has been parked or excess funds withdrawn. We may approach valuation somewhat differently if we have a nonoperating asset or liability. Of course, attached to that would be any interest income or expense.

Yet another facet of this area involves the ultimate asset distribution and allocation in a divorce. This likely would only be an issue in equitable distribution jurisdictions rather than community property jurisdictions, but even then, there may be some practical concerns. What I am referencing here is the percentage of allocation. It is common in equitable distribution states that the nonbusiness spouse (which more often than not still means the wife) gets less than 50 percent of the allocated business value. Generally, the distribution is from 30 percent to 40 percent. However, that spouse also typically gets 50 percent (assuming a "long" marriage) of the nonbusiness assets (money in the bank, the marital home, various investments, and so on), net of the liabilities.

Assume for the moment that we have a business with a $500,000 receivable from the owner and, of course, the concomitant $500,000 liability on the personal balance sheet payable to the business. Further assume that we are in an equitable distribution state, and the spouse will likely get a ⅓ carve-out of the business but 50 percent of the personal assets, net of liabilities. In effect, that spouse is only going to get ⅓ of the $500,000 asset on the company's books—$170,000—but yet fully share 50 percent of the $500,000 liability on the personal balance sheet—$250,000. Give or take, that is an $80,000 swing to the bad for this nonbusiness spouse and, of course, an $80,000 swing to the good for the business owner spouse. It gets even worse if that $500,000 asset is treated simply as an asset of the business within the context of an income approach. In that case, it is possible that no special recognition is given to that asset; thus, the nonbusiness spouse receives none of asset but does suffer a $250,000 share of the liability. The extent of the attention given to this asset and liability and how it is treated (business versus personal) can make a significant difference in what each of the litigants receives at the end of the divorce matter.

Equity

For divorce purpose, it doesn't matter if we are talking about capital, stockholder's equity, paid-in capital, retained earnings, and so on; they are all forms of equity, and that is what we are considering here. Typically, this is among the most boring of accounts because it usually has no changes. However, when changes have occurred in the last few years, it is an area that absolutely has to be reviewed. The one exception to the "has to be reviewed" concept is when we know that the changes in equity are merely the result of undistributed profits of a C corporation or pass-through entity.

However, other than benign changes like that, we need to see the documentation that supports what might be the issuance of stock, which suggests somebody performed a valuation; in that case, we are going to want a copy of that valuation. We also need to see supporting documentation for the movement of stock among individuals, which is not all that uncommon among family members. We would typically only see this movement in the details rather than the dollars because when that movement happens, dollars may not change hands. We obviously want to know all the details when an old partner gets bought out of a multipartner partnership or a new partner buys in. By itself, the equity accounting area will not give us all that information, but it will certainly provide us with a heads-up about what information needs to be obtained as part of our discovery, along with the justification for why we want that discovery. Sometimes, one of the hardest aspects of getting discovery is convincing the judge of the justification for the discovery, so that he or she can order it.

If a treasury stock account exists, that certainly suggests that there was some form of a buy-back. Once again, if it has been within the last few years (subject to the specifics of our case, perhaps even further back is relevant), we are going to want all the details. We will also want to access the stock register, which in many small businesses is often simply not accessible because nobody can find it. However, assuming we do get access to it, has it been regularly or irregularly updated? Is it consistent with the tax returns? Does is contain other indications or evidence of stock ownership percentages? In a similar vein, access the corporate minutes books. Once again, in the typical small and midsized business, these do not exist, or if they do, they are probably worthless. However, once in a while, particularly in a business with multiple shareholders or owners, the minutes book will be very important, revealing discussions or items of consideration that are relevant to our work.

BEST LITTLE CREDIT CARD IN NEW YORK—Credit cards are a wonderful thing, and nowadays, you can charge just about anything to a credit card. Don't you love it when somebody is in line in front of you at the local sandwich shop and charges $5.73, rather than simply take out a couple of bills? Then again, they do come in handy when the tab is a bit larger, such as $1,000 per night for a special companion. With little imagination and a clever name, you can have a credit card authorized business venture that caters to a select few business people. As part of the process of proving that the expenses being run through the credit card were nonbusiness; personal; and, shall we say, somewhat inappropriate, we got the telephone number of this special vendor with the help of the credit card company. We then purchased a throw-away, prepaid cell phone and called this house of wonder. Just the way the phone was answered pretty well convinced us about what we had thought all along. Obviously, that convincing did not rise to the level of concrete proof, but hey, this was only a divorce, not a criminal trial.

6

Operating Expenses

NO FRIEND OF ADP—It absolutely boggles the mind how some things totally escape the most obvious observations of the IRS. Picture this: a gas station on a busy highway, having about 16 gasoline pumps, is open 24/7, and does nothing but pump gas—no car repairs or anything else. The tax returns show several million dollars of revenue, a modest salary to the solo owner, and total other payroll for the year of $42,000. Yes, $42,000 for a gas station that is open every hour of every day throughout the entire year and that, by simple visual observation, employs anywhere from 2 to 4 pump attendants on a constant year-round basis. Suffice it to say, there was at least a smidgeon of off-the-books payroll, which was funded by off-the-books (unreported) income. Yes, the owner did take his "fair share" of this unreported income.

As a natural segue from chapter five as to the balance sheet, chapter six addresses the issue of looking into operating expenses. In most of my business investigations, particularly where unreported income is not an issue, this is the area that typically takes up the most time. I have tried here to provide you with suggestions which start with the assumption that you already have some/several years of experience, and that you know the basics. I have no doubt that for many of my readers, some of what I have provided herein is already known. However, bear with me—the intent is to provide you with some insights that perhaps aren't common or run-of-the-mill, maybe something that you don't see every day, and maybe something that, even for the experienced among us, helps to reinforce some thoughts and procedures relevant to investigating the myriad of operating expenses of the typical business. This chapter will take you through various broad concepts, as well as specifics in dealing with payroll, rent, insurance, professional fees, and a wide range of other expenses. The goal here is also to provide you with some ideas as to how to get a comfort level as to the reasonableness and legitimacy of various expenses.

This chapter will deal selectively with various expenses typically of importance to the forensic accountant, and at the same time, it will look to avoid, as much as possible, overlap and duplication with the fine detail provided in the recent publication *Forensic Accounting for Divorce Engagements* by Huber and Glenn. Thus, although there will be some degree of overlap, the intent is to either address only those areas not covered in that book or provide a different angle or view of a particular area. Keeping in mind this desire to avoid overlap and deal with what perhaps might be considered more advanced or in-depth issues, I trust my readers will understand if I do not dwell on certain areas that are routine and that you would expect in reference to, for instance, analyzing various expense accounts.

Disbursements in General

Spend some time early on simply perusing the basic underlying journal and general ledger through, perhaps, QuickBooks or even the old-fashioned cash disbursements journal. The point here is to familiarize ourselves with what runs through the books and records on a regular basis. This exercise is not typically done with anything specific in mind but, rather, to give us an opportunity to get an overview and a general awareness that will prove useful as part of our overall analysis.

Owner's Compensation

This is an area that we cannot overemphasize or say too much about. On one hand, it's rather simple in concept: how much did the business owner take as his or her pay? On the other hand, this area has many nuances, and it is an extremely important area to test and, in some cases, investigate in-depth. If nothing unusual happened in this area, then odds are that we will be able to address it and resolve it simply and quickly. After all, the owner took compensation, the money is on the W-2, and it went into the family bank account. Those of us who have done this work for some time know that in many situations, the reality is far more complex. We will deal here with what is less routine and mundane.

First and foremost, assuming that a business valuation is part and parcel of our assignment and putting aside the accounting issues, such as tracing the flow of money, we are going to want to make sure that we interview that business owner in a thorough and organized fashion. We need to understand what that owner does, so that we can proceed with our determination of reasonable compensation as effectively as possible. This will include understanding what that person does on a day-to-day basis, as well as a long-range basis; the necessary skills and education, as well those actually brought to the table; when appropriate (and it often is), how many hours constitute a typical work week; the job functions of other key employees within the company and what they get paid (sometimes an excellent starting point for determining reasonable compensation for the owner); and perhaps when the owner has a multitude of interests (some of which might have gotten that person into the divorce problem in the first place), understanding the interests and the time commitment they require. All of these steps are probably better considered in the economic sphere versus accounting sphere; we will deal mostly with accounting elements.

Keep in mind a couple of issues that are perhaps unique to divorce. Compensation and, sometimes, how it was done and its frequency can be directly connected to an alimony obligation. Also, in the context of the work that we are doing, being an owner does not equal an entitlement to payroll. Typically and ultimately, the business owner is going to be paying alimony. That needs to be kept in mind in our analysis because it may become very important to understand whether this person's compensation is paid routinely on a weekly or biweekly basis or comes in the form of erratic commissions, occasional bonuses, and so on. As a practical matter, this type of knowledge will be helpful when we assist our client (whichever side we are on) in trying to work out the determination of an alimony amount, as well as how it is going to be paid. In more than one case, a substantial portion (sometimes as much 80 percent or 90 percent) of an individual's total compensation is received in the form of a bonus once per year. It is important that in assisting in an alimony determination or, at least, providing the information for others to assist, it be understood that, for instance, a $500,000 per year compensation package, $400,000 of which is received in February as a bonus for the prior year, does not enable that individual to pay alimony ratably during the year as if that $500,000 was received ratably, unless we have a cushion to use as a funding vehicle. This type of approach has worked in situations in which a typically large bonus was paid at a particular point in the year, and it repeated itself year after year. When the finances were solid enough, what has worked is that the most recent year's bonus is set aside and used to start the process of paying a level amount of alimony throughout the year. Once that is put into place, subject to the ever-changing landscape, that can be continued month to month.

When the person under investigation is an owner but not the major player in the business, what sometimes occurs is that he or she receives compensation that is significantly in excess of what that person would be able to receive in a real job or for the actual services provided. We know the situation: a minority shareholder with little power or maybe the son or daughter of the founder of this business who, perhaps, has a token interest and is getting handsome compensation because of the family relationship. This brings in a totally different dynamic, one that is typically outside of our ability to control. For the unrelated minority interest, that salary could always be in jeopardy (of course, compensation always is in jeopardy one way or another but more so here); when it's family, we might argue less jeopardy, but on the other hand, where is the assurance of continuation at a certain level? Typically, those are concerns for us only in the reasonable compensation aspect of valuation, but for the attorney and one side, this is a bigger concern and one that has the potential to open up its own avenues of litigation. For us, being aware of this issue and making our team aware of the issue, particularly if we are working for the owner spouse, is probably the extent of where we go in this arena.

Sometimes we run across a situation in which a large bonus is paid soon after or even some months after the filing of the divorce complaint. Typically, earnings after the date of the complaint are outside of the marital estate and not up for grabs in the litigation, but that is too simplistic of an approach. If we find a situation in which a large bonus was paid sometime after the filing of the complaint, we certainly want to discuss this with counsel in order to have a better sense of how this needs to be handled and how the rules in our jurisdiction apply. Typically, we are going to want to perform full due diligence on any such bonus. What was the foundation of determining bonus? Is there a history of bonuses being given at that time of the year? Is the bonus arguably for past or future services (this is a whole separate area by itself and, certainly, varies by jurisdiction)?

Most of the time, unless a solid case can be made that the bonus is for future services (even then it is doubtful the case can be made adequately), at the very least, that bonus is pulled into the marital estate ratably based on allocating it over one year and excluding the number of weeks or months subsequent to the filing of the complaint until that bonus was received. Even then, that may be unfair. If bonuses are typically given in February or March for the prior year, and the complaint is in December, a strong argument can probably be made that the entirety of that bonus belongs in the pot.

It will serve us well to develop a history of how this company has given out bonuses to establish whatever approach we feel we need for our client. Of course, it may be a completely different story if the person who is involved in this divorce case (the target of the litigation) is the controlling owner of the business. In that case, whether a bonus is received may be irrelevant because the issue is the profits of that business through the complaint date and whether the profits were distributed. Again, this is on a case-by-case and, often, jurisdiction-by-jurisdiction basis.

Particularly in professional practices and when several owners are involved, it may be necessary to access the documentation in support of how compensation, as well as bonuses, was determined for that ownership group. If we are dealing with a professional practice, which is where this type of situation often occurs, what is the arrangement between the partners or owners? Is it eat what you kill, a certain amount based on billable or total hours, a percentage of revenues, new business production, a premium for management or administration, or a percentage of some kind of book that is maintained? In regard to that last point, that might be a very critical factor that is far beyond the issue of compensation. It may lend itself to having a better grasp of the value of that person's interest in the business. This is particularly and, perhaps, only where we can argue the carve-out of a piece of a business (once again, typically, in professional practices).

Particularly for law firms, although it could certainly apply to other professionals, does the lawyer (partner or owner) in a multipartner firm also receive one or more W-2s from one or more municipalities or other sources outside of the law practice? What often happens is that the attorney might be a municipal judge or the local prosecutor for a town or county and receive a W-2 for that service, in addition to whatever else that attorney receives from the law practice. Sometimes, those types of side jobs also come with a pension. These are all important items to know. In addition, if reasonable compensation (value) is relevant to our role, it is important to know how these side jobs play into the compensation arrangement that attorney has with the practice. Is there an offset, and if so, how is it determined? If there is no offset, does that mean that implicitly, that person simply has a lower salary? Regardless of whether there is an offset, if we are trying to determine reasonable compensation, what amount of time do these side jobs require in respect to what otherwise might be full-time employment and the determination of reasonable compensation?

Other Payroll

When it comes to payroll, although the typical area to attack first is that of owner compensation, often, an area of great concern and requiring a substantial amount of attention is everyone else's payroll. There can be a number of reasons why this area requires our attention, including no-show jobs; family on the books; the proverbial girlfriend or boyfriend; use as a benchmark for reasonable compensation; and if we are the type who extends ourselves, maybe even to argue efficiencies and, thus, potential improved profits and value. Let us briefly address these areas:

- *No-show jobs*. Unless we are dealing with fraud, no-show jobs usually mean paying a salary to a family member (spouse or children) or paramour, so that the business owner receives a particular benefit for such payments. In the smaller businesses, this may be easier to evaluate and determine. If the business only warrants three employees but has four or five, depending on our strengths, the nature of the business, our knowledge of the business, and so on, we may be able to make a very convincing argument that certain jobs are no-shows. Of course, our client may be able to give us that insight, or depending on which side we're on, we may have to attack this differently. It can often be helpful to ask about the various job functions that each employee fills. You will be surprised how vague the answer may be for someone who really does not work. The issue does not simply stop with making a determination that it is a no-show job and thus we have added the payroll back to the income (disallowed the expense). Do not forget that we also have the payroll taxes and, perhaps, other related costs that go along with such payroll; depending on the situation, we may also find it important to trace where those salary payments have gone. Who has been cashing the checks? Into which bank account has someone been depositing the checks? If it is a paramour, that may enable us to pull that person's financial life into the divorce case, expand your reach, and improve our forensic analysis. Usually, the financial records of paramours are off limits, unless you can make a convincing argument that they are getting some unearned tangible financial benefit from the business that is within the marital estate.

- *Excessive compensation.* This one is similar to no-show jobs but often more difficult to challenge (except in the extreme). Here, we have someone who is unquestionably working for the company, but we (or our client or client's attorney) are convinced that this person is significantly overpaid. I emphasize significantly—modest overpayment (for instance, think about $40,000 for a job that calls for $35,000) is a no-winner; we are going nowhere with that one. However, if it is that same $35,000 job, and the person is getting paid $60,000, then we have something to look at.

  The problem here is that everyone has acknowledged that the person works in the business; we now have to justify why we think the compensation is too much. Again, except in the extreme, this is not always an easy task. For instance, the referenced $35,000 job in which someone is getting paid $60,000 may not be an easy one to win, but if that same person was getting paid $100,000, perhaps our work is already done for us by the simplicity of the excessive payroll. Keep in mind, though, that paying that same person $60,000 for a job that arguably is only a $35,000 job is not a slam dunk. Perhaps that person brings a certain skill level, education, or training that arguably entitles that person to a premium. Further, maybe that $35,000 job is really a $40,000 or $45,000 job, narrowing the differential just a bit more. Regardless, this is another area that needs to be addressed as part of our forensic analysis. Furthermore, if we are going to argue excessive compensation, typically, we are also going to have to prove (that word *prove* is an interesting and tricky word) that there is an inappropriate reason for anybody to get paid in excess of what he or she is entitled, particularly the person in question. The usual reasons involve family, paramours, and the like. In the absence of that type of argument (presumably with support), if the pay is clearly above what is normal (even significantly above normal but not outrageously above normal), we will likely have a large burden to overcome in arguing that this unrelated individual for whom we have no particular relationship connection to the owner is getting paid what we, in our estimation, deem to be excessive payroll.
- *Reasonable compensation.* Even when no games are being played with payroll (no-show jobs, special friends on the books, and so on), analyzing the nonowner payroll can be a very useful tool in arriving at a reasonable compensation figure for the valuation element of the assignment. Determining reasonable compensation (replacement salary for the owner) is often one of the most significant of the normalization adjustments and, at the same time, one of the most difficult. Typically, we use some benchmarking information from the industry. However, think how much stronger the support for our determination of reasonable compensation would be if we had an actual arm's length payroll situation that provided us an underpinning of support for a conclusion. In trying to determine what is reasonable compensation for the job being filled by the business owner, what could be better than having someone not only in the same industry but in the same business who is unrelated to the owner and being paid a

presumably arm's length and fair rate of compensation for his or her efforts and skills? The following are a few examples:

- *Medical practice.* Are doctor employees filling the same or similar role as the subject owner? We may need to tweak the reasonable compensation number for years of experience, management responsibilities, and the like, but at least we have a real, live foundation.
- *Law firm.* This is the same as the preceding concept. Is an associate, particularly one with a fair amount of experience and skill, serving as a foundation for a reasonable compensation determination? Better yet, maybe two or three associates or a junior partner are serving as a foundation.
- *Distribution or manufacturing company*. Depending on many factors, not the least of which is the size of the operation, maybe a general sales manager or shop or factory foreman or someone else with a fairly high and responsible position might establish at least a starting point for determining reasonable compensation for the owner. Obviously, the owner's responsibilities and duties are very important, but often, in these types of businesses, they are a blend of various responsibilities of the otherwise highest paid and key employees. Once again, that could help as a starting point.
- *Managerial premium*. Besides those already mentioned, a multitude of other possibilities exist. Ultimately, it comes down to comparing a high ranking or key employee of the company who is paid at arm's length with the owner. Even when using outside sources for benchmarking information, it is often a similar situation. In some situations, the following will not apply, but generally, the owner is entitled to not only compensation commensurate with the highest paid employees but an additional premium for certain superior level responsibilities along the lines of running the business. Although we usually cannot arrive at a specific supportable number or premium for that element, particularly when dealing with the typical closely-held businesses, it is reasonable and appropriate (our peers do the same) to factor in a managerial responsibility premium that is typically along the lines of 20 percent or 25 percent of the compensation.
- *Multiple job functions.* This area, along with the preceding, is not directly related to the forensic investigative process but is important as a general understanding and certainly relevant when our role is to arrive at reasonable compensation for the purposes of valuation. When the business owner we are evaluating fills a number of job functions or roles, sometimes, an attempt is made to determine reasonable compensation based on a blend. Please do not do what has been done on occasion (fortunately, the exception to the rule): making the totally unsupportable assumption that this star owner, by virtue of filling a few roles, is entitled to 100 percent of the reasonable compensation for each of those roles. Not long ago, in a valuation involving a car dealership, I remember the other expert opining exactly along those lines: because the

owner (for whom he was working) filled the roles of general manager, sales manager, and so on, he was entitled to the compensation of 2½ full-time employees. Stated in the report and preposterously advocated in depositions, this expert actually had the temerity to argue that his client (the owner of the car dealership) worked not only full time but 2½ jobs full-time jobs, which is equivalent to 100 hour per week. What is far more logical, reasonable, and professionally responsible is to attempt to allocate this person's job functions over the spectrum of what he or she does and apply appropriate percentages to the benchmarked salaries. This will give us what is arguably a fair salary for the blended roles. To that, we are entitled to add (once again, in the typical situation) some mark-up (premium) for whatever other responsibilities and overall management issues are the province of this individual.

- *Managerial efficiency*. This is an issue that we usually do not see, and frankly, it is a very dangerous area to pursue, but every once in a while, it is something worth addressing. This involves making a determination that although no special friends are on the books, no-show jobs don't exist, and so on, and no single individual is receiving excessive payroll for being a friend, the reality (as we see it) is that fat is in the payroll, and the company is not running as efficiently as it should. Thus, we are making the decision that, as one of our normalizing adjustments, we are going to eliminate payroll that we have deemed to be unnecessary (keep in mind that there is no inappropriate excess payroll).

  This takes us out of the role of forensic accountant that we commonly fill and puts us into the role of a management consultant, which can be a very dangerous position for us to be in as an independent expert anticipating the need to testify at trial. Unless we are a particular expert in that industry, or we have performed significant analysis about the operations of the subject business (an analysis that far exceeds just about anything that we will typically perform in these cases), it is a fair bet that we are overextending ourselves by going in that direction. Even if we are right because we have solid benchmarking information that says nonowner payroll should be 31 percent of revenues, and the subject entity has payroll running at 50 percent of revenues, it is quite a leap to go as far as disallowing truly arm's length payroll because we know how to run the business better. Also, the likelihood is that we are being asked to value the business that exists, not the business that we would like to exist or think should exist. I can relate a situation involving the valuation of an accounting practice; I was not involved in this case, but I was aware of the experts who were involved. One of the experts did exactly that: he opined that the practice was not as profitable as it should have been; thus, he imputed additional net income simply because it was not being run as efficiently as he felt it should have been run. He then valued it on that hypothetically improved operation basis. To be polite, he was slammed by the judge.

The following are some suggestions for how to approach the area of investigating payroll, keeping an eye out for things that are not right and areas that require adjustment:

- *W-2s*. First, when we get the W-2s, make sure they add up to the total listed on the W-3. It is not unheard of to have a W-2 (or two or three) removed from the pile when it is presented to us. Once we have ascertained the integrity of the W-2s, scan them for large amounts; barring some pervasive fraud, it is generally not worth it to worry about whether there are a couple small W-2s that maybe should not exist. Also, scan the W-2s for the last name of the business owner, as well as maiden names and family members—we should have knowledge of those names in advance. In addition, look at addresses. Once in a while, we may come across an address that is a duplicate or one on which the address is the same as the business owner (in that instance, the W-2 turned out to be for a paramour). Look for addresses that are too distant from the business location. Of course, those W-2s could possibly for a traveling salesman or saleswoman, but we need to know what we are looking for.

- *Employee benefits*. Scan the benefits expense areas, such as health insurance or group term life, and see if anyone who should be covered is not. That might be a sign of a no-show job or something else worth noting.
- *Time records*. When applicable (that is, professional practice firms) and when we have enough juice to get these types of records, get a comfort level that everyone who should be filling out a weekly time sheet (or the current equivalent) is in fact doing so. Not surprisingly, people in no-show or paramour jobs often cannot be bothered with the formalities of time records.
- *Endorsements on the back of checks*. This is a tried and true audit step: see what kind of signatures are on the backs of various checks, as well as perhaps the bank account reference thereon. Granted, in this day and age, it might require a special request of the bank to provide us with checks, let alone the backs of them.
- *Sorting by Social Security number*. If the system with which we are working; if our data analysis abilities allow; and of course, if there are that many employees and we have the appropriate level of suspicion, consider having all the W-2s sorted in numerical order by Social Security number. Look to see if there is anything particularly unusual, and be familiar with the current state of issued versus nonissued numbers in the Social Security system. Also, look for sequential numbers. It is unusual to have numbers that are in sequence; they may suggest relationships, possibly (though unlikely) a phony number, and so on.

Ultimately, if we are really, really suspicious and have not come up with anything else that will support our suspicions, maybe a good old-fashioned audit-style payroll check-off would work. I have never seen this done in a divorce case, and I can picture the brouhaha that this would set off among the attorneys and in the court room. On the other hand, if you have the right argument to make, go for it. Who knows, you may wind up doing the business owner a favor—maybe the business is being ripped off from the inside, and the owner does not even know it.

Rent

Generally, this is not an area that is fruitful in the investigative process; however, we do want to address a few aspects of this area. First and foremost is determining whether the rent is being paid to an unrelated third party. If it is, generally speaking, that is the end of the story. Assuming we do not see a second monthly rent payment to some special apartment somewhere, rent is not going to be an area for adjustment. On the other hand, if the rent is being paid to a related party, then besides ensuring that everybody on our side (or both sides) is aware of it (they usually are), we are going to want to have the full details and either bring in a real estate expert to opine about the appropriate rent or calculate our own version of appropriate rent in order to arrive at the normalized income. Be familiar with the number of locations of the business, and make sure the rent is consistent with each location. If rent is paid (in part or in whole) based on a percentage of sales (not all that unusual in the retail world), insist on getting those sales reports, so that we can reconcile them with the books and records. To get a sense for how many years (including options) remain on the lease, review the lease, particularly if this is the type of business that cannot simply pick itself up and move to another building (like most professional practices). For purposes of valuation, as well as a comfort level looking forward, a business that has one year left on a lease and no options and cannot easily find a replacement location may have problems that need to be considered in our investigation.

Perform a walkthrough of the business to get a sense of the amount of space. Besides the ridiculously obvious and flagrantly problematic issue of whether the rent expense is true and accurate for the place we are seeing, we also want to get an idea about whether there is excess space and other tenants who are perhaps subleasing. Does it appear that the place is overcrowded and that any growth in the business would be butting up against the existing location? All these are relevant factors for us to understand, particularly if valuation is part of our assignment.

If the premises are owned by the business, which is generally a bad way to structure a real estate ownership situation (nevertheless, it exists), are we going to be taking the position that the premises are part and parcel of the operations of the business; thus, it is not necessary to determine a hypothetical arm's length rent? If not, we will need to remove the depreciation on the real estate (and possibly also the improvements). This affects both the profit or loss, as well as the balance sheet. Mortgages should be treated similarly; as well as the interest expense thereon. We may also need to remove the real estate taxes unless, in determining reasonable rent, the real estate taxes are expected to be paid by the tenant. This area can make for some interesting and complex normalization adjustments that affect both the operations, as well as the balance sheet.

One final comment on the rent expense area that is based on a situation that this author experienced on a fairly significant case. It involved a substantial business with substantial rent expense and a long-term lease. The lease provided for certain increases over the years. This business was audited every year, and the financial statements properly disclosed the lease terms, as well as went through a convoluted accounting-based calculation about future lease increases, and then reflected both a substantial rent expense adjustment and, in this case, a substantial liability on the balance sheet, recognizing the deferred rent obligation. Again, all of this was in accordance with generally accepted accounting principles. However, just as Internal Revenue Code (IRC) Section 179 depreciation is good tax but bad accounting, this type of deferred rent obligation recognition is good accounting (maybe) but bad valuation. In the subject matter at hand, our normalization adjustments included a very significant reduction in rent expense, as well as the elimination of a several million dollar liability. Need I say that the effect on value was substantial?

Determining Reasonable Rent

Along the lines of determining reasonable compensation in a valuation assignment is sometimes having to determine reasonable rent. The situation here assumes that we have a business location that is owned by a related entity; thus, barring some actual study or analysis that is available, the rent cannot be accepted on its face. This may also apply when a business owns the premises. The easy resolution to this and one that is preferable in essentially every case is to get a full appraisal that includes the value of the property, as well as the appropriate rent (through the income approach if nowhere else). If fair rent is an issue but not value, get a real estate expert to opine about reasonable rent.

Getting an appraisal is the easy way. Now, assume that we don't have an appraisal. What can we as accountants do in that situation? Consider the following:

- Call a local realtor or appraiser and get an answer. This may only be verbal (barring a real engagement, most likely, none of them would want to do it in writing and may not want to be called to testify), but it is something, and it goes beyond merely one of us, as CPAs, opining on fair rent, which for most of us is outside our body of expertise.
- If multiple tenants are involved, and it's a related entity that owns a property and we have access to its records, get a handle on what the other tenants are paying. Assuming that they are unrelated, the rent would be at arm's length. Allowing, if necessary, for any differences in rent particulars and, perhaps, the amount of space being occupied, certainly using what an unrelated tenant is paying could be an excellent method of coming up with a fair rent for the subject business.
- Check the local area real estate board (whether it be county or municipal) to see the appraisal of that property, per the town records. Then, depending on our locality, apply an appropriate equalization factor to come up with an approximation of the current fair market value of that property. Multiply that fair market value by a range from 8 percent to 10 percent to establish what is generally considered a reasonable rule of thumb for rent. Of course, if the business at hand only occupies a part of the building or property, we need to come up with that appropriate percentage of the total. Yes, we've reached a bit here, applied an equalization factor, and are applying a simplistic rule of thumb for rent. Remember, we've got nothing better to work with, and this at least shows something that is respectable. Need I say that the appropriate caveats in our report are critical?
- Finally, consider using a benchmarking tool. Whether general or more specific for the industry, come up with a reasonable rent typically based on a percentage of sales. We benchmark this company to its peer group, or perhaps, the benchmarking might be on a rent per square foot basis. In either case, shortcomings exist because these are only averages, we've got local geography to make a difference, we may not know whether these are triple net leases or otherwise, and so on. Regardless, at least it's something.

Moving Expense

When we observe a moving expense, several interesting aspects need to be considered. This is also the case even if we do not observe a moving expense, but we know that during a particular time frame this business moved; therefore, there should be some kind of moving expense. The following are some of those aspects to consider:

- *Moving expense*. This item itself, which has triggered the investigation into this area, although a legitimate expense, is nonrecurring. Thus we need to make a normalization adjustment for it.
- *Moving expenses not reflected*. If we know that the business moved, but do not see a moving expense, then we need to do a bit more investigation. In all likelihood, the moving expense got buried (intentionally or unintentionally) in some other expense category (for example, repairs and maintenance, office supplies, or the like). Once again, we have a nonrecurring item that calls for a normalization adjustment.
- *Rent expense*. Along the lines of what was previously discussed, this is another area that needs to be addressed but this time with an eye specifically because of the move. In all likelihood, there will be one or more months of overlapping, duplicative rent expense. Again, this is totally legitimate as an operating expense, but it requires a normalization adjustment for the purpose of appreciating this business's normal operations, as well as this business going forward.
- *Future impact*. Some moves are benign: the lease was over, and for various reasons, the business desired to move, so it swapped 10,000 square feet in one location for 10,000 square feet (or 9,000 or 11,000) in another location a few blocks away at a similar cost. In all likelihood, nothing further needs to be considered relevant to the work we are doing. On the other hand, maybe the business went from 10,000 square feet to 5,000 square feet or from 10,000 square feet to 20,000 square feet. Maybe the business moved from a side street to a main street; maybe the business moved from a town to a county seat or from a suburb to a city or a city to a suburb. You get the idea. All of these types of moves suggest that there will be a change in this business going forward, whether good or bad, increasing or decreasing its sales, and so on. Even if nothing can be predicted from this, knowing about this type of change is important. Further, if this change happened two years prior to the date of valuation and, thus, within the five years that we are analyzing, but it is not representative of the entire five years, what can we tell from the subsequent changes? Also, keep in mind that almost any change has some kind of break-in period. We may not be able to tell, even one year later (we could possibly tell two years later), what that change will likely mean. How that affects our work, the determination of income, projecting value, and so on is an interesting exercise for us to address.

Depreciation

The obvious issue here is adjusting the expenses of the business for a fair economic depreciation as contrasted with tax-motivated depreciation. We all know the games (legitimate of course) that IRC Section 179 and bonus depreciation play in grossly increasing depreciation expense in a year (and the similar opposite effect on depreciation expenses not taken in future years). That second part is important; in making normalization adjustments, do not forget that adding back, for example, $200,000 of bonus depreciation in one year means recognizing that depreciation ratably over a certain number of subsequent years. Also, particularly if book value is going to in some way affect valuation, do not forget that we will need to make a comparable normalization adjustment to the balance sheet, likely reducing accumulated depreciation and increasing book value. Don't forget that these types of adjustments typically need to be accompanied by a tax provision. The company saved taxes by taking the bonus depreciation; if we are going to undo it for valuation purposes, we should also recognize that to the extent of our reduction of accumulated depreciation, a tax liability is going to be attached thereto.

One of the more frustrating misconceptions that we need to deal with on a regular basis is the layperson's belief (and that of some attorneys and judges) that depreciation is not a real expense. After all, depreciation is a paper entry, and it is just simply voodoo because there are so many different ways to calculate it. As accountants, we know that depreciation is a real expense. The issue is getting that message across to clients, lawyers, and judges in a fashion that is easy for them to grasp what we are talking about. This is probably more easily done (comparatively speaking) by illustrating a several-year span that includes the purchase of equipment in one year and its gradual write-off over several years. Likely, this information can be presented in such a way that nonaccountants will understand it. Alternatively, think in terms of explaining that the equipment is financed with, for simplicity, the payments ratably over the life of the asset. In such a case, we should be able to get those clients, lawyers, and judges to grasp that we accept either the depreciation expense or cash outflow to pay for the acquisition because either one represents consumption of that asset.

Retirement Plans

Regardless of the type of plan and whether we call it a pension or profit sharing plan, the issue here for us to address is the magnitude of the expense, who is benefitting from that expense, and whether that expense is a normal operating expense or just a wonderful benefit for the owner. Don't forget that by virtue of this expense, an asset needs to be considered. Generally speaking, in the world of normalization adjustments, if the retirement plan expense is not unusual and if the rank and file employees are reasonably benefitting from the plan, then it is likely there will be no normalization adjustment. On the other hand, think about a doctor with two employees and a large retirement plan contribution, 90 percent of which is going to the owner. Now, we have an expense crying out for a normalization adjustment.

Connected to this issue is making sure that everyone is aware that this owner has some kind of retirement plan account or benefit (the existence of an asset). Was that disclosed in whatever financial disclosure documents are required in our jurisdiction when the divorce complaint was made? We may be the one who discovers this asset, and may be asked to either value it or bring in a pension expert to perform the valuation. Generally speaking, no valuation expertise is needed for a defined contribution plan (profit sharing or 401(k) plan), but expertise is needed when valuing a defined benefit pension plan. Whether you take on that valuation responsibility or bring in an outside expert is a case-by-case decision for you and your team to make. My suggestion is do not overextend yourself. If it is a defined benefit pension plan, stay away and bring in a pension expert, unless you are particularly proficient in valuing one of those plans.

In regard to the company being investigated, what do these plan contributions mean? What kind of difference do they make to the net income of this business? If accrued at the end of the year, what kind of effect does that have on the balance sheet? In regard to a defined benefit pension plan, at the end of any particular year (as of our valuation date) is that plan overfunded or underfunded? If so, what effect, if any, does it have on our valuation?

In investigating this area, generally, such investigation is nonproductive (meaning that this area tends to not have any surprising finds). If we do have concerns or are just being thorough, be sure to require the production of not only the annual Form 5500 but also the papers in support of the development of the figures that make up Form 5500. Where is the detail of the various investments and accounts making up that retirement plan? What about any funds that might have been distributed or loaned out of the plan during the year?

Finally, in some situations, another avenue for us to investigate is where the fund's assets are invested. Again, most of the time, nothing of consequence is here. Investments are typically marketable securities, bonds, mutual funds, and so on. However, every once in a while, we come across a more esoteric investment (particularly when it is a plan with few participants or individually directed accounts), and we will need to make sure that everyone understands what investments are held by the subject being investigated. Tied to that is whether they are stated at the appropriate value. Maybe that plan account is invested in a private equity deal that is stated at cost, and the actual value is a multiple (or fraction) of cost.

Repairs and Maintenance

Keeping in mind that our thrust is achieving a comfort level about the reasonableness or normalcy of an expense, are unusual items in the repairs and maintenance category that require a normalization adjustment and might be considered nonrecurring, disguised fixed-asset acquisitions, or the like? Besides looking for these unusual large items, also check out service or delivery addresses on various invoices. Was that paint job done at the place of business, or does the marital home show up as the address on the invoice? Further, even if painting is a legitimate operating expense of the business, it is typically done only every several years. Perhaps that expense should be amortized over several years rather than allowed to have a large impact on just one year, especially if that one year is the most recent of the years we are investigating for purposes of valuation. Also look to see if several expenses (invoices) are more appropriately considered a single series or interconnected. What we might have is several items that individually appear to be nothing more than just maintenance or other operating expense but that are collectively substantial and constitute a leasehold improvement or some other fixed asset acquisition. Again, keep in mind that any such adjustment (reclassifying a repair to a fixed asset) also calls for a commensurate balance sheet adjustment.

Insurance

At least two facets of the insurance expense area are worth addressing because they might yield results in our forensic analysis. One is the typical perquisite normalization adjustment issue; the other is the information that the insurance policies might provide us that is relevant to other aspects of our investigation. The routine normalization-type issues would include concerns over whether any personal insurance is being paid; the extent of certain benefit packages (for example, long-term care or disability insurance being paid by the business or even life insurance expensed as if a normal expense); and sometimes, year-end games with the near year-end payment of a large premium that ignores setting up a portion of the premiums as prepaid. This last item is generally of no great consequence, and certainly, over a period of from a few to several years, it tends to be of no consequence.

One item involving a normalization adjustment arising out of an insurance analysis that is of great significance and amazingly overlooked is the possibility of unstated cash surrender value. Often, through a combination of extreme aggressiveness, oversight, reliance on IRS carelessness, or negligence, substantial life insurance can be paid through the business and deducted as if a business expense. Sometimes, the companion to the life insurance premium is a cash surrender value that can amount to hundreds of thousands of dollars and is unstated on the balance sheet. This becomes a significant asset to take into account and almost always is a nonoperating asset, which means it is just pure extra.

Perhaps more frequently than the preceding is when the insurance provides information that is useful in other ways. When reviewing the insurance expense category, it is often important to go beyond merely proof of payment, as well as getting a bill to prove the business connection. It is suggested that at times, a significant benefit is to be gained from insisting on seeing the underlying policies, especially riders and attachments. Look for things such as the following:

- Is any of the coverage personal in nature (the standard normalization adjustment issue)?
- Look for addresses and locations. Is a location covered of which we were previously unaware? Perhaps it is a vacation home, a second company location, or the location of a special friend.
- What about asset detail? Some policies will go into a line-by-line, asset-by-asset listing of all the assets, sometimes even listing the insured values of each asset.
- Look for related-party names. It is very common that when a business operates under different names and has subsidiaries and the like, the package insurance policy is going to name a multitude of insureds. Maybe we were unaware of some of those names. Maybe the financial data or results of the operations of some of those named

insureds are not included within the company we are investigating. If so, why not? Where is that information, and how is it related to the business that we are investigating, the person we are representing, or the spouse of our client?

- Typically, the concept of reviewing an insurance policy certainly applies on the personal level. We might find floaters or riders for things like jewelry and collections. If so, for how much are they covered, what is their value? Were both sides aware of the existence of such items? Tied into that may be to understand how those assets or collectibles were purchased. It may not surprise us to find out that there is no trail because they might have been purchased for cash.
- We might find that there is coverage for being a trustee of a trust, and that might raise a whole slew of additional questions. The point here is that we must keep our eyes open; when we see something like that, it naturally leads to more questions and the need to expand the investigation. At the very least, make sure that whomever we are working for knows about these types of possibilities, and let our client make the decision about whether he or she wants us to investigate further.
- The insurance might lead us to understand that a buy-sell agreement is in place. Maybe we were not aware of it before, but now, an insurance policy has awoken us to that fact. If so, we certainly will want to demand a copy of that agreement, and we are going to want to know what that means relevant to value. Also, a buy-sell agreement often includes some form of life insurance. If we come across evidence of a buy-sell agreement through anything other than life insurance, do not forget to look for that. One more aspect: a buy-sell agreement sometimes means that somebody has performed a valuation in order to justify the buy-out numbers. If so, we obviously want to demand a copy of all such valuations, regardless of whether they are formal or informal.
- Do not forget cars, boats, and planes. Maybe we need to consider where any of these modes of transportation are garaged. How many cars are covered, and how many are justified for the business? Are any listed as being garaged at a personal home or maybe at a college dorm for one of the owner's children? More exotic interests include boats and planes. The same issues arise there, and in addition, if we see either of those, we are going to want to make sure we understand how those toys are paid for. Boats typically require some form of docking, as well as maintenance; planes require a hanger, as well as maintenance and, perhaps, flying lessons. How are all those things being paid for? Once again, if we do not see the evidence, maybe they are being paid in cash.
- Finally, consider the magnitude of the coverage. Even with straight, legitimate business coverage (for example, insurance for the contents of a factory or business interruption), review what is stated as the value of the underlying assets, the revenues of the business, and the inventory that is covered. If the insured amounts are considerably disparate from what we have observed in the books and records, maybe something requires further investigation. Yes, it could be inertia, and the numbers were never changed from some previous time; it could be that there is coverage for peak needs and what we have seen is off peak; and so on. All that may be true, but rather than go forward with ignorance, it's better that we know about the coverage, so we can explain it.

Travel and Entertainment

I suspect that I do not need to go into much detail here for our readers to appreciate this quintessential goldmine of add-backs. The reality is that many times, this is the easy pickings (the low-hanging fruit) that often is also not all that significant. Do not misread: in plenty of cases, the add-backs in this area can be in the five digits and more. Nevertheless, this is simply the easy target that everyone considers. When attacking this area, do not forget the interplay with the 50 percent deductible issue. If our starting point for expenses is the tax return (typical for so many small businesses), do not overlook that the entertainment number is already reduced by 50 percent. Thus, when we are making our normalization adjustments, depending on our style, we will first need to allow (that is, add an expense and subtract from income) the 50 percent that was disallowed for tax purposes before we then apply whatever normalization adjustments we are going to make to arrive at the economic expense. If the entertainment expense is all legitimate, not only will we have no reduction as a normalization adjustment, but we will actually have an increase in that expense by allowing the 50 percent that the IRS does not allow.

If we are dealing with travel expense, which is 100 percent deductible, look for things like the length of the trip and its location. Five days in the industrial heartland of the United States is most likely legitimate business; five days in a resort community may not be legitimate business. Also, be sensitive to the purchase of tickets and registration at hotels. If we have that type of documentation, reference to "Mr. and Mrs." may not be all that it seems. Indeed, they might be "Mr. and Mrs.," just not each other's "Mr. and Mrs." By the way, that does not make it a nonbusiness trip; it only means that some part of the meals and the added airfare are personal.

Entertainment is one of those areas that classically lends itself to test sampling. It is hardly unusual to see lunches or dinners two, three, and more times per week being run through a credit card and always claimed as a business expense. Further, if we have multiple owners, simply multiply that number. Generally, the only cost-effective way to address this issue is to test sample it. An acceptable test sample is usually two or three months (rarely more than that) per year for two years (three years if you really feel the need to be more thorough). Based on the results of that test sample, extrapolate the results to the universe. Probably 90 percent of the time the reasonableness and logic of that approach is understood and grasped by even nonaccountants. Once in a while, we will be taken to task over it—there is not much we can do when facing unreasonable people.

One final note in this area when dealing with travel-related expenses: every once in a while, a situation is going to arise in which someone travels frequently to one or perhaps two locations. This is hardly unusual because many businesses have important customers or clients who are regularly visited, and that entails travel. However, think in terms of an underhanded business person frequently traveling to one or two locations and setting up a bank account or maybe even purchasing real estate in that location (generally, this is not the case). Consider doing the appropriate searches at these locations or, perhaps, having the attorney involved and aware of this situation and making those searches. Is the existence of a bank account or piece of real estate in some distant state a possibility? Of course, we might already have evidence of this by going through Schedule A of Form 1040 and testing the amount of the real estate taxes to find that something more than the marital home is being paid for. Schedule B of Form 1040 may reflect bank account interest from some distant location. However, if such a situation exists yet neither of those items happens to be on the tax return, this may be one way to find it.

Automobile Expenses

Similar to travel and entertainment expenses, I would expect that my readers know full well how to attack this area. However, let me share a few thoughts that might be a little off the typical forensic analysis attack. Besides the customary issues of the appropriate percentage that is business versus personal and the existence of cars on the books that are for a spouse, children, and the famous proverbial special friend, think about the type of car in particular. For the moment, assume that the business owner needs a car, regardless of whether it is a legitimate business expense 50 percent, 80 percent, or 100 percent of the time. Needing a car is not necessarily synonymous with needing the car that is on the books. By way of example, maybe we are investigating a plumbing business, and the books reflect a $100,000 luxury car. We may not argue that the plumber/owner needs some kind of wheels to get around, but we might have a problem swallowing the need for a $100,000 luxury car versus a $30,000 car. By the way, do not forget just how much more expensive insurance is for that $100,000 car.

On the other hand, a real estate agent, especially one who does business in an upscale area, may very well need a four-door luxury sedan. Doctors are harder to call; typically, the only legitimate business need is to get from the office to the hospital and back, and that does not require a luxury car. On the other hand, it may be a hard sell to suggest (in our report and court) that because the doctor's need is very modest and does not require a luxury car, he or she should be required to drive or allowed to expense no more than a smart car. Indeed, this is one of those judgment call areas. Also, when analyzing the gasoline expense, consider paying attention to the frequency of fill-ups (two times in one day suggests more than one car) and the location—why is a fill-up in a distant location being charged to the business (on the business gas credit card)? The answer might be as simple as the business owner's child is in college and has a business gas credit card.

Keep in mind that if we have made a determination that auto expenses are personal in some fashion, this may extend itself to looking at the balance sheet from the perspective of whether the autos are personal. If so, do we have a nonoperating asset (unless you are doing some form of a book value valuation) that represents additional value?

Telephone Expense

This area is usually no big issue. Telephone costs have come down so much that this is almost a throw-away, and even if the cell phone bill for the entire household is paid on the company books, we are probably talking a relatively modest adjustment. Most family plans nowadays might mean that we are looking at no more than $10– $20 per month as a premium for each personal line. However, one area is a little off the beaten track and might be important in a limited number of situations: an analysis of the telephone calls. Get a printout of all the calls on that account and then search through them to see if any telephone numbers are important to note. Classically, this would be done by a lower-level staff person, and it would be great if the telephone company could actually organize the printout for us in numerical sequence. Regardless, the idea here is that maybe a number or two are of particular interest for other aspects of the divorce case besides business, and we could prove helpful by zeroing in on these.

Professional Fees

This is one of those expenses when a 100 percent analysis, not a sample, may be warranted. A number of possibilities and angles, such as the following, need to be kept in mind when reviewing professional fee expense:

- The obvious perquisite issues, such as estate planning for the family, which could cost thousands of dollars in professional fees (doing the personal tax return of the business owner is usually a throw-away).
- Look at the accounting bills to see if, for instance, they contain a charge for preparing business or personal financial statements. In that case, were we aware of that? Perhaps it was denied. Certainly, in the case of a personal financial statement, we are going to want to insist on getting a copy of it. Having evidence through the professional bills should end any argument that it does not exist. Even if not retained by the business owner or spouse, we can be pretty sure that the accountant has a copy.
- Legal bills can include something along the lines of setting up a new company, which is we are certainly going to want to know about. Does another entity exist of which we had no knowledge?
- Every once in a while, non-recurring or special services show up. Do legal bills exist that represent the company or one of its key people in a lawsuit? That is generally a legitimate business expense (take a good look), but in all likelihood, it is a nonrecurring expense. For our normalization adjustment area, this might be something for an add-back. Be cautious here because some businesses have lawsuits as a regular part of their business. In such a case, it likely would not be an add-back.
- Maybe our review of professional fees reveals expenses for defending some form of a liability or malpractice action; on the other side, perhaps the company is suing for a patent infringement or some other kind of recovery. Putting aside a possible issue of nonrecurring legal fees, what we have is the possibility of a substantial liability or asset (recovery) waiting in the wings. This is something that is important to know regardless of which side we are on. How does this play into what we are doing, and how does it play into the issue of valuation?
- Maybe fees evidence that someone has done some tax planning, some fiscal strategizing, or maybe retirement planning with projections. Evidence of fees being paid for such services should immediately flag to us the importance of getting a lot more

information, including whatever analyses, worksheets, documents, reports, and so on were produced as part of this process.

- Don't overlook that even a small bill can still be revealing, although some people will tell us there is no such thing as a small legal bill, and others will tell us there is no such thing as a small accounting bill. For instance, typically, we are still talking only in the three digit range for the formation of a company. That may be an important item to know, even if it is only a $500 charge.
- More often than not, especially when the business is owned 100 percent by one of the spouses subject to this divorce action, the legal and expert bills and fees for the divorce action are simply paid through the business as a routine operating expense. However, we know that is not the case. Even if we are going to argue that because of the business focus, they are business expenses, they are nevertheless certainly nonrecurring business expenses (unless your client is a serial divorcer).
- Finally, simple curiosity is a wonderful thing. What I mean by that is one of the reasons to review the professional bills is to see what others are charging. Yes, admit it, you are curious about that too. Whether stated by the hour or some other mechanism of billing, most of us, when we are being candid, will acknowledge that we are curious about what our competition is charging. What better way to find that out than as part of the necessary forensic steps in the divorce investigation.

Payroll Taxes

Probably 95 percent of the time, this is a nonarea for investigation, and if we do investigate it, it is probably not productive. It is the exception to the rule that we have an interest here. The obvious exception does not originate from the payroll tax account but, rather, through the payroll and comes about when we make an adjustment to the payroll taxes on account of an adjustment to reasonable or appropriate compensation. That is not the issue here. Take a look at the payroll tax expense. Generally speaking (an overly broad generalization), payroll taxes should run approximately 10 percent of payroll. Plenty of exceptions exist, and I am not looking to make that any kind of rule. My point here is that we should keep in mind, based on the specific company and what is normal in our area, that there is some kind of a norm to expect for payroll taxes. If we are looking at a business that is significantly abnormal, then it may be advisable to investigate further. If payroll taxes are running 20 percent of payroll, why is that happening? One answer could be as benign as sloppy bookkeeping. Maybe some of the net payroll was dumped in payroll taxes, or maybe some office supply expense was dumped there. This is no big deal because it is less of one expense and more of another.

On the other hand, in a few situations, payment may have been made with the filing of the payroll returns that included extra withholding taxes on behalf of the owners, and those withholding taxes were written off as if payroll tax expense. Truly, this is unusual, but I have seen it happen. We may also find that the expense is high because the business paid penalties for late filing, underpayment or the like and treated the penalties as if they were simply a payroll tax expense. This is not such an easy call because we know that from a tax perspective, penalties are not a legitimate expense and should not be permitted. However, in our world of normalization and valuation, it may be necessary to accept (consider) that these types of penalties are just another form of operating expense, which is truly a judgment call and case-by-case situation. This is another area in which we also have to keep in mind that our role in the divorce tends to be more focused on the economic income rather than the tax income of the business.

Officer Life Insurance

Whether we call this life insurance or officer life insurance, the point here is that we are not dealing with the standard $50,000 or one-time salary group term life coverage but, rather, far more significant life insurance premiums being paid by the business and written off as if an operating expense. At times, the argument is made that the life insurance is to fund the buy-sell agreement; thus, it is an operating expense and legitimate deduction. I would suggest that more likely than not, that argument does not carry the day. It may be that the life insurance is helpful for the buy-sell agreement or even necessary, but that does not make it an operating expense. In fact, I would argue that it is for protection against a buy-out; thus, it takes the form of some kind of investment protection and would have to be added back as a nonoperating expense.

On the other hand, a more difficult call is when the bank or lending institution requires life insurance on one or more key people as part of maintaining a line of credit or having a substantial loan with that bank. The argument could certainly be made that the life insurance premiums represent an operating expense. Because the loan is necessary for the operations of the business, related expenses for that loan (for instance, life insurance premiums) are merely part of the cost of borrowing. Another way to look at it is that it's another form of interest. Perhaps, without that life insurance, the business would have to pay a few more points in interest expense; thus, the premiums are merely a trade-off for a higher cost of borrowing. These arguments may carry some weight and need to be considered.

Interest Expense

At the very least, when we see interest expense, we need to trace it to its source. Why does interest expense exist? What loan or obligation is being paid? Sometimes, it is really nothing—maybe just bank charges for an overdraft situation, a bounced check, or the like. However, assuming that the interest expense is on some form of debt, we need to have a comfort level that it is reasonable and appropriate, and we need to be able to tie one to the other. Typically, when debt is on the books of a company, we will see interest expense. If the normal rate of interest is 8 percent, and the company seems to have a constant $1 million debt load, we would certainly expect to see approximately $80,000 of interest expense. If we do, putting aside any other concerns, that might be a sufficient level of analysis to give us comfort. However, perhaps we see interest expense of $40,000 or $150,000 in such a circumstance. Then, we are going to want to investigate further because $40,000 of interest expense with

$1 million worth of debt suggests either an unusually low interest rate or that something is wrong somewhere. It could be a misposting or, perhaps, an overstated debt. A number of possibilities exist, and they are going to be unique to the situation. The point is that the interest expense does not correlate to the debt load. This is also true in the case of the previously mentioned $150,000 of interest. Maybe it is as simple as this company's cost of borrowing is 15 percent. However, if that is the case, that itself may warrant further inquiry. From whom is the company borrowing, and why is it paying 15 percent? Maybe it is from a related party (perhaps the parent of the owner), and it is a way to siphon money to that person.

Also, when interest expense exists, we would expect there to be debt; in that case, some form of financial disclosure is provided to the lender. Make sure that you have seen that document. Typically, it will be the company's financial statement, but it may also be the personal financial statement of the business owner. If the company has no financial statements, that disclosure might be as simple as the company's tax return, but once again, in all likelihood, it also includes a personal financial statement.

Depending on our approach to valuation (think of approaching it from a debt-free vantage point), it will be important for us to separate the interest on debt from credit card interest (if that is where it is being posted), routine bank charges, and the like. If the interest is on an auto loan, determine whether that auto is personal. If so, the interest expense does not belong as a business expense. Maybe the interest expense is on the buy-out of a former partner or shareholder. In that case, it is a pretty sure bet that the interest is not an operating expense and needs to be part of our normalization adjustment process. That alone will also flag for us the importance of making sure that we understand the terms of that buy-out. Other issues include debt load, the foundation for that buy-out, and the valuation that was used for the buy-out and how it was derived. This is another area where one thing connects and leads into another.

Bad Debt Expense

This is one of those expense categories that often fluctuates dramatically from year to year. I'm sure we have seen this expense category go from literally zero in one year to hundreds of thousands of dollars in the next year then back to zero in the following year. On one hand, we have a possible issue of a nonrecurring expense for normalization adjustment; on the other hand, we have an item that is clearly a business operating expense (hardly unusual in the big picture) that may have distorted a particular year's operations. Assume that this is a legitimate write-off—a sale that was recorded on the books was simply not collectable. The complicating factor here is often how to best and fairly apply this write-off over a spectrum of some years. Probably the first thing to determine is what was written off. Was it just one customer, and if so, over what time span were the sales generated by this customer? Based on that analysis, we should be able to determine whether we are going to allow that expense for just the year it was recorded or whether it needs to be applied in some specific or ratable fashion over perhaps that year and one or more prior years.

In effect, a *bad debt write-off* is the reversing of sales from one or more years. Arguably, if our use of the normalized income for valuation purposes is to simply average those years, then perhaps we do not have to worry about fine tuning to which years the bad debt expense belongs. On the other hand, it may make a difference if it is for an older year or a more recent year, and it may make a difference if we are interested in more than just valuation, but rather, what the income of the business was on a year-to-year basis. Also, assume that we are reviewing and analyzing the classic five years of financial data for our investigation and ultimate valuation and that the bad debt occurred in the most recent or second most recent year, but it applies to a receivable that is for a sale made a few years earlier and has been carried on the books year after year without a reserve for collectability. In that case, even though the bad debt expense is legitimate, perhaps it does not belong in our five-year analysis at all because it is the writing off of a sale that occurred in the first of the five years or even before that. In that case, our normalization adjustment will have it removed entirely from the figures under consideration, notwithstanding that it was a perfectly legitimate write-off and a very real loss.

Every once in a while, we come across a situation in which the bad debt write-off expense is one of those manipulative items that is used to even out the reported income from year to year. Writing off a bad debt is often a judgment call of the business owner. Depending on other factors of a particular year and the net income number, if any, which is a target for the business owner (think in terms of the desired taxable income or a number for the bank), liberties may be taken with a bad debt expense. In a strong year, there will be an inclination to aggressively write-off more bad debt expense; in a weaker year, because there is no need for another expense in structuring that year's net income number, perhaps a gentler hand won't write off certain items that maybe should be written off. To what extent, if any, is this being practiced, and to what extent, if any, is this relevant to our analysis?

One other concern in the bad debt expense area is when we think it may be a disguised way of the owner writing off what he or she has already collected in cash. Do we see the writing off of receivables (bad debt expensing) or sales for what logically are good or should be good customers and who continue as customers? Why would a business allow someone to continue as a customer and give credit to someone whose receivables it has to write off? Yes, businesses have legitimate reasons for doing so, but it is certainly an area that raises suspicions and will require further analysis. Finally, if we have suspicions about a propitiously timed substantial bad debt write-off in a particularly profitable year, consider reviewing collections and postings to that customer's account for several months subsequent to the write-off. Perhaps a bad debt recovery is in the wings, and that write-off was just a bit aggressive and done more for taxes than anything else.

Memberships and Dues

This area typically has at least two angles of interest to us. First, conventions and related expenses can easily be disguised as vacations, and membership dues, although typically a legitimate business expense, may lead us to sources of comparable benchmarking and trade and industry information. Perform a forensic analysis to determine if postings to this expense category are for conventions or meetings or if, perhaps, the dues are inclusive. Once that is determined, then we need to determine whether those were legitimate business expenses or more along the lines of a disguised vacation.

The other often helpful part of this area deals with understanding the organizations to which this company belongs and then using that as a stepping stone for obtaining relevant industry and benchmarking information. Many organizations publish magazines and books, state of the industry articles, and annual reviews; some of the more substantial organizations even perform their own (often proprietary) economic analysis of the industry and conduct a survey of their members, gathering significant information and compiling it into an annual survey. That type of survey can be extremely useful in understanding what makes that industry tick, as well as benchmarking the subject company against the industry norms. Also, look to see if any of the owners or officers of the business we are investigating are officers or directors of one or more trade groups. This may suggest a reputation within the industry, influence, and connections, all of which are factors that may be relevant in regard to the subject entity and, possibly, a reasonable compensation determination.

Subscriptions

No, we are not terribly interested here about whether a personal *Time* or *Newsweek* subscription is being run through the business. Rather, look for things that may lead to inquiries of substance. By way of example, if you note a subscription to *Aviation Week & Space Technology* or *Boating World*, then you have been given some insight into the interests of the business owner, which may then further suggest the existence of a plane or boat; the expenses that go along with those vehicles should exist somewhere. The point here is that the subscription expense is being used as a guide to something other than the expense itself.

Utilities

The key item here is to look for the service address. Another giveaway could also be multiple payments to the same or different utility companies each month, which may be more significant in telling you that something is being paid for other than just the business.

Computer and Technology

Depending on the magnitude of this expense, it may flag the need for an outside technology expert, unless your firm has someone within. The key here is to try to get an understanding about whether, by going through these tech-related expenses, this matter appears to involve more than just the customary type of computer support, hardware and software purchases, and Internet presence. By all means, do make it mandatory to check out the target company on the Internet. The obvious element of this is that the company has a website. If that is the case, make sure to review it carefully, print out what is found (or otherwise make it part of your file), and make the appropriate observations from how the company presents itself to the world on its website. Even in the absence of a website or one that is of little value, see what kind of information is available on the Internet, keeping in mind that just because it is on the Internet does not make it true. Also, particularly for businesses with somewhat generic names, there may be multiple businesses throughout the country with similar names or even the same name. Be careful not to attribute something to your target from a different company of the same name.

Outside Labor

Whether the term is *outside labor*, *independent contractor*, or *consultant*, the concern is all the same: individuals or businesses being paid, especially on a recurring-type basis, for services of one form or another. Most of the time, this is simply going to be a routine aspect of the business operations. However, for a company that has proven very aggressive in this area, one consideration might be whether that company has created a substantial unreported payroll tax liability. Every once in a while, the government (that is, the IRS) decides to make a project of testing for, and going after, businesses that make it a practice of avoiding payroll tax expenses and related costs by treating many of their employees as independent contractors. If the company involved in our investigation is one of those, there may be an unstated and latent (and possibly substantial) tax liability. It is also unlikely, even if that liability exists in theory, that that will ever actually happen, unless this company is being investigated, its industry is a current target, and so on.

We also want to review this area for what it might provide us in terms of information of how this business operates and what it needs and gains from these outside service providers. For instance, engaging specialists to help develop a patent can be a fertile area for the equivalent of a no-show job. One interesting example I recall from a case some years ago was that the business owner who was the subject of the divorce paid himself not only through payroll reported on a W-2 but also as an independent contractor (think in terms of the occasional bonus that did not go through payroll). The problem was that, conveniently, no Form 1099 was issued for that so-called independent contractor compensation nor was it ever reported on his tax returns. Yet, it was right there in the company books, paid by check.

Credit Card Analysis

When reviewing credit card expenses, do not ignore the build-up of frequent flyer points (or some such equivalent), but do not overemphasize this area. On one hand, there will be the psychological issue because for some people, those 1 million frequent flyer (or just general credit card) points will be the object of much heat and emotion. We want to make sure that we do not ignore that, so we are informed and can address our client's needs in that area. On the other hand, let's be realistic. One million points (which is more than what most people have) at a currently generous 1½ cents per point means they are worth $15,000. It is a good chance that in the case that we are working on, a $15,000 asset does not rise to the level that it is going to matter greatly, one way or the other in anybody's settlement. Yet, turn

$15,000 into frequent flyer points (the 1 million points we are talking about), and they are now extremely important, rising to a level that sometimes rivals custody (allow me a little exaggeration here). I have had more than one case in which I have spent time trying to bring logic to the equation and calm frayed nerves and tension over 1 million plus points, but the only thing that is impressive is the number 1 million. I am not saying to ignore it—just put everything into perspective.

WHO NEEDS EMPLOYEES WHEN YOU WORK 150 HOURS PER WEEK?—Many times in investigating a business, our concerns about payroll are when no-show jobs, family, or a paramour is on the books because these things reflect inappropriate expenses. In reviewing a gas station and repair shop run by two brothers, we had the opposite type of problem: nobody was on the payroll other than the two of them. This seemed rather odd because of the hours maintained by the gas station, as well as the fact that it had two repair bays and eight gas pumps. The husband/brother assured us that the payroll was correct and that he and his brother were able to avoid hiring any employees by working long hours to keep the operation going. So, we dropped by the gas station (unannounced) on a weekday afternoon, weekday evening, and weekend day. Each and every time, we found no fewer than two additional employees (besides the two brothers) working at the gas station, both at the pumps and repair bays. Obviously, unreported expenses paid by unreported income.

7

Unreported Income

WAS THAT TROY OR AVOIRDUPOIS?—We interviewed the owner and operator of a convenience food store in his lawyer's office with the lawyer present; observing; and, to a degree, restricting us. As the husband explained, his business was heavily lunch crowd oriented, and his biggest thing was sandwiches. We commented that his gross profit seemed a bit low, and he responded (he obviously knew some elements of finance) by explaining that competition forced him to be a bit more generous on his sandwiches than the average. He provided eight ounces of meat with each sandwich for the same price that his competitors were charging for five ounces. As he explained, this kept his customers coming in, and he was satisfied with a lesser margin because he kept the volume up—a very good and logical business explanation. Obviously, being the curious sorts that we were, we had to test this. So, one of our employees, unannounced, made a visit to the store and purchased a couple of sandwiches. Those sandwiches were then – in hermetically sealed containers – rushed back to our office where, with great precision, the meat was surgically removed from the sandwiches and then weighed on two separate postage scales. What we found was that there was only 5 oz. of meat in each sandwich *(by the way, it was the owner himself who had made these sandwiches – not an employee), not the eight ounces that he promised. Not only that, but when we were at his attorney's office, he provided us with a box of cash register tapes for the register at the store. The totals agreed to the reported sales to the penny. That was simply too good to be true. So, one of the other steps we took when we bought the sandwiches at the store was also to make some simple observations, which included that two cash registers were in operation. We had been given the tapes from just one.*

I don't know about you, but my favorite part of dealing with a financial investigation of a business is when we need to prove the existence and amount of unreported income (URI). Alternatively, when we are called upon to challenge the other side's claims of URI (or at least to challenge the magnitude of same). Chapter seven is replete with examples and approaches dealing with both determining the extent of unreported income, and challenging claims of such. There is, of course, a fair amount of addressing the gross profit approach; and there are also a wide variety of other methods addressed, dealing with the issue of URI. We also provide suggestions relevant to how URI might impact valuation, as well as some thoughts about our responsibilities when we come across evidence of URI.

Issues and Concepts

The aim of this chapter is to enlighten our readers about the multitude of issues involved in determining, as well as challenging, claims of URI generated by a business. Depending on one's outlook and perspective, it is fortunate (or unfortunate) that URI, sometimes of significant amounts, is a commonplace occurrence for those of us who practice forensic accounting and business valuation in the divorce arena, as well as in shareholder suits, partnership dissolutions, and other litigation typically involving closely-held businesses.

It's certainly less likely that we would experience URI concerns in publicly-held companies or even larger privately-held companies. Typically, (but not exclusively) URI is of concern only in smaller and midsized privately-held companies; generally with only one or a few owners. That is not a blanket, absolute statement but merely an indication of what is more common. Further, that's not to suggest that simply because a business is smaller or has few owners that it is prone to having URI. Other than having certain experience-based suspicions, which will be further expounded upon in this chapter, we present and make no predetermined conclusion about URI without having the benefit of performing the appropriate level of forensics.

The basic concept of URI is that a business (typically one at the retail or professional service level) in which the revenues come from individuals may have the opportunity to not deposit or report all of its revenues. This nonreporting of revenues is the classic example of URI. Some might also argue that taking perquisites through a business, especially when done egregiously, is but another manifestation (the other side of the coin) of URI. Indeed, the economic consequences are probably identical. However, unless indicated otherwise in this chapter, URI only considers and reflects the nonreporting of some part of the top line—sales or revenues.

The classic example of a business having URI is that of a retail establishment that receives cash as some part of its revenue stream (for example, a pizzeria, a restaurant, most main street retail establishments, and so on). It is also not uncommon in a professional practice, especially medical practices with copays. However, to have URI does not require that there be cash in the pure sense of cash. That is, and using a professional practice as an example, some businesses get paid by check, and the check is payable to the individual owner rather than the business. Another example is when the business name is essentially one and the same as the owner.

By way of simple illustration, think of Dr. Jones practicing as Central Jersey Pediatric Associates. It is certainly not uncommon (it's also a lot easier) for a patient to write a check payable to Dr. Jones and not to Central Jersey Pediatric Associates. It is probably reasonable to say that many readers can personally identify with this scenario. It is hardly a difficult step, hardly a leap of faith, to realize that a $20 copay check payable to Dr. Jones is very much like cash handed to Dr. Jones. It would not be difficult at all for Dr. Jones to take that check, go to his or her bank, and cash it; and never enter it in the accounting records of the practice. Of course, the patient will still get credit for paying the copay, and to whatever extent records are maintained for payments and balance due, they will be kept appropriately. Thus, banish from your beliefs that URI can only come about from cash; it can very well come about from checks.

When URI is, or is believed to be, an issue of substance, it is an opportunity to bring out the best (and unfortunately sometimes the worst) in the skills and abilities of the forensic accountant. This chapter will provide a number of examples of how the determination of URI is approached, as well as how those determinations can be challenged. This tends to require superior forensic accounting skills and analysis, and the determinations are typically imperfect—that area of imperfection is what sometimes brings out the worst in our profession. Fortunately, there are relatively few forensic accountants who so mishandle URI, that the conclusions (as to whether or not URI exists) are truly without some degree of foundation.

Sheridan v. Sheridan (or Your State's Equivalent)

This is one of the bogeymen of our practice, a kind of horror story villain raised from the dead on a regular basis to scare litigants into being more reasonable, acquiescing, and warning them of certain things they can't possibly do before a judge. Yes, the dreaded specter of URI and egregious perquisites…either one of which constitutes tax fraud. In New Jersey, as an outgrowth of the infamous *Sheridan v. Sheridan* 247 N.J. Super. 552, 589 A.2d 1067 (1990) case, whenever a judge is presented with convincing evidence or testimony of tax fraud, the judge is obligated to put a halt to the proceedings and hand the matter over to the IRS.

Some believe this to be one of those areas blown out of proportion. The parties have been living all these years, in large part, through the benefit of URI, and as a result, they are clearly guilty of tax fraud. Is that or is that not really a fair reason for saying "a pox on both of your houses," washing our hands of the matter, and calling in the financial police?

Most of our peers believe that such a position is not fair; does a disservice to the clients; and makes the difficulty of a divorce situation, which is already difficult, even more difficult. When children are involved, this draconian approach threatens their already fragile existence. Is this really done out of a true sense of justice and what is right or more out of pique, a frustration over perhaps the outrageous antics of the litigants. While some practitioners feel strongly that such wrongdoing warrant preventative action, most feel it is not the family court's obligation to be the moral arbiter and compound the grief of the divorce process by bringing down on the parties the financial threat and power of a potential IRS examination. There must be better ways to handle these things. One of those ways may be to simply proceed as normal and not try to pass too much judgment on the financial practices of the litigants. Unfortunately, that might be interpreted as official approval of such improper activities.

Perhaps the irony of all of this (if what we CPA's hear is correct) is that after all these years of being subjected to the fear of *Sheridan v. Sheridan*, the word is that despite being handed the case on a silver platter, the IRS has yet to take action against the *Sheridans*.

Preliminary Steps

On-site Inspection

Generally, it is advisable to visit the business. This is standard procedure when valuing a business; it should be no less standard when attempting to determine URI. It can be as simple as walking around the property, entering a store just as any other customer, buying a product to see how the process is handled by the personnel, observing the number of cash registers, and so on. While there is always the possibility of exceptions, in general, visiting the "scene of the crime" is priceless. Depending on the approach taken in determining URI, visiting the business and seeing the posting of certain prices, hours, or other information that is important for the buying public to know can also be very important for the forensic accountant to know. It also doesn't hurt to ascertain that type of information before interviewing the business owner in order to pose relevant questions to the business owner and see what kind of responses we get.

Interviewing the Business Owner

Sometimes, obstacles are placed in our path for this very basic process, and that only tends to make the process more difficult and more expensive. However, interviewing the business owner can be very important in terms of determining the existence of URI and good explanations for various issues. Before anyone assumes that interviewing the business owner is going to be a trick that's going to result in a determination of URI, consider the possibility that there may be good explanations for variations from the norm. For instance, a lower gross profit margin because major customers keep the price pressure on, but the business is worth it because the owner can sell in volume and collects receivables in 30 days with no bad debt risk. This example indicates there might be a good reason why margins are below average, and that knowledge may expedite the forensic analysis process.

Interviewing the Nonbusiness Owner

The preceding section addressed the need to interview the person who runs the business. This is in the typical divorce case where the marital unit has a business that is owned and operated by one of the spouses. We have all seen this probably hundreds of times. It is also generally pretty obvious why we would want to interview the spouse who runs the business. However, when we are representing the spouse who does not own or operate the business or when we are neutral, it is normal to also interview that nonbusiness spouse. When representing the business spouse, it is not common to interview the nonbusiness spouse, although under certain circumstances, we might deem it to be helpful to do so (assuming we were given permission). There are at least two broad reasons why we would want to interview the nonbusiness spouse:

- *Business reasons*. It is important to find out what this spouse knows about the business; we may get an answer that is inconsistent with what the business owner tells us. That does not necessarily mean that the non-business spouse is right, or that the business spouse is either. Sometimes, it is only a matter of perception or interpretation; sometimes, getting different answers may lead us to inquiries that will give us the right answer. Also, let's face it, if there are games going on within the business, the nonbusiness spouse may be able to give us answers that are more candid than what we would get otherwise—mainly because that spouse has a vested interest in the truth coming out now, as contrasted with joint concurrence in tax dodges during the more harmonious days of the marriage. It is now he against she, rather than us against the IRS. By the way, the nonbusiness spouse has as much incentive to exaggerate the income and games as the business spouse has to understate them. There are rarely saints in divorce. What can the nonbusiness spouse tell us about how business is handled, who does what, and how many hours does the business spouse spend on the business? What about the inventory, habits and standards for billing or product mark-up, and names of related family members or unrelated close friends who are involved in the business? The whole interview process can prove very useful in understanding the business operations, as well as guiding us in our normalization adjustments function.
- *Interplay with lifestyle*. Regardless of whether our function in this case includes some form of a lifestyle analysis, it certainly involves knowing to what extent, if any, personal expenses are being run through the business—and especially if there is a cash concern. At least to a degree, these are things that we should be able to discern from our interview with the nonbusiness spouse. The perquisite issue is generally important during the interview—even though we are likely going to see that in our foren-

sic analysis of the books and records. However, of potentially significant importance, this spouse may be able to tell us about the cash. For instance, does the spouse have his or her own checking account out of which household and family expenses are paid? If so, what is the source of funding for that account? Assuming the funding is from the business spouse, does the source of the funds leave a clear trail? Perhaps, are those funds paid in cash? The point here is tracing. And making sure that the funds received by the nonbusiness spouse can be accounted for from known resources and sources. Although anecdotal information may not be strong enough to have us commit to certain conclusions, it will certainly provide us with insight and background and help direct our attention. Further, if our review of the family checking account reveals (as we just discussed) a source of funds that cannot be tied to any known source, then this avenue likely provides concrete support for a conclusion about additional (unreported) income.

First Impressions

Often, a brief review of tax returns or financial statements will reveal those certain telltale signs that something is amiss and, perhaps, it is URI. By itself, this type of observation generally is not sufficient to be the determinant that URI exists, but it is most helpful to the forensic accountant in providing direction. Also, perhaps when nothing is amiss, it may suggest that there may not be URI or that it may be done on a more sophisticated plane. Some examples of how the possibility of URI kind of jumps off the page include the following:

- *Gross profit percentage that is just simply illogical.* By way of example, in a case that we had a number of years ago, a bar showed a gross profit of about 40 percent when the industry norm was far greater.
- *Total payroll that is simply illogical.* Another example involved a 24/7, multiple-bay gas station that had total payroll (not counting the one owner-operator) of under $50,000 per year. This meant, of course, that there was off-the-books payroll, which meant it was being paid with URI, which also meant that the owner inevitably was benefiting from some of that URI.
- *The topline, gross revenues do not make sense.* A situation we had a number of years ago involved a solo practitioner professional who we knew billed himself out for at least $150 per hour. He claimed that he worked almost all the time, and yet his reported annual gross revenues hovered around $100,000.

Determining URI

Caution

We do not see this type of approach happen all that often, but as a caution, be wary if the determination of URI was made with no stronger support than a broad comparison of the specific business being investigated with its industry group in general. Or in other terms, a determination was made that URI exists simply because the subject entity's benchmark percentages are out of whack with what is normal for that business or industry. That is rarely a satisfactory way of determining URI. It is certainly possible that a situation may be so unusual and documentation so unavailable or nonexistent that comparing the subject entity against the industry average is the only way to determine URI. Nevertheless, that approach is a weak one, fraught with shortcomings, and should not be accepted other than in the most extreme situations, such as when records don't exist; cooperation is nil; and the signs (that is, how the people are living) clearly point to the existence of URI.

Original Source Documents

Whenever possible, it tends to be helpful to use the company's actual source documents, such as daily logs, cash collection sheets, invoices, paid bills, and so on. It is also important to note certain key items thereon, such as the numbering sequence and whether those numbers are sequential. At times, this will afford irrefutable evidence of company activity that cannot be denied by the business owner. Unfortunately, in this day and age of computers, for a business owner with deception in mind, it is not all that difficult to create documents from the computer that are of the quality that makes them essentially indistinguishable from those that might be legitimate and printed by third-party sources, such as professional printers.

Nevertheless, it is something we need to use. Fortunately, many times, when documents are created to mislead rather than as legitimate original documentation, such deceptive documentation has shortcomings, such as typeset, numbering issues, date, and the like. Also, there are often alternatives to verifying the legitimacy of such documentation – such as reaching out to third parties and confirming same. Sometimes, tracing issues reveal that other company documents are in contradiction to these false documents.

Gross Profit Test

Much has been said in the literature about this approach to determining URI, as well as in conversations that our readers have probably had over the years. It is one of the basic foundations of determining URI. When done correctly, it can be a very powerful tool and one very difficult to counter. The basic concept is that the target business is selling a product or service to which a direct cost can be attached. A simple example would be a shoe store in which the process is really very basic: the shoe store purchases the shoes wholesale and sells them retail. No modifications are made to the shoes, and no other processes are involved. The theory is that if we know what is purchased (for the most part, that is a given because purchases tend to be recorded as the business owner wants to write off expenses) and the sales price, we are then able to figure out what sales should have been based on purchases. By not reporting all the revenue, a business artificially raises the cost-to-sales ratio because the basic premise here is that all costs are being reflected; thus, if all sales are not reflected, costs will be relatively inflated, making the margins out of whack.

To illustrate this very simply, if the merchant marks up shoes 100 percent, which creates a 50 percent gross profit, and if that merchant purchases $500,000 of shoes from his or her supplier during the year (ignore swings in inventory, as well as many other factors), then the merchant should be showing $1 million in sales. If instead only $900,000 in sales has been reflected on the tax returns, then perhaps $100,000 of those actual sales exist as URI. This simplistic approach has shortcomings and might be wrong; however, for illustration purposes, this is the concept of what is involved.

In order to determine gross profit, it is necessary to determine a reliable profile of what the business buys, and for how much; and what the business sells, and for how much. Any mistakes in either of those critical aspects of operation will cause a mistake in a conclusion of gross profit and, thus, any reconstruction of income. This approach can be used in many kinds of businesses – basically whenever a connection can be made, a straight line drawn, from the purchase of various items by the business to the sale of various items. Whether it be simply turning over shoes from wholesale to retail, buying a lot of food and repackaging it into small packages, or buying a volume of raw plastic material and turning it into widgets, a connection can be made that takes us from input to output. Sometimes, this is a very difficult exercise, and sometimes it's not possible to use a gross profit test. When the test is difficult to use, it is also open to challenges.

Why the Gross Profit Test Doesn't Always Work

Some businesses simply don't lend themselves to a gross profit analysis. These include service businesses in which no benchmark is available for a gross profit analysis. A common example is a beauty salon. Simply, no single item can be relied upon for gross profit purposes or consumption purposes to serve as a basis for determining actual sales. With a beauty salon, the closest we get to that is the labor factor, and there are a number of shortcomings in same.

Putting aside those situations in which gross profit is simply not applicable, there are others where it could be applicable. For instance: when the business owner is a bit smarter than the average bear and compensates for URI by using some portion of that URI to purchase product off the books. In this fashion, the margins remain where they should be (or at least much closer to where they should be) bringing in the margin of error issue and, thus, countering the utility of a gross profit test for the determination of sales and, in turn, URI. By way of example, consider a restaurant in which some of the cash is used to purchase food, which is then modified and becomes part of sales. By purchasing food for cash (allowing that this expense won't get reported anywhere), the restaurant owner is helping keep margins in line by not being a "pig" about URI.

The rough concept here is along the lines of the old adage used on Wall Street: bulls will make money, bears will make money, and hogs will get slaughtered. When we are faced with that kind of intelligent approach toward URI, we need to employ other methods, if available. Using the restaurant as an example, another method might be based on the napkins or other linens that are laundered, the number of placemats, or some other benchmark—each case being different and requiring its own type of observations and determinations.

Labor as a Basis for Gross Profit

Although the gross profit approach to developing a foundation for supporting a determination of URI is among the best approaches for that purpose, in a wide range of businesses, a gross profit analysis either won't work or would be exceedingly difficult to apply. These tend to be businesses that rely heavily on labor and do not have a real cost of goods sold component other than labor. By way of example, this would include most professional practices, many contractors, and beauty salons—essentially, any business in which the revenues are driven by labor and no particular product is available against which to benchmark sales.

At first blush, a reaction to this might be along the lines of "So what? We will use labor as our benchmark for gross profit." Of course, in theory that is fine; in practice, it is rarely doable. Let's address the reasons why labor tends not to be a useful and reliable tool for benchmarking the cost of goods sold in order to arrive at gross profit:

- *Downtime, including setup and breakdown*. As accountants, we might equate this to billable versus nonbillable, although the concept of nonbillable time contains far more than that to which I am referring right now. Assume a contractor who bills out his or her laborers at a certain rate. It is a virtual guarantee that not every hour for which employees are paid can be billed to a project, customer, or client. Perhaps travel time to the job site cannot be billed to the customer. Perhaps once the employees get to the job site, they hang around until the foreman shows up. Maybe on a construction job, a certain specialty trade is needed but only for part of the day, and it cannot be billed to the job for the whole day, even if we have to pay that person for the whole day. Perhaps labor finished a component of the job in five hours, but by virtue of being called in for the day, they have to get paid for eight hours, and the other three hours cannot be billed to anybody. In a beauty parlor, perhaps employee responsibilities include cleaning up at the end of the day, for which no customer can be charged. Essentially, almost every labor-intensive field has situations in which the employees are going to get paid for time that cannot be charged to a client or project.
- *Billable versus nonbillable time*. This is typically an issue with professional practices and one to which most readers can easily relate. Think of your own accounting practice or employment situation. Perhaps your employees are paid for 40 hours per week, but if you do not give them 40 hours of billable work each week, some of their time should not be considered billable hours. Depending on your system and how your practice works, that time might be spent cleaning up files, taking a potential referrer to lunch, staring out a window or at a cubicle wall, working on some in-house continuing professional education, and so on. The point is not all the time for which the employee is getting paid can be charged to a client. As forensic accountants, particularly with a professional practice, this should not be a problem. Nowadays, we would expect a time and billing system to be in place that will tell us how many billable hours that employee worked; thus, we can separate (actually, the separation is done for us) the nonbillable hours and then use the billable hours for a calculation of billings. However, that does not always work, and it is often better in theory than in practice.
- *Fixed fee engagement*. Tied into the preceding and typically for professional practices, it is hardly unusual for some client relationships to be based on a fixed fee (for example, $1,000 per month for services for the year). In such cases, it would not matter whether the billable time at so-called normal rates (what is often called standard) amounted to $500; $1,000; or $2,000 per month because this client is being billed $1,000 per month.

- On a completely different level, think in terms of a beauty salon. This is one of the most difficult types of businesses for which to reconstruct income because among other reasons, no product gives us a relationship for grossing up revenues. An alternative is to consider the labor factor. How many hours is the beauty parlor open? How many hours do how many operators work? Based on the answers to those questions, try to calculate the revenues generated. Keep in mind that this approach includes the following shortcomings:
  - — *Hours vary by day*. Typically, the beauty parlor is open different hours on different days; however, this is typically easy to overcome by simply understanding the hours of operation.
  - — *Starting up and closing down*. Someone has to open up the shop in the morning and make sure everything is lined up, and someone has to close down in the evening, including perhaps performing a final brooming of the place and other factors that go into shutting down a storefront-type operation each day. How much time do those functions take up? This is time that is not spent with customers generating revenue.
  - — *Downtime in general*. Maybe we are investigating a shop that is booked solid from morning until night. More likely, the shop's bookings have gaps, downtime, no-shows, and the like. These are times when labor is available, but it is not generating revenue. How much of that downtime is there in a typical day or week?
- Let us take one more example that provides us with a slightly different twist: let's assume a plumbing business that employees a few plumbers, as well as the owner who is a master plumber. We could apply this just as well to any skilled trade, whether it be electrical, carpentry, or the like. We have issues that are similar to the preceding beauty salon example, but we've got the following additional significant complexity:
  - — *Owner labor*. Assuming some degree of accurate payroll recording, we can at least figure out how many hours the laborers were paid for and then deal with how many hours of billable work they performed. However, it is not so simple when the owner is involved. As previously stated, assume an owner who is also a master plumber. How many hours does he or she work that are chargeable to a job as contrasted with general supervision, running from one location to another, and doing whatever else this owner might be called upon to do that cannot be billed on a project or to a customer. That is a difficult one to call.
  - — *Paid time off*. Depending on the type of business, we might have a situation involving various skilled trades people, and part of the employment arrangement is that they get paid time off, whether it be sick time, holidays, vacations, and so on. When we are attempting to reconstruct revenues based on paid labor hours, keep in mind that some of those hours might have been for time off, which is time that was not directly generating revenues.

Besides all of the preceding, ultimately, it is not really how much time or billing value was generated but how much was billed and collected, which is an area that most readers are familiar with. Even if we are dealing with a situation where there are no fixed fees, just because $10,000 worth of time was spent on a job (regardless of whether it is an accounting job, a construction job, or the like) does not mean that the business was able to charge the customer that $10,000. There may have been a need to adjust the bill (here, we are virtually always talking about adjusting downwards) to reflect the realities of the market, how much time the job should have taken, mistakes that might have been made, and so on. When trying to reconstruct unreported income, and we are faced with this type of issue, it is extremely difficult to be sure that we are going to derive the appropriate adjustment to our reconstruction. We might try to determine if we can use, for benchmarking purposes, a number of jobs in which there were write-offs. However, it is unlikely that we will be able to make a sufficient and acceptable connection between any such sample and the overall universe.

Finally, the issue of collection. We are all familiar with billing and having clients who have or concoct issues with those bills, so that we are effectively forced to compromise in order to collect and avoid a lawsuit. Depending on the accounting system and type of business, we may see these adjustments in bad debt expense, in which case we can refer to the discussion elsewhere in this book dealing with that type of issue and the forensic relevance. If it is a typical cash basis reporting business, then there would be no bad debt expenses, unless we are reviewing this from the point of view of the time and billing system. Rather, we would simply see revenues as a reflection of collections. The point here, as with so many other places, is to understand the business that we are investigating and recognize the practical limitations of what our forensic analysis is capable of doing and how in virtually any such situation the best result we are going to have is a very good approximation of the true revenue stream.

Absence of Cash

Sometimes, an absolute giveaway of URI is the simple absence of cash being deposited or, perhaps, far too little cash being deposited. Although this serves well as a smell test type of approach and consideration, it generally is not adequate by itself to be able to reach a conclusion about any specific amount or range of URI.

Consider if we are investigating an auto body shop. It would be reasonable to expect some volume of business that is not insurance based (thus, the opportunity for cash). However, the mere absence of cash being deposited, although raising suspicions, would unlikely be a strong enough observation to then conclude, by itself and without any other corroborating support, that there was in fact URI.

Perhaps we are investigating a medical practice that routinely receives copays. If we observed no cash being deposited, that would be a strong indicator of URI, but again, by itself, maybe not sufficient evidence. To the other extreme, if we are investigating a pizza parlor and found no cash being deposited, we would probably have something bordering on insanity! When it comes to basic retail, cash has to be deposited—it's just a question of whether it's all the cash.

Rental Property

An example of a type of business or financial activity in which URI is not automatically linked (or at least thought of in the way it would be for a pizza parlor) is rental property, particularly residential rental property. URI can be generated from a number of possible aspects involving rental properties: rent being paid in cash; rent being paid in a split form, partly by cash and partly by check; "off-the-books" rental units, such as a basement apartment, garage, and so on; and claiming that a particular unit is vacant when it's not vacant. These types of situations warrant an on-site visit to the premises; going through every floor of the premises; trying to determine the number of units (including possibilities such as the basement and garage); and possibly even going to third parties, such as a local realtor familiar with the rental market, to find out the going rates for various types of units. One related approach that we successfully employed a number of years ago with multiple residential units and when many of the tenants spoke English as their second language was the use of bilingual confirmations sent to each known tenant asking for a confirmation about the amount of rent paid. It does not require 100 percent (or even near that) of the responses in order to get enough information to make such an exercise worthwhile and meaningful.

Third Parties

On occasion, it is helpful to reach out to third parties to secure information to buttress or refute what we have been told or have observed from the business. For instance, perhaps we are investigating a business that manufactures certain products and have been told about a waste factor by the business owner. Calling the company that manufactures the machinery that is used by the subject business and talking to the appropriate personnel at that company will give a sense for whether or not we are getting an honest answer from the business owner.

Challenging Claims of URI—Concept

Overview

It is unlikely that when two skilled and competent forensic accountants are involved on opposite sides of a financial investigation, one would conclude URI of substance, and the other would conclude either no URI or that the amount is insignificant. However, as unlikely as that situation would be, it is possible. The basis for a claim of URI being incorrect could be due to any number or combination of procedures and steps taken or not taken by the forensic accountant, such as a gross profit test, a sampling, certain assumptions about costs or prices, and the like. It's certainly possible that what looks like a well thought out, nicely presented illustration of URI could have one or more fatal flaws or, perhaps, a whole series of not necessarily fatal flaws but potential mistakes or areas of challenge that are significant enough in the aggregate to cast serious doubt on the conclusion.

The purpose here is to provide the reader with a sense of how to challenge, where the weaknesses are, in the development of a claim of URI by the other side. Before anyone gets carried away with believing he or she found a slew of errors, understand that by its very nature, the determination of URI is virtually always an estimate and, thus, almost always subject to a degree of attack. The issue is whether the attack has enough substance to truly and successfully refute the claim of URI.

Magnitude and Margin for Error

Before we get into specific approaches to URI and how to challenge them, let us deal with the overall issue and, in particular, two aspects that are oftentimes connected: the magnitude of the conclusion of URI and the margin of error. Simply put, if a forensic accountant concludes that URI is $5,000, with normal room for a margin of error, the conclusion could just as well be that there is no URI. That is, in most circumstances, $5,000 of URI in virtually any business of substance is such a relatively small amount that the slightest tweaking of any assumption used for the calculation of URI could easily double that conclusion and just as well eliminate it, bringing it down to zero.

By way of simple example, if we are dealing with a business that reports $500,000 of sales in a year, a conclusion of URI of $5,000 represents just 1 percent of reported sales, which is equivalent to 3 days of generated income. In virtually any assumption, it wouldn't take much of a variation to double or eliminate URI, and the fact that a very minor adjustment can cause a doubling or an elimination of the URI conclusion makes that approach suspect.

Any approach that we develop without having the benefit of the quintessential second set of books is inherently based on assumptions. That is not to say that the assumptions are wrong or improperly or poorly done, only that it must be recognized that striving for perfection is an unrealistic goal. Generally, if the conclusion is as modest as this hypothetical, barring some very good support, it is probably just as well to leave it alone and assume no URI.

Challenging Claims of URI—Gross Profit

The Mix of What Is Purchased

Very few businesses buy and sell only one thing; most have a range of items. Did the forensic expert develop the right profile of what this business buys and sells? By way of example, if we are dealing with a women's clothing store, there can be very different margins (mark-ups, gross profit, and so on) on dresses, pants, gloves, handbags, various accessories, blouses, and so on. How well did the accountant develop the sample of what is representative of what the company buys and sells?

The Mix of the Sales Price

Although businesses often have a standard mark-up, they do vary sometimes by product, as well as by time of year. Businesses may have clearance sales in which slow moving items are heavily discounted and, sometimes, sold at a loss just to get them off the shelves and generate cash flow. Depending on the specific business, something such as a sidewalk sale might eat into margins to the extent of one or even a couple percentage points. Was that taken into account in developing the profile or sample? In a similar vein, does the business typically have a month when it discounts products, and has it established a following, so that this has become a substantial event that generates traffic and enhances business in general? Think of it as almost a business's spring cleaning.

Components of the Product

Sometimes, a business modifies what it purchases. In other words, it's not simply that the business purchases a dress, puts it on the shelf, and then sells it. Rather, perhaps the business purchases metal tubing and applies various procedures, labor, and other materials to modify the tubing, thus creating a product it can then sell. In developing the gross profit, did the accountant take into account what goes into the product that is eventually sold?

Volume

Assuming, as is the case in most situations, that a business is selling a variety of products or services, was a sufficient volume of transactions or activity tested to arrive at a reliable benchmark for determining actual sales? Depending on many variables and aspects specific to the business, using or testing, say, 5 transactions is almost assuredly too few; testing 500 transactions is probably overkill. The extent of the sample size is a judgment call and open to challenge.

Change

Did something of substance change in the past few years that might make the approach used or conclusions reached less reliable? For instance, did volume increase dramatically because the company entered into another market where it possibly has to compete with big-box merchants? If so, there's a good chance that a reduction in profit margins was part of the price of growing to that size. If that is the case, what did the forensic accountant use as the time frame and sample for determining gross profit? If the sample or testing was done based on where the company was a couple years earlier in a different market that would sustain greater profit margins, but now, the business is selling much more but is in a greater competitive environment, margins are probably not the same.

Waste or Shrinkage

Various types of products are prone to a degree of waste as they go through the process from, for instance, raw materials to finished goods. Others, because of perhaps a heating process, are prone to shrinking. The consequence is that a certain volume of input results in a lesser volume of output. For instance, it might take 10 tons of a certain metal to turn out 9½ tons of product. If a calculation assumes that sales were generated based on 10 tons of purchase without recognizing that there were only 9½ tons to sell, there would be a mistake. In a similar vein, certain meats shrink as they get processed. If a calculation was done based on the purchase of 100 pounds of meat with the assumption that 100 pounds would be sold, the conclusion would be incorrect because in reality, shrinkage means that only 80 pounds are available for sale.

Challenging Claims of URI—Other Approaches

Calendar

If a conclusion was reached based on a particular month, week, or day, was that a representative period of time? Some obvious examples are trying to determine the sales of a greeting card store if we are using the month of May, which has Mother's Day and is typically the biggest month for greeting card stores. In trying to determine the sales of a beauty salon, was a Friday or Saturday used to the exclusion of any other day of the week? Those are typically high-volume days, and an extrapolation from there to the entirety of the week and year would almost assuredly be wrong.

Hours

If the calculation was done based on the number of hours that the business operated, how were those hours determined? Is the business open the same number of hours every day? Was the right balance of hours taken? Another angle involves a service business and a calculation made based on the number of working hours of the personnel. Was a reasonable amount of downtime (nonbillable) considered? Were the right number of people multiplied by hours (man hours) considered, and if so, how was the calculation done?

One comment in regard to professional practice investigations: keep in mind we are really only talking about where there are concerns about the existence of URI—thus, the need to do some form of reconstruction of revenues. For example, does the subject business at hand bill secretarial time? From our experience, typically, law firms do not bill secretarial time, but accounting firms do bill that time. It is important to know the type of practice and then address the number and rate of billable hours. Making any kind of mistake in this area can result in a significant error. Think in terms of a business with three secretaries generating an average of 800 billable hours per year per secretary. Two thousand four hundred billable hours at, for example, a rate of $70 per hour equals $168,000 per year. If those hours are billed, and we do not include them in our reconstruction, we may wind up concluding that the business is reporting more than it collects; on the other hand, if it is the type of business that does not bill those services, but we have included them in our calculation, we would be doing a gross disservice and may conclude URI that simply does not exist because our number is much higher than the actual URI, or we have concluded URI where none exists.

Inventory

Some businesses, such as many retail and manufacturing operations, have inventories. One approach to determining URI is to take into account the amount of goods purchased, assume a certain profit margin thereon, and conclude what sales should have been. However, that assumes that whatever was purchased became a sale. What if that was not the case? What if some of what was purchased was retained by the business in inventory, providing the potential for a future sale? In that case, perhaps the calculation of sales, which formed the foundation for URI, was overstated. Of course, that would also mean that the inventory was understated on the books, and an adjustment would need to be made. The bad news is that means additional income and another asset; the good news is that at least it's not URI.

Employees

What if the employees are the guilty parties? In some businesses, employee theft is a real concern and very large expense. Perhaps the approach and calculations were all correct, and the conclusion about URI is correct in theory, but a substantial portion of it was taken by employees. That becomes an ordinary and necessary operating expense of the business; certainly, it's not for the benefit of the owner. Was that fact of life for the business taken into account in the determination of URI?

The Personal Touch

Overview

Whether as a supplement, further support, or because we have been unsuccessful in determining URI (or convincing ourselves that there is none) in the business, sometimes looking at the personal lifestyle helps cinch the URI issue. It might also convince us that either URI does not exist, or the person with the URI is just too clever or careful for it to be found. Of course, this assumes that it is of substance rather than a modest amount that can simply fall through the cracks. When we are faced with that type of situation, we may have little or no choice but to fall back on the personal financial records and use those to either prove URI or at least provide strong support for a determination of URI.

Lifestyle

Essentially, this is the classic situation, along the lines of "how could these people live like this based on their reported income?" We analyze the lifestyle enjoyed by the family and review checking accounts, credit card records, and anything else to investigate the paper trail that illustrates how they have been living. Of course, this includes the basics such as mortgage or rent, utilities, house maintenance, food, vacations, clothing, cars, and so on. Typically, when URI is of consequence, this will prove that the lifestyle is inconsistent with (considerably greater than) the reported income.

Sometimes, the way this is proven is by what does not show up in the lifestyle. It's not unusual for people with URI to pay for various personal expenses (for which there is no tax benefit) in cash. For instance, we see this with food, vacations, clothing, and the like. What might be the case in such a situation is that a thorough review of the personal lifestyle expenditures may reveal that nothing was spent for food, vacations, or clothing. Because we know that the family had to eat, they probably had clothing, and they maybe went on vacation, that could very well form the foundation for proving URI.

Debt

The preceding briefly explained how lifestyle or the absence of certain items from the lifestyle may prove the existence of URI. Before that's considered a done deal, it is often important to make a determination about whether it is possible that the high lifestyle (high in reference to reported income) was, to a degree, supported by the buildup of debt. Thus, for whatever time frame is being reviewed, it is important to get a handle on what debt (whether it be conventional bank loans, the balance due on various credit cards, or the like) existed at the beginning and end of the time frame. If we find that there was a large increase in credit card debt, then some part of that lifestyle was funded by debt, not URI.

Insurance Policies

Once in a while, a review of insurance policies, particularly the riders or floaters, may reveal the existence of additional insured assets, and these assets may have come about from the use of URI (for instance, jewelry, art collections, comic book or baseball card collections, and so on). If the existence of these assets cannot be explained from traceable purchases, especially if one spouse was not aware of them, one answer may be URI. Thus, URI has now been proven by virtue of the accumulation of certain assets for which there is no other explanation.

Deposits

As absurd as this may sound, it is possible that a review of the personal bank records of the individuals may reveal deposits that exceed the reported income. I know that sounds a little ridiculous; if someone has URI, why would he or she deposit it and, thus, create a paper trail? The answer is that there is no good answer – sometimes people do that. Of course, sometimes the excess deposits can be gifts from family members, borrowings that then in turn were deposited, transfers of funds between accounts that create artificial deposits, or other nonincome receipt of funds. Those must be carefully considered before jumping to a conclusion of URI.

It is sometimes advisable to gain access to the children's bank records to see if they contain deposits that don't make sense. Regardless of whose account, if we were to see, by way of example, frequent deposits of odd amounts into the personal bank records of the individuals, it strongly suggests that something is going on (that is, the deposit of checks from a business rather than those funds going into the business account).

Valuation

Taxing URI in Valuations

The issue here is should we or should we not tax the URI portion of the normalization adjustments we make to arrive at the net income that is then going to be capitalized in determining value. Valuation professionals have mixed reactions to this question. Currently, it is likely that a majority do tax effect URI, but a substantial minority does not. One issue is whether the hypothetical buyer would be doing the same. Another argument, particularly relating to divorce, is whether any likelihood exists of the present owners selling or simply continuing the operation.

Not surprisingly, a corollary issue is whether to tax effect perquisites. Economically, they are essentially the same concept as URI. In general, valuation professionals, even those who tend not to tax effect URI, uniformly tax effect perquisites (though extreme or egregious situations may call for special treatment). In part, this is justified by the reality that, as an example, the IRS treats cash and URI differently than it treats perquisites: the former is tax fraud, but the latter is rarely tax fraud.

Another consideration is to tax effect URI but give a bigger percentage of the result as alimony. Besides being outside of our (CPA) area, the consideration avoids the issue of how to treat URI in valuation, which is the valuator's job.

In the valuation arena, it has been suggested we can adjust the discount rate to take care of the tax burden. However, that smacks of simply avoiding the issue and creating something that could not be easily justified, as well as resulting in a predetermined conclusion. The same holds true when playing with the tax rate.

Effect on Value

Besides the issue of whether to tax effect the URI in arriving at a normalized level of income for valuation purposes (reference the preceding), we also have the issue of how the extent, if any, of the existence of URI affects value. For instance, does it create a greater risk situation, thereby increasing the cap rate and reducing the value? Does it warrant a separately stated potential liability as an offset against value? None of these are absolute, and we will not likely find anything close to unanimity among forensic accountants about whether these issues are real.

One aspect of this area that remains undetermined and, certainly, subjective is whether the existence of URI presents any particular issue about the specific business at hand. Before any reader expresses dismay at such a statement, let's put into perspective the URI issue. For instance, how long have instances of URI been going on? Is the threat of IRS action real or imminent? Has there ever been an audit, and if so, was there ever a determination of URI? Is URI commonplace for this type of business (that is, a retail establishment)? Is the extent of URI fairly normal, or is it particularly egregious?

The point is that if the answer to most of these questions tends to be "No," in those situations, what would make anyone think that the prospect of URI negatively affecting this business is realistic?

On the other hand, assume for the moment that we are valuing a law practice instead of a retail establishment and uncover significant URI. Certainly (hopefully our readers would agree), URI is not commonplace in legal firms, and this represents a very significant problem. In such a case, perhaps an increase in the risk factors (an increase in the cap rate) would be warranted, or perhaps a separately stated liability for potential taxes would be warranted.

Other Issues

The Effect of URI on Related Areas

URI does not exist in a vacuum. Although a determination of URI clearly is a conclusion that more income exists than has been reported, the issue often does not stop there. Some of the related aspects of a determination of URI include the following:

- *Unstated or understated liabilities*. If URI exists, that also means that taxes on that URI have not been paid. To what extent does that create a potential or hypothetical liability as a consequence of URI? For illustration purposes, if we are to assume several years of $100,000 per year of URI, the tax on that is probably between $30,000 and $40,000 for each of several years. In addition, the likelihood of penalties and interest exist, which for something as serious as URI and spread over several years, can be more than the tax itself. Thus, it is hardly out of the realm of experience to suggest that even in a moderate case of URI, the potential tax, interest, and penalty liability can amount to hundreds of thousands of dollars.

  Furthermore, although not directly an issue in expressing such conclusions but a practical matter, in many situations, URI is used to enjoy a higher standard of living than would otherwise be the case. URI is consumed while living; it doesn't become savings. That means this potential liability has no way of being paid. Just how real, how serious, this potential liability is, is a separate issue – although putting aside all technical issues, most of us would probably suggest that it's not a real liability unless it is a realistic possibility that the IRS or a state taxing authority will step in.
- *Cash hoard or undisclosed assets*. A fair question that arises once a determination is made that URI exists is, where did it go? As previously stated, in many of these situations, particularly when the amount of URI is not eye-opening, URI has gone to maintain a lifestyle that could not otherwise be maintained. Thus, no cash hoard or other assets exist. However, that is certainly not always the case.

  If we are fairly convinced that URI was not simply spent on riotous living, the answer may be that some asset exists (whether it is cash or something more tangible). This could take the form of commodities such as diamonds or other collectibles; other times, it might be in the form of real estate or improvements in real estate, which is another form of lifestyle expenditure that doesn't show in the same way.
- *Standard of living relevant to alimony*. An obvious outgrowth of the determination of URI is that more income (determination of URI) one way or another means a higher standard of living; an increased lifestyle (even if it's only for savings); and, thus, a greater alimony entitlement or obligation (depending on our perspective in the case).

  A concern is the effect URI has on alimony because in part, the standard of living enjoyed has been made possible without taxes. If we were to tax URI in determining alimony, it would create an artificially low level of net posttax income. That would create an unfair advantage to the business owner who will continue to enjoy a level of income without tax, even though the alimony he or she will be paying would have been predicated as if there was a full tax. Perhaps having some part of the alimony treated as nontaxable (thus nondeductible) is one way of addressing this issue.

- *Fraud or other criminal charges.* This is rarely applicable in a divorce action. However, if this was, for example, a shareholder suit or partnership dissolution action, particularly in regard to an oppressed shareholder or partner, the determination of URI when one of the parties did not benefit from URI may very well result in serious charges that reach into the area of criminality rather than what we have taken for granted (in the divorce field) as just a financial issue between husband and wife.

Forensic Accountant Responsibility

The determination by the forensic accountant that URI exists potentially raises a couple of ancillary issues. Namely, to what extent do we have responsibility to report URI when we have uncovered it, and does it make a difference whether we are court appointed? A related issue is the level of responsibility put on the business's accountant when URI is determined and that accountant is made aware of it.

It is a widespread (but not unanimous) belief by forensic accountants that we have no responsibility to any governmental body (typically, the IRS or a particular state taxing authority) to report the existence of URI in a particular business. In fact, arguably doing so would be an ethical breach because we are bound to confidentiality as one of the hallmarks of our profession. That is not to suggest for a second that our work papers are immune from discovery by the government or that we have a particular privilege. As a body, accountants are of the general belief that uncovering URI as part of the functions we are performing in a litigation matter do not compel us to report URI to taxing authorities. I am not aware of this belief being tested.

Business Accountant Responsibility

A more nettlesome issue is in regard to the company's accountant when he or she finds out (and take my word for it, they generally don't want to find out) that this business, for which he or she has at least prepared tax returns if not also financial statements, has URI. A multitude of questions need to be answered and issues need to be addressed before we can truly appreciate what that company accountant needs to do. For instance, just because a forensic accountant discovers URI, that doesn't necessarily mean that he or she is correct—refer to various parts of this chapter dealing with challenging allegations of URI. It is also possible that regardless of whether we are right, the company accountant may have reason to disbelieve us, may have reason to believe that, for instance, the business owner uses URI for legitimate business expenses that are simply also unreported; thus, the net is a wash and doesn't require any reporting. It is also possible that in the eyes of the company accountant and his or her estimation, even if we are to be believed, perhaps the extent of URI is not material and of enough consequence to require any kind of reporting or concern.

Assume for the moment that we forensic accountants have determined significant URI, the argument has been made very persuasively, and even the business owner has acknowledged URI. In other words, we've got a situation in which no dispute is possible, but significant and material URI exists, and the company accountant is now aware of URI. At the very least, that accountant needs to make his or her client aware that the accountant can no longer prepare returns unless things change because it would be unethical to prepare false returns.

It is certainly possible that the business owner will provide his or her accountant with assurances that what was in the past, regrettable as it is, will no longer be the case and that the business has now come clean and will report its income going forward. Assuming that such representations are believable, it would probably be advisable (though it is certainly not required) for that accountant to achieve, by appropriate testing, a level of comfort that those representations are accurate and that the coming year's numbers can be considered accurate and truthful. In the absence of some level of assurances of a new leaf being turned, that accountant truly must refuse to prepare the tax returns of that business going forward.

What about the past returns? That is not so clear. However, it would certainly be prudent for the company accountant to strongly advise the business in writing that amended returns be prepared, so that honesty and integrity will prevail. How many years back amended returns have to be prepared is a separate issue; URI has a habit of being the same as fraud, and that can open up a number of past years. A related interesting question or issue is whether the preparing of amended returns by the accountant is synonymous with the filing of the returns by the client. The answer is "No." In some situations, amended returns were prepared by the accountant, almost always in good faith and with the expectation of filing by the client in order to properly correct past years' wrongful filings because of the income issue; however, some of those amended returns were never filed. Thus, the right thing was done, but it was just for show.

Fees

One final comment about URI and the forensic accountant is in regard to the ever-sensitive issue of fees. Simply put, the existence or belief of the existence of URI—thus, the need for the forensic accountant to perform the appropriate analysis in order to determine the extent of URI—will inevitably cause our fees to be more or significantly more than they would be were there no such concerns about URI. The reason is simple: the determination of URI is an additional step otherwise not taken, and an additional step means more time, which means more fees. Thus, as a very practical issue, if it is the belief that URI exists, how much is believed to exist, to what extent will determining URI affect our accounting fees? Generally, it is money well spent, and the return on that "investment" justifies the cost. However, be cautious if the suspected amount of URI is very modest (it takes a lot of work to determine URI even if URI is modest) or if some serious doubt exists about whether the claim of URI is real or spurious.

> *CASH IS KING—Consider this: a middle class family of 5 in Central/Northern New Jersey living on approximately $30,000 per year. Sounds unlikely? We thought so, too. Yet, that's what the business owner claimed as his income from his retail business.*

Every week, without fail, he would get his paycheck of $600 gross and approximately $500 net. Also, every week, without fail, cash deposits were made in his personal checking account of between $1,000 and $1,500. Worse, none of those deposits were his paycheck. During a meeting with the parties and their counsel while trying to negotiate a settlement, we questioned him about how he could have that extent and frequency of cash deposits in his checking account, which well exceeded the entirety of his paycheck. He explained to us that he received a lot of medical expense reimbursements.

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Valuation

PUSHING THE ENVELOPE—It is not unusual for investigation and valuation professionals to have a difference of opinion. However, as with so many other things in life, you would imagine that such differences have reasonable limits. One case involved a corporate executive who had a minority interest in a company. The company was in existence all of two years as of the valuation date, and all of its revenue came from the parent company in which this corporate executive had absolutely zero interest and control, which was acknowledged by both sides. Further, this side company had no business operations or assets of its own and received income only to the extent that the parent company directed some its way. We're not quite finished. It was documented that the side company existed only because of certain operational needs of the parent company relevant to compensation of certain individuals; once such compensation was paid, the side company broke even. All of those issues notwithstanding, the other expert concluded a value of $2.5 million, and that was just for the executive's minority interest. We suggested that the appropriate value was zero, which is exactly what the trial court found.

The approach here is not to provide you with a step-by-step, "how-to-do" a valuation. There are several very good books out there on business valuation that cover this in-depth, and to which I would never presuppose providing a competing text. Rather, the concept in this chapter is to deal with issues that involve valuation that you might run into on a somewhat daily basis (or perhaps infrequently) that are interesting and challenging. Also, to explore areas that provide some serious moments of thought, which call upon you to look at things not in your standard, run-of-the-mill, rudimentary manner. This chapter invites you to think about to what extent someone's age or health impacts value; whether and how you should be averaging five years of income; whether what impact (if any) actions by a business owner might have on value; the perils of trying to use the market approach or a contrary view on S corporation valuation concerns; and a variety of other issues. My purpose here is to provide an array of interrelated topics that you would find interesting, perhaps challenging, but already assuming that you know the basics of how to perform a valuation. Also, although very much part of valuation, this chapter will not provide you with typical, classic textbook technical explanations of business valuation. It is my hope that the diverse array of subjects covered herein will cause you to think about these topics out of the box and recognize them as helpful in addressing some of the more interesting and challenging issues that arise in our line of work.

Age and Health—Impact on Value

Both age and health can have an impact on value, but generally, only in the negative sense as relating to some "normal" benchmark. As a simplified general rule, it is agreed that, all other things being equal, the value of an old person's interest in a business is worth less than the same interest owned by a younger or even middle-aged person. (In order to avoid offending too many readers, assume that 80 is old within the context of owning a business and trying to sell it.) In the same sense, again as a general statement, all other things being equal, the interest in a business of someone who is seriously ill is worth less than the same interest of someone who is not seriously ill. After all, an old or ill person doesn't have as long to hold out for the right deal than someone in a better state of age or health.

In a real world sense, value relies on the ability of the seller to function for his or her own best interest and be in a reasonably equal position with the buyer to negotiate a deal. Arguably, someone who is old is in a weaker position to negotiate a deal than someone who is 40 or 50 years old because plainly speaking, time is running out. In the same vein, someone who is seriously ill to the point that the illness adversely affects that person's ability to operate the business is also in a weaker position to negotiate a deal than someone who is in moderate or good health. However, at least in regard to health, sometimes, that is not public knowledge, whereas age is pretty much an obvious issue.

Thus, when we perform valuations in a situation involving an extreme, such as an old or a very ill person, we need to at least consider the extent, if any, that we believe those conditions affect value. Generally, the numbers speak for themselves. When it is determined that the value is affected, it is addressed either by some form of a discount against the otherwise determined value or by increasing the capitalization rate (increasing the risk factors) of value.

Interestingly, at least one argument would suggest a possibly enhanced value because of age. That is, an older seller is more likely truly trying to sell, more likely trying to make the sale a clean transfer, less likely to steal away the business afterward (become a competitor), and more likely to abide by a short-term phase-out and transition. Not the strongest of arguments for value, but they are something to consider.

This also tends to be more of a concern in a one-man or woman operation because the key person's age or health tends to have an outsized effect on the business. Although the person's individual bargaining strength would certainly be weakened because of age and health, at least if he or she owned 10 percent of a $20 million business, it is likely that the business itself would not be adversely affected by that person's age or health (assuming that this person is not the driving force).

Another concern, particularly with older sellers, is that many times, their clients or customers are also older because of relationships built up over the years. Thus, the customer-client relationships are more in jeopardy than would typically be the case with a younger seller.

Averaging the Numbers

In the majority of business valuations, we average something in one or more key places within the valuation process. Often, an area of disagreement between the experts is the justification for using an average. Essentially, we need to consider two areas: arriving at the income to be used for valuation purposes and the valuation conclusion when two or more valuation approaches have been employed.

In arriving at the income to be capitalized (or against which some multiple is to be applied), we tend to review a few years (often five) of operations. The result is a conclusion about the normalized level of income for anywhere from one to five years of operations of the subject entity. The issue then arises about how to most properly use those five years of conclusions. Do we take a straight average or weighted average, disregard one or more of the years, or use only the most recent year? Thus, even if we have two experts concluding the same normalized net income for a five-year period, they may disagree on what that means about the anticipated level of income going forward because indeed, it is the expectation going forward that is the foundation for value.

The past is used to help as a guide for future expectations, and the question here is, how do we use the past? Do we take a straight average, arguing that no one year is more reliable or meaningful than any other? Do we take a weighted average, arguing that the most recent years should be given more weight than the older years? Do we disregard one or more years, arguing that those years are not indicative of this business going forward? Do we take just the most recent year, believing that it is the most meaningful in regard to where this business is going? Do the numbers suggest a trend, and do we need to use a measure reflecting that trend?

The preceding dealt with the income that will eventually serve as a foundation for valuation. Assume the income decision has been made, and valuation has been approached from a few different angles (for example, capitalization of income, discounted cash flow, the excess earnings approach, one or more market approaches, and so on). It is to be expected that these different approaches will conclude with different values. Do we take a simple average of these different value conclusions, weight them in some fashion, and disregard some of them? If the values are very close, a simple averaging is probably appropriate. However, if significant differences exist, what is the justification for some kind of a blend, weighting one approach more than others? What is the rationale or justification for disregarded one or more of the approaches?

Buy-Sell Agreements

Whether called a shareholder agreement, partnership agreement, or buy-sell agreement, the concept is the same. We are dealing with some form of an agreement (a contract) among the multiple owners of the business that provides for the buying out of one or more interests upon the occurrence of one or more triggering events, such as death, disability, or voluntary or forced retirement. A standard element in our work is to always request (demand) the production of any such documents. In the event that the existence of those documents has been denied (a very possible and real situation), keep that in mind when performing our forensics. If we see a professional fee from a lawyer for the preparation of such an agreement, it may give us ammunition for challenging denials of the agreement's existence. What might be a legitimate explanation is that the agreement was drafted, and the work is in progress, but no agreements exist in final and signed form. In that case, we would certainly want to see the drafts.

Regardless of whether the agreement is a draft or final version, make sure that you review the agreement to see what it says about valuing the business, especially the final and signed version. Keep in mind, especially in a divorce situation when the interest involved is a controlling interest or, perhaps, 1 of 2 equal 50 percent interests, that the valuation parameters (if any) expressed within that agreement are often considered not binding in our need to perform a valuation and the ultimate disposition of the matter. That could be quite different if we are trying to value a 5 percent interest in a multiowner operation that has such an agreement in place. Regardless, we want to know what the agreement calls for in regard to valuation, even if we ultimately decide (or are directed by counsel) to ignore the agreement as not relevant or determinative for purposes of the specific litigation.

To what extent, if any, are buy-sell agreements (or shareholder or partner agreements) relevant in our valuation process? As is understood by probably all valuation experts, such agreements need to be considered but tend not to be dispositive in regard to valuation, particularly in divorce cases when the interest being valued is a majority interest or when the agreement involves family members. Nevertheless, the agreement does at least need to be considered, even if it is dismissed as not economically realistic or applicable.

Among the concerns regarding the applicability of a buy-sell agreement include whether it has ever been used, and if so, how recently, how often, and for what size interest? Also, does the agreement provide for a living buy-out as contrasted with only a death buy-out? Only a death buy-out may significantly impair the agreement's applicability in regard to valuation in a divorce context.

If the interest being valued is a minority interest, especially a very small minority interest, the likelihood of the buy-sell agreement prevailing increases, perhaps dramatically. In the extreme, when valuing a 1 percent interest in a large law firm with many small ownership interests in which that buy-sell agreement has been "tested" by being used numerous times over the past several years, the chance is much greater of that agreement persevering as the determinant of value.

Other concerns about the applicability of a buy-sell agreement would include, by way of example, the extent of restrictions specified in the agreement. For instance, does it require that in any attempt to sell one's interest it first be offered to the other existing owners? Does it prohibit the sale of an interest in the entity or otherwise severely limit the sale without the approval of the others? These restrictions would tend to strengthen the relevance of such an agreement. On the other hand, if valuing a majority interest or even a large minority interest that might control the operation, the relevance of a buy-sell agreement is likely weakened, at least from an equity point of view and, in particular, in the context of a divorce action.

Even when not applicable, it may be helpful to see how the promulgators of that agreement decided to express a value for purposes of obligating each other. It might be as crude as a static number or an overly simplistic multiple. It might be far more elaborate and even include an independent valuation. In that situation, we are going to insist on the production of any and all such valuations. We may even want to provide an illustration of the valuation of the business in accordance with that agreement as part of our report. We might do so, so that we are not accused of ignoring the agreement. We may also want to do so to show that our valuation is similar and not inconsistent with the agreement. To the other extreme, we might want to show the unreasonableness (dare we say illogic) of that agreement's terms relevant to the valuation issue. It is likely not ours to argue the issue (that is typically a legal argument for the attorneys deal with), but it is our province to present the valuation.

Cap Rate Build Up

In developing the discount and then the cap rate, the majority of accountants use the Ibbotson or Morningstar data, but a number also use the Duff & Phelps data. Both of these sources provide return on investment rates based on public company data and data and returns based on the posttax income of those public companies. Typically, we use those returns in developing (building up) our cap rate, and apply that cap rate to the normalized (posttax) income of the company we are valuing. The critical element is the use of posttax income. Typically, we apply statutory tax rates to our normalized income; for a relatively profitable operation, that means using a 40 percent combined federal and state tax rate. However, some studies have shown that the average public company pays a considerably lower (lower than statutory) rate—perhaps something in the 20 percent range as an average. Therefore, is it flawed to use posttax income that has had a 40 percent tax rate applied to it and then apply against that income a cap rate that has been developed based on posttax income with a 20 percent tax rate? Does this constitute a serious flaw or any flaw? Are privately held companies inherently different than public companies in regard to this issue? If so, should we be using the Ibbotson, Morningstar, or Duff & Phelps information at all? If we can use that information, do we need to make some adjustments because of the differing tax rates, or is this an acceptable deviation because it is appropriate and necessary to apply statutory rates to our normalized income? I am not suggesting to you that I have any answers, but I and our peers (based on discussions) have a lot of questions.

Contingent Assets and Liabilities

This is not something we run across very often, but on the other hand, it's not a rarity, and when it happens, it is often substantial. The concern here typically is with a lawsuit in either direction: either the subject business as the plaintiff facing a potential reward and, therefore, an asset or the subject business as the defendant potentially facing a (significant) liability.

Another area where this concern may arise is when a business is subject to governmental regulatory oversight and audit and has a history of that happening, especially if that past history drew blood. Although every business is subject to IRS and state tax audit situations, unless the business has a history of those audits, the concern here is not about the general standard exposure to IRS tax audits but something more special to the specific business. For instance, a business that generates its revenues through Medicare or Medicaid is subject to a layer of oversight that few other businesses are subjected to. If the findings are fraud, the exposure is not merely the company having to pay some taxes (plus a fine); it possibly extends to the personal liability of the owners of the company and even to criminal charges.

To what extent should these types of exposures be considered in the valuation of the business? At what point (any clearly definable point is unlikely) does this type of exposure cross over from the hypothetical, possibly remote and routine business exposure to something more serious and likely? Obviously, that is a conclusion that would need to be reached on a very case-specific basis. Then, even if that exposure were more likely than not, quantifying the extent and likelihood of that exposure brings in another set of variables and issues. If a personal exposure issue exists, compounded in some cases by the possibility of criminal charges, this area can be far more difficult.

On the other side is when the company is the plaintiff in a damages suit, patent infringement, or some other situation in which it stands to be the beneficiary; thus we may need to reflect such as an asset. Again, to what extent is such a potential benefit factored into the valuation? It may be that unless both parties are willing to conclude with some currently definable value, the most likely and, perhaps, most equitable approach would be to ride along with the situation and share in the recovery. That sharing doesn't quite work the same way in the negative, such as when, as previously discussed, the company is at exposure in an audit or a lawsuit. It is much more difficult, if not practically impossible, to look to the former spouse (nonbusiness spouse) to give back when something happens years down the road. Holding back a share of the earnings differential at this point (for example, in some form of an escrow arrangement), tends not to be a reasonable or satisfactory approach.

Covenant not to Compete

In negotiating a purchase or sale, it is not unusual, particularly for privately held and small businesses, that the deal includes a provision for a covenant not to compete (CNTC). Sometimes, these CNTCs provide for a specific level of payment to be made by the buyer to the seller. Sometimes, the arrangement is truly a fair or arm's length arrangement, and sometimes, the CNTC aspect is merely an agreed-to carve-out that is often determined for tax reasons in a negotiated arrangement between buyer and seller. In a nondivorce environment, that might be the end of it, but life is not that simple in a divorce matter. Assume that we have just this type of situation: a real purchase or sale happening around the same time as the divorce. Among the provisions of the deal is a CNTC. Further assume, as is not unusual in a CNTC, that the stream of payments called for in the CNTC are considerably less than what the seller was earning in the recent past and, thus, considerably less than the family's lifestyle.

An interesting issue arises within this context along the lines of what the seller's income is going to be going forward for purposes of alimony and support determination. In such a situation, are we looking at the seller taking a position that his or her income will not be what it used to be in the past; thus, any alimony and support obligation needs to be considered in that light? On the other hand, should that seller be obligated to make alimony and support payments out of investment return (assuming there is any) that is the result of the funds received in the sale? If so, would that be fair because by this time, the sales proceeds would have been allocated between husband and wife as part of the divorce? In that sense, the other spouse received his or her fair share of the sales proceeds and, thus, is able to invest them as that person sees fit. Of course, this is ignoring the possibility that the seller may be employed elsewhere, but that opportunity is very limited because of the CNTC.

One way to address this issue is to value the CNTC and carve that value out of the otherwise stated value of the deal. Then, via equitable distribution or community property, share only the value or sale price exclusive of this CNTC carve-out. The CNTC value that remains plus the actual income stream from the CNTC will be amortized over a number of years and treated as the seller's level of income for purposes of alimony and support. This is an interesting possibility to consider in the circumstances when it might prove relevant.

Date of Valuation

One of the more complex and interesting items for us to ponder is the issue of the choice of the date of valuation of the business and the interaction of that with practical and equitable concerns. Although in some jurisdictions, value is as of the date of dissolution or distribution, for purposes of this section, the basic premise is that a business, as the classical active asset, is valued for marital dissolution purposes as of the date of complaint (DOC) (variations exist, but put those aside), meaning the proverbial clock stops at the filing of the complaint. The business valuation process then begins soon after the DOC, and depending on many factors, a value conclusion is reached from several months to one or two years after the filing of the complaint. Again, depending on many factors, the actual marital dissolution and payment to the nonbusiness spouse of his or her share of that business happens from one to three years or more after the DOC. For those of us dealing with value as of the DOC, at least two broad concerns arise from this process: the practical concern about what information can or cannot be used in the valuation process and the equitable concern about the potential for a significantly different value when the actual marital dissolution happens as contrasted to the DOC.

From a practical point of view, we are often faced with the conflict between valuation theory and real life experience and practice. Simply presented, *valuation theory* is that value as of a certain date must be based only on what was known or knowable at the valuation date. By way of example, this means that information, news, or events happening one year, six months, one month, one week, or one day after the DOC (after the valuation date) cannot be considered and are irrelevant to the valuation of this business as of the DOC. This book is not a valuation treatise and will make no attempt to go into the many nuances and complexities involved.

One of the difficulties with the concept of known or knowable is that not everyone will necessarily agree about the state of knowledge at a point in time. What if the information existed in raw form but was not collected or published in a readily accessible form until subsequent to the DOC? For instance, data to provide us with market comparables or the state of the industry existed but hadn't as yet been organized to the extent that it would be easily accessible as of the DOC. Generally, that the information existed is considered sufficient to warrant its permissibility for valuation purposes.

However, if six months after the DOC, while the valuation experts are busy performing their investigation and valuation, the business lost a major customer or gained a major new customer, to what extent, if any, should that weigh on the valuation being performed as of a point in time six months earlier? This is not raising the issue of changing the valuation date or performing two valuations; this is a very basic issue about whether, in such a situation, an event happening six months after the valuation date should be taken into account.

The existence of a large customer as of the DOC was no secret, and the valuation expert would have taken that into account as a risk factor in valuing the business. However, that is not the same as knowing that the customer was lost. Businesses are always trying to acquire new customers, and efforts might have been going on for quite some time to secure a large new customer; it just didn't happen until six months after the valuation date. How much of that should be taken into account? How relevant is a gain or loss that may be offset in due course?

Do we also need to look at this from a practical point of view? If this was a commercial transaction, and the acquiring company was performing its due diligence and found out that a major customer was lost, is there any doubt that that information would negatively affect the offer and value? Conversely, if during that due diligence, the company being acquired obtained a new major customer, is there any doubt that the seller would be trying to receive additional value because of this change? Why should valuation in a divorce context be any different? Because it is divorce and because at least to a degree with a business, we are concerned about the active asset issue, is it appropriate to treat divorce valuation differently? If so, how much differently and when?

Of course, we also have the equitable issue, and although it can cut both ways, more often, a concern is expressed about equity on the downside rather than upside (that is, it is inequitable to force a sharing of lost value but maybe not so inequitable to not allow a sharing of increased value). Forgetting valuation theory and what was known or knowable at the DOC, if we are either trying to negotiate a settlement or going to trial one and one-half years later, how much does the business's current situation versus where it was at the DOC matter in resolving the case? The kind of easy one is the extreme when the business simply has no value because it is now bankrupt. That one is almost too easy because a very strong argument could be made that it would not be equitable to force the distribution of a share of value that no longer exists.

However, when we get away from such an easy absolute, the judgment calls are not so clear. What if the business is only weaker (not defunct) at this time versus where it was one and one-half years earlier? Who determines that it is weaker? Does the business require another financial investigation and valuation, and what will that do to bringing this matter to a conclusion? Is the downturn merely cyclical, and can we expect that the business will recover to its previous level in the normal course of operations? How much of a moving target can the litigants and system tolerate? A *moving target* means forever pushing back the ultimate date of resolution, as well as increasing the fees.

What about the other direction: the business has increased in value? Do we have the same issues here? Who says that the business has increased in value? By how much has the business increased in value? Are we faced with an active or passive argument that the business increased in value because of postcomplaint efforts; therefore, the increase is out of the pot? On the other hand, this business has been a martial asset for a number of years; the marital partnership concept must prevail; and the increase subsequent to the DOC was at least in part (if not in its entirety) the result of years of marital devotion, with the culmination being realized at the current time. Again, how much of a moving target can we tolerate? Is the (alleged) increase real or merely a cyclical upturn in the business's fortunes?

When faced with these types of issues, one possibility is to keep the door open longer to provide either side with the ability to rebut or reaffirm. However, that again creates the moving target issue, an end point that is perhaps never in sight, and continuing and escalating fees. Perhaps instead, the DOC valuation will be used, with the ability to revisit the valuation one or two years later. Of course, that is fraught with many issues, such as reopening the case; reopening the wounds sometime in the future; additional costs and fees; and once again, disagreement about the existence of a larger or smaller value. In addition, this simply skirts practical and equitable issues at the present time.

In regard to a change in value, reference was made earlier about the issue of cyclical fluctuations and whether what appears to be an increase or decrease in value is merely the result of cyclical fluctuations. Quite possibly, the value really hasn't changed, and in the normal course of business operations, we will shortly see the flip side of that cycle. Let's put aside such cyclical concerns and deal with the magnitude of change. We are now looking at this business one and one-half years after the DOC because one side or the other is claiming that the business has changed in value. For this purpose, it doesn't matter whether that change is an increase or a decrease; we are dealing with the fact (or is it a fact) that it has changed in value. How big of a change warrants recognizing a change in value?

Remember that valuation is a subjective process and that a modest change in value can easily and legitimately arise from any of various subjective determinations of the valuation expert. Therefore, we would probably need a somewhat significant change in value to warrant it being considered in this negotiation and settlement process. We have at least two concerns: absolute dollars and relative dollars. For instance, if we are dealing with an absolute dollar change of $100,000, does it make a difference (it almost certainly does) whether that is a $100,000 change in a business valued at $5 million versus one valued at $300,000? In the former, it is less likely that the litigants would seriously pursue this issue; in the latter, it is extremely likely that someone would pursue this issue.

Alternatively, if we are dealing with a 10 percent change in the value, there would probably be a reaction in the opposite direction from the illustration just given. A 10 percent change to the business valued at $5 million puts $500,000 into play, which is certainly a significant amount and one that would likely be pursued by one side or the other. On the other hand, a 10 percent change to the business valued at $300,000 only puts another $30,000 into play. Although probably important in the lives of the people involved, the rather modest absolute dollars involved would mitigate against any significant efforts to bring that into play.

Tied into all of this is ownership interest. The discussion here assumed that the business was owned by one person or by marital estate. If we were to throw in the variable that we are only valuing a 30 percent interest in this business, that makes these issues that much more complicated.

Improper Actions—Impact on Value

Now that the title of this section has gotten your attention, let me tell you that the issues being considered are financial, not salacious. To what extent, if any, do clearly inappropriate activities affect value? Concerns here are for egregious perquisites (personal benefits paid by the company), unreported income (URI), licensing issues involving regulatory bodies, failing covenant requirements, violating franchise agreement provisions, very poor accounting, selling products with implicit or explicit guarantees that cannot be supported, and other areas that cannot be specifically mentioned because they range far and wide and tend to be particularly unique concerning the business at hand.

As a general comment, if we are an outside third party trying to buy a business, many of the issues applicable here would probably have no impact at all on the value if we are contemplating an asset purchase rather than a stock purchase. However, certainly within the context of divorce, although the valuation theory is what would be paid by a third party, it may be necessary to take into account the specifics of the business at hand and what damage to value there might be because of any of these actions.

In the area of tax-related wrongdoings, we have egregious perquisites and URI. Generally speaking, when those types of activities are commonplace for the type of business (that is, URI in many cash-type businesses), the valuation being considered implicitly understands the nature of the business. On the other hand, when those types of activities would be clearly frowned upon (for example, in a professional practice), then it is more likely that there might be a degree of negative impact on the otherwise determined value. How much negative impact is one of those questions for the ages.

In a similar vein are problems involving licensing, regulatory body issues, and violation of franchise rules. If serious enough, these could substantially eviscerate the value of the business. However, it is possible that those problems (damage to value) might only exist in the hands of current ownership, whereas a very viable business operation that has a "normal" value to the outside world still exists. It may be that these problems (violations) can be satisfactorily addressed in a fashion that does not cost too much in order to rehabilitate the company and bring it back into the fold. Failing to meet bank covenants can be very serious; on the other hand, depending on a multitude of factors, that issue could be nothing more than a temporary blip that the lender will ignore.

Poor accounting usually is not significant enough to warrant an impact on value, although particularly bad accounting can create a level of uncertainty about the reliability of the figures and, thereby, have a negative impact. If it is in an area where instant accessibility to reliable information and company finances is critical, then very poor accounting certainly may affect value.

An area not usually experienced but one of some interesting adverse potential is when a company sells its goods along with some form of guarantee that it will provide service in the future (for example, reimbursement, a guarantee, or the like), but that business simply does not have the wherewithal to back up nor does it reinsure its promises. For instance, if a manufacturer of a product promises to replace the product if it is defective but makes no internal financial reserve for this replacement, does not buy coverage by or through an insurance entity, or has sold many of these products with a history of defects, that company may be facing devastating liabilities. This concept assumes something far more substantial than merely normal business practices and responsibilities.

Inflation—Impact on Value

This is likely only an argument if we are dealing with a separate active asset in which a value is established either at the time of the marriage for an asset that existed at that time or at the point in time during the marriage when the asset was gifted or inherited. Is it appropriate to impact the starting point value (date of marriage or date of inheritance or gift) for inflation?

The following is support for that concept:

- It is fair and necessary in order to properly provide for the true economic change in the value. To not remove the inflationary aspect of the increase in dollars would be to unduly enrich the other spouse.
- Had that same asset been in the form of a passive asset, such as stocks with a broker, a treasury bill, or a savings account, it would have benefited as a general economic issue from market returns over the long run and as a reasonable benchmark (at least) at the rate of inflation. The only argument to make would be that such an increase would be out of the pot.

The following are the arguments against that concept:

- Both parties are ending the marriage in today's dollars, and to that extent, whatever the nonbusiness spouse receives will be affected by whatever inflation existed over that time frame. To take out the inflation would be, in effect, to deprive that spouse of today's dollar value.
- Although the increase in value on a passive asset, such as a brokerage account statement or money in the bank, would be out of the pot, that's a hypothetical and not the subject at hand. The specific case involves an actively managed business, and that cannot be simply equated to a passive asset.
- Arguably, a business's value (an active asset) would not and could not simply increase at the rate of inflation were it not managed actively. Without active management, it is likely that the business would cease to exist.
- Studies have suggested that there is an inverse relationship to values in the market and inflation. Publicly traded stocks tend to perform better (increase) in times of moderate and low inflation than in times of higher inflation. Thus, by this line of thinking, inflation hinders value appreciation.

Some very practical are issues involved, even if we put aside the theoretical issues. For instance, unless the starting point (carve-out value) is substantial, odds are that the amount of money involved is not all that substantial. If the business was worth $100,000 at the time of marriage, and it is worth $1 million 15 years later, and the cumulative rate of inflation during that 15 years was 50 percent, all that this approach does is remove $50,000 (50 percent of $100,000) from the otherwise $900,000 ($1 million less $100,000) pot. On the other hand, with the same ending point of $1 million but a starting point of $500,000, we would be talking about removing $250,000 of the $500,000 increase (not an insignificant consideration).

The second related aspect is simply the rate of inflation. During the last 10 years, inflation has been relatively modest. Thus, unless the time frame is long or encompasses a relatively high inflationary period, the magnitude of what is involved may not be all that substantial.

Location

In the valuation of a business, sometimes, location is critical to the value. This is more than merely saying that the value of a business may differ if it is located in New York versus Los Angeles versus Miami. The issue here is not macro- but, rather, microgeography. If we are valuing a manufacturing operation that has polluted its property, the present location may be somewhat unique and essential because trying to value that entity apart from the property may not be feasible. If a restaurant operates within a country club and has a superb view of the rolling countryside and golf course (a view that cannot be replicated), the uniqueness of that location may weigh heavily on how the business is valued.

Most classical white collar, professional-type businesses are not in any way tied into microgeography. A law practice, an accounting practice, and so on can typically and fairly easily change location by moving next door, around the corner, or into just about any other office building complex without affecting value. To a degree, that might also be the case with a retail business, but the difference of moving one block or around the corner off the main street might be significant. How unique is that location? Is it practical to expect that business to be able to move laterally one or two doors down? Is that location so fully rented that the risk of the lease expiring and having to move even around the corner or to the next block with less foot traffic is a serious detriment to value? This issue can get far more complex when involving a manufacturer or a business that relies on the visual impact of its existing location.

Perhaps this involves an undesirable business—one that makes noise, causes pollution, or creates a lot of traffic. Existing where it does, it operates and is, perhaps, grandfathered into its location. If the lease is to expire soon, moving may not be practical because that business may not be accepted in other locations because it is an undesirable neighbor.

Of even more complexity is the issue of comparing being a tenant with owning the property. Certainly, a tenant is exposed to many of the concerns previously expressed. However, if the interests that control the business also own the underlying property or if the company itself owns the property, that doesn't eliminate the possibility of the importance of the location. For instance, to value the property separately, which is typical in these situations, and then take the position that the business has its own stand-alone value as contrasted with the real estate might ignore the importance of that real estate to the business if it fits into any of the various categories previously discussed. Then again, how unique is unique, and how special is special?

Market Approach

What could be better than the market approach for determining the value of a business? After all, this approach relies on real-world market transactions to provide a benchmark for determining the value of the subject entity. What could be wrong with that? The answer is plenty. Yes, in limited circumstances, the market approach can be and is an excellent and, sometimes, the best approach to determining the value of a business. However, when used for valuing a closely-held business, the market approach needs to be seriously challenged, not because it is necessarily wrong but because so many things could be wrong with it, and for most small and even many midsized businesses, the market approach is fraught with shortcomings.

The market approach contains three general methods: public company comparables (or guideline companies), private company transactions, and rule of thumb. Rule of thumb doesn't rise to the level of the other two and will be discussed in a separate section.

Although a lot of information is available on public company comparables (one of the benefits of the companies being public), the reality is that for the vast majority of the valuations that we as experts in the divorce field handle, public company comparables simply cannot be used. The reasons include the following:

- Typically, public companies are hundreds and thousands of times larger than the subject entity. That brings comparability into question.
- Public companies tend to be far more dispersed, have far more locations, and sell into a much broader market than private companies. The difference can be so substantial that, again, we cannot consider them comparable.

- Public companies usually have multiple products and multiple lines of sale. In contrast, privately-held companies are generally far more limited.
- How many companies are available for comparison? If only one or two are available, it is questionable whether a real market comparable base has been established. Experts generally agree that we usually need from a few to several public companies to make a reasonably reliable comparison.
- In some situations, it is simply impossible to find comparables (for instance, no publicly traded medical practices exist).
- Imagine your reaction to an expert who compared the local computer store retailer with Dell, a manufacturer earning $5 million with General Electric, or a one-doctor surgical practice with Tenet Healthcare.

So, comparing with public companies is only infrequently applicable. Instead, use private company transaction databases, which is what virtually all valuation experts use. At least then we're comparing private companies to private companies, typically of much better alignment in regard to size. However, the following problem areas exist:

- *Comparability*. At least with public companies, significant information is available, so that it is understood what the public companies do and, thus, how they are or are not comparable. In private company databases, usually only a few words or, at the most, a sentence describes the primary business of that company. Many times, it is difficult to get more than a rough sense that a company listed in a private transaction database is indeed comparable with the one being valued.
- *Extent of information available*. Not only is there a question about the extent of comparability, but the reality with virtually all private databases is that the extent of information available is very limited. Typically, the database will have no more than the most recent year (prior to the transaction) sales; one or two key financial measures, such as gross profit and net income; very little information about the balance sheet (assets and liabilities); nothing about the trends of the company; and maybe some limited information about compensation taken by key people (but sometimes nothing about the number of key people and their roles and responsibilities).
- *Geography*. In some situations, the location of the business is very important relevant to its value and acceptability as a comparable. This is certainly not true for every type of business, but in many cases, when this information is provided, the transactions are in locations other than the subject entity.
- *Stale transaction date*. With public companies, we are getting today's market value, or we can step it back one month, one year, and so on. With private transaction databases, the transactions (and all financial data) are based on when these businesses were sold; in many cases, the transactions are from a few to several or more years old.
- *Reason for the transaction*. What we will virtually never see in these databases is the reason for the transaction, and even if we do, we certainly won't have the background information. Was the transaction because the seller was ill or old and had pressure to sell? Was the transaction truly at arm's length, or did it involve a family member? Was

the business on the market for one week or five years before it sold? Was the sale triggered because the business lost a major customer or gained a new major customer?

- *Strategic acquisition*. Along the lines of the reason for the transaction is the issue that it might have been a strategic acquisition, in which case the price was likely more than fair market value and even more than fair value.
- *Net income*. Remember that these are private companies, and net income is a very fluid phrase. We could not possibly know from these databases how net income was derived or what type of expenses were or were not expended through that business. For example, we cannot rely on those databases to contain adjusted normalized net income, which we would use in determining the true income of a business.

That is not to say that we can never use the private transaction databases; it's just safer to use them when a relatively high number of transactions in businesses are not too exotic (providing us with a comfort level about comparability). Also, it is important that the benchmarks for value (whether sales or income) have at least some serious bunching in order to enable the determination of a norm. Some of our peers consider the use of the transaction method only suitable as a sanity check.

Price-Earnings Ratio

Even in the recent recessionary time, the Wilshire 5000 had an average price-earnings (P/E) ratio of 17, which as we all know translates into a cap rate of under 6 percent. With that in mind, how do we justify the numbers that we use in our cap rate buildup, which virtually never get down that low and are typically 2, 3, or 4 times that much? Further, historically, the lowest the P/E ratio gets for public companies is approximately 12, which represents a cap rate of slightly over 8 percent. Thus, virtually any way we look at it, from a broad spectrum of public company multiples, the P/E ratio tends to be far greater (the cap rate far lower) than almost anything we ever use in our valuations. The obvious question is, why? None of the usual answers, such as capital market access, daily public trading, greater dissemination of information, and so on, can adequately explain why public company multiples blow away private company multiples. One possible answer is that small companies are simply different. However, if that's the case, then a related question is, Why do we use (how can we justify the use of) Ibbotson, Morningstar, or Duff & Phelps data that is based on public companies?

Professional Fees

In performing our forensic analysis, if we come across professional fees relevant to the acquisition of a business or sale of the current business or negotiations for something along those lines we have been given a bonus in our quest to analyze and value that business. Use that information as a springboard for pursuing its relevance to valuation. Certainly, if negotiations to sell the business are occurring it would not be unheard of for the business owner (particularly in regard to a lucrative and very rewarding deal) to conveniently overlook mentioning that information in whatever financial disclosure documents were provided. Furthermore, sometimes, those acquisitions are strategic or synergistic; thus, their value might far exceed our fair market value or fair value approaches to valuation for purposes of the divorce litigation.

Alternatively, there may be indications of negotiations to acquire another company (likely a competitor) or, perhaps, an operation that might improve the vertical integration of the subject business. If that is the case, get as much information as possible about this potential acquisition, including the valuation metrics that are being considered in the negotiations for that business. If it's a competitor, there may be useful benchmarking for valuation purposes. After all, if the business that we are investigating is willing to pay six times earnings before interest, taxes, depreciation, and amortization for a competitor, that may be an indication of what the subject business is worth. At the very least, it is something that we cannot ignore, and it is something we need to consider within the context of what we are doing. In a vertical integration situation, the concept is the same. It is important not to ignore (obviously, you first have to know that it exists) information that may be relevant to our valuation process. Even if we make the decision that the information is not relevant, that decision should be made from an informed point of view, rather than not being made because of ignorance.

Reasonable Compensation

In probably every income approach to valuation, as well as in some market approaches and the hybrid Revenue Ruling 68-609 approach, it is necessary to determine the economic income of the business. One of the key factors in that process, many times requiring the largest adjustment, is the determination of reasonable compensation. The owner of a business can take out as compensation or in the form of benefits whatever he or she desires, subject to cash flow and other business needs. However, other than by coincidence, that compensation is not the same as the *market compensation*, which is what the business would pay someone to stand in the owner's shoes, do the job, and get paid what the market dictates is fair. Anything above that is part of the economic income of the business. Sometimes, especially when the business is not doing well, the owner gets paid less than a replacement salary.

Usually a significant adjustment, reasonable compensation warrants a lot of attention and adequate support. In evaluating our determination of reasonable compensation, as well as the other side's expert's determination, we should be asking questions along the lines of, what sources were used, and how authoritative are those sources? A danger sign is when the expert opines purely based on his or her own so-called expertise or cites some vague, undocumented source, such as "My firm did a study of some of its clients."

Among the issues to be addressed is obtaining an understanding of the subject's job functions, experience, and number of hours worked. In regard to the last item, if it is normal for someone in that position to work 50 hours per week, but the subject at hand is a workaholic and puts in 80 hours per week—and by that is more effective and covers more job functions—then that person should be worth proportionately more than the otherwise appropriate benchmark.

Although the quantity of work effort, often considered the number of hours worked, can be useful in arriving at reasonable compensation and, certainly, serves as an easily used barometer, this area must be approached with caution because not everything done by the boss or owner can be fairly measured in hours. Many times, the boss's or owner's performance contains certain qualitative, rather than quantitative, elements, and the blind use of hours may do an injustice to the determination of reasonable compensation. We also have some very tricky issues when we are dealing with the so-called superstar for whom there may be little or no comparable benchmarks.

Another issue is that of an executive filling multiple roles and whether we are simply considering one job with broad areas of coverage or, perhaps, someone who is filling two job categories. In a sense, the latter is common for closely-held business owners but hardly unique. Oftentimes, we need to address the reasonable compensation for different functions and then weight them in some fashion to recognize the functions that are filled.

Relative Power

The question here is essentially along the lines of, is every identical percentage interest (think in terms of 4 people each owning 25 percent of the business) worth the same? Perhaps at first blush, it would seem almost a silly question; we are all trained accountants, and 25 percent is 25 percent. However, is that necessarily the case? To take 2 simple extremes, assume on one hand that we are valuing the 25 percent interest of the key mover and shaker of the business; on the other hand, we are valuing the 25 percent interest of that ne'er do well brother who inherited his 25 percent share and is paid not to show up. Are those 25 percent shares equal? When does 25 percent not equal 25 percent?

In pure valuation theory, if we are valuing a 100-share block of a multibillion dollar company, all the shares are worth the same. Does that necessarily hold true when we are valuing an interest (usually a significant interest) in a closely-held business in which individual roles and interaction among owners is a completely different world than in the classic billion dollar public company? Assume for the moment that the business is worth $1 million. As the buyer, would we pay the same $250,000 to buy out the mover and shaker (without whom that business is not going to be worth $1 million) as we would for the ne'er do well brother, the absence of whom would not cause the business to even experience a blip?

Turn the question around: would the mover and shaker and the ne'er do well brother be willing to sell each of their respective shares at $250,000? In one sense, clearly, the interest of the mover and shaker is far more valuable than the interest of the ne'er do well brother. On the other hand, if we are talking about each of them considering selling their respective interests, there would be an excellent argument to make that the interest of the ne'er do well brother is worth more than that of the mover and shaker. Wouldn't we be willing to pay more to be part of a business with a dynamic leader (meaning buying out the ne'er do well brother) than we would to be part of a business with no such dynamism (meaning buying out the mover and shaker)? Does that result in a perverse logic that the interest of the weaker shareholder is more valuable than the interest of the stronger shareholder? How relevant is that? Are we talking about valuing 25 percent, or are we talking about valuing the interest in the hands of a particular person?

Typically, when we are involved in a divorce action, we are only valuing a particular interest; it would be rather unusual to have the situation of having to value two of these interests (as being hypothesized herein). However, that does not really change the quandary of this concept. Does it make a difference which interest we are valuing, and does it make a difference who owns that interest? Would we approach and conclude our valuation the same way in both of these two cases?

Rule of Thumb

Attention, the initials of rule of thumb are ROT, and many of us believe rules of thumb are exactly that: rot. Interestingly, in some sense, ROT is the precursor to a market approach based on private company data. Perhaps the major, critical difference is that the market approach develops with the accumulation of a number of transactions and reasonably sufficient data to provide data points and bases for comparison. On the other hand, ROT tends to be less authoritative and provides ranges that can border on so wide to be almost meaningless and that are generally less reliable and less supported.

It is not unusual to see ROT indicate that the valuation multiples are, by way of example, between 50 percent and 125 percent of annual sales, between 2 and 4 times the owner's discretionary income, between 1½ and 3 times gross profit, and so on. All of these are not only approximations, but they are also fairly wide ranges that cover a lot of territory and tend to provide nothing more than a very crude sense of whether calculations done in some other fashion are within the so-called ballpark. Even then, we don't know who built the ballpark and its dimensions.

Another problem with ROT is that it is sometimes published semianonymously and without adequate source identification. One example from a case that we had a while ago involved a pool service business in Monmouth County, New Jersey in which ROT indicated a certain multiple of revenues. From an income point of view, it didn't seem to make any sense. When the publisher of the book in which this ROT was published was called and asked to provide more information, we were advised that the source was one business broker; thus, this ROT was really the opinion of just one person. When we asked further, we were also told that this one person only did business in Arizona where, of course, outdoor swimming is a year-round event, as contrasted with perhaps three months in New Jersey. Thus, this ROT was absolutely meaningless for the subject business.

S Corporations and Pass-through Entities

One of the hottest of the "hot button" issues in valuation currently is that of S corporations and other pass-through entities (PTEs) (that is, partnerships, LLCs, and LLPs). For purposes of our discussion, we will call all of them PTEs. The issue here is, are PTEs valued differently? In other words, assuming that we have two identical business entities, one operating in the form of a C corporation and the other operating as a PTE, is the value of the PTE worth more or less than the value of the C corporation merely because of the form of entity? That is one of the current hot issues in business valuation, with a majority of valuation experts (as this author understands it) taking the position that entity form does not matter because value is value. A minority have taken the position that a PTE has inherently more value than a C corporation, and virtually no one (apparently) is arguing that a PTE is worth less than a C corporation.

The thought goes along the lines of a PTE pays no corporate tax; rather, the income flow goes directly to the owner(s) who then pays taxes on that income. Therefore, a PTE has no tax and is worth more than a C corporation that has that same income encumbered by a tax. In fact, there have been various tax and appellate court decisions (involving federal estate tax law) on exactly that point, supporting the concept that a PTE is inherently worth more than a C corporation. Notwithstanding those findings, most valuation experts still believe that is incorrect. Further, at least for the purpose of divorce practice, it is questionable whether federal estate tax law should be determinative. Also, at this point in time, there appears to be little to no empirical evidence to suggest that a PTE sells for more than a C corporation.

A counter argument is that there should be no difference in valuation because it somewhat defies logic to suggest that two otherwise identical companies—one a C corporation and the other a PTE—can be valued differently merely because of the entity form that was chosen. In many cases, that can be undone or done very easily; with the filing of a simple piece of paper, a C corporation can elect S corporation status. In addition, not for a partnership entity but for an S corporation, certain restrictions on ownership exist, such as a foreigner cannot be an S corporation shareholder nor, in most cases, can another corporation, and S corporations are limited in regard to the number of shareholders. None of those restrictions apply to the other forms of PTEs. Often, as a practical matter and sometimes as required by an agreement among owners, the PTE will distribute at least enough income (for example 40 percent) to provide the owners with the cash flow necessary to cover their tax burden on the income passed through. In this manner, the PTE is effectively paying the same tax as the C corporation but using the owners as a conduit.

An underappreciated aspect of this area goes in the other direction, and this is an area for which little to no literature exists but that would suggest that a PTE can be worth less than a C corporation. At least two aspects of this issue lend themselves to this logic, one of which applies all the time to a PTE, and the other applies sometimes:

1. Among other things, the concept of value assumes an informed buyer. Thus, in the hypothetical discussions and negotiations regarding valuing and buying a PTE, the buyer will be quite aware that the entity operates in the form of a PTE. As such, the buyer will also be aware that the PTE provides certain tax advantages to the seller that a C corporation does not (a potentially significant tax savings on the sale of the business). Thus, armed with that information, it is logical to assume that a buyer, in negotiating the price, will look to take advantage of what he or she knows will be the lesser tax burden that the seller will incur versus what the seller would incur had it been a C corporation. The buyer will seek to share in the tax benefit and can be expected to offer and pay less. The seller

would be willing to accept less because the government will cover some of the difference in the form of lower taxes.

2. Assume a PTE owned 60 percent by one person and 40 percent by another, and the interest being valued is the 40 percent interest. When valuing a minority interest in a PTE, especially when there is a majority interest, a concern is that the income of the PTE is taxed to the owners in proportion to their ownership interest. Further, the income is taxed regardless of whether any actual cash flows to the owner. If a PTE shows a $100,000 net profit, the owners will pick up that $100,000 on their tax returns, regardless of how much, if any, of that income is actually distributed. Thus, in this example, if management decided that it needed to retain the $100,000 of income in order to conduct business, the 60 percent owner would have to reflect $60,000 of income on his or her personal tax return, and the 40 percent owner would have to reflect $40,000 of income on his or her personal tax return, with no cash flow to cover the tax burden of either owner. Most of the time, PTEs distribute at least the tax burden on the income and usually somewhat more. However, that is not guaranteed because it is not a tax requirement. Thus, if we have a 40 percent owner of a PTE facing a 60 percent oppressive owner who, perhaps, decides not to distribute any or enough income, in a sense, we can have a minority shareholder squeeze or, perhaps, oppression, but that's another issue that can be expensive to pursue. Meanwhile, the minority shareholder is subjected to the pass-through of income for which he or she doesn't have the cash to pay the taxes. This would not be the case were that a 40 percent interest in a C corporation. Thus, arguably, that 40 percent interest in a PTE is worth less than the comparable 40 percent interest in a C corporation.

At the time of writing this book, there was considerable discussion about the likely increase in tax rates, which certainly may have come about by the time this book is printed and you reading it. The possibilities that were being considered included not only increasing the personal income tax rates, which along with the special Medicare investment tax would represent a significant increase of the upper levels, but also the possibility of reducing the corporate tax rates (the concept being to make U.S. corporations more competitive internationally). If either or both of these possibilities come about, then there may be a rethinking about the popularity of S corporations; the pendulum may swing back to C corporations, with their greater ability to control income realization (allocation between the owners and company). If so, that may also affect relative values between an S corporation and C corporation (negatively in regard to S corporations) or at least provide a degree of counterbalance to some of the thinking that S corporations are worth more than C corporations. Certainly, none of this is definite at this stage and, perhaps, may never really become much of an issue, but it is something for consideration, especially in response to those who argue the alleged inherent greater value of an S corporation to that of a C corporation.

Standard of Value

The issue of the standard of value used in divorce is a rather boring topic. For standard of value, there are many rulings to consider on a state-to-state basis, but for illustrative purposes, we will reference *Brown v. Brown* 348 N.J. Super. 466 (App. Div. 2002). Before *Brown v. Brown*, the New Jersey standard of value in a divorce case was fair market value, which meant an assumed value that an arm's length buyer would be willing to pay and the seller willing to accept. With the advent of *Brown v. Brown*, it is now generally accepted in New Jersey that the standard of value is fair value, which is essentially the same as fair market value, but absent exceptional circumstances, it doesn't allow discounts (such as for marketability and lack of control).

Another stream of thought says that the standard of value should be value to the holder (VH) and that the language in *Brown v. Brown* really means VH; however, no standard accepted definition or framework for developing a so-called VH exists. If you ask 10 valuation experts to define VH, you will probably get 11 different definitions. Putting it into practice would be an absolute nightmare, unless its meaning was clearly defined and explained.

By simple way of trying to expound upon the confusion, does VH include sweat equity? Is it based only on the cash flows to the spouse at issue? Do cash flows include an assumed tax burden on benefits that historically do not get taxed? Does it matter if income is retained by the business and not distributed to the business owner? Does the business owner's ownership percentage matter?

What if the income generated by the business is no more than the owner would earn were he or she employed in the general corporate world (that is, the business is producing nothing more than a living wage)? In such a situation, typically, there would be little or no value to that business. However, under VH, would value be placed on that business because it is worth something to this business owner not to have a boss, to be independent, and to have a lesser risk of losing that source of income and employment? On the other end, despite what might otherwise be a modest value, the business owner has aspirations of taking that company public or, perhaps, growing it to be a major force within its industry. In that case, do we have a very large VH? Absent a clear consensus, VH can mean virtually anything we want it to mean.

- **Fourth Valuation Approach**—the long used and well respected valuation method called "the house in exchange for the business" is overdue for recognition as the 4th approach to valuation.

URI—Effect on Value

Does the existence of URI affect the value of the business, and if so, in what way? This issue does not deal with the rather obvious aspect of added-back URI that results in the determination of additional income and value being determined on that basis. In that sense, URI, as well as reported income, affects value. The issue under consideration here is whether something is inherently special about the nature of URI that warrants a different treatment in the determination of value.

Other than as possibly a factor in determining the appropriate tax rate to apply to the business's economic income, we tend not to see any different treatment in arriving at a value conclusion merely because some part of the economic income is derived from URI. In that sense, income is income, and valuation approaches don't change.

However, we may (and sometimes do) approach the valuation of a business with URI differently than one without URI. We need to establish a very important base point: are we dealing with a business in which URI is the norm, such as restaurants, beauty parlors, and many other retail businesses that receive cash as a significant portion of the sales transactions? This is in contrast to when URI is not the norm, or perhaps, it would be frowned upon and potentially cause the loss of a license. In the former situation, generally, the only difference we might see in a valuation approach is the use of a lower tax rate than would otherwise be the case, which will be explained a bit more immediately following. However, in the latter approach, we might see a valuation approach that also increases (perhaps significantly) the capitalization rate because of the greater risk and exposure that such activities present in that type of business.

When valuing a business that has significant URI, particularly when that is the norm, it is not unusual to see a lower tax rate being used in developing the value. The typical approach to determining value is to arrive at the adjusted income, then tax effect it based on the appropriate tax rates for that level of income, and then capitalize the posttax income. When applying theory to a business with significant URI and it can be anticipated that most operators of that type of business would conduct themselves in a somewhat similar fashion, some experts believe it is inappropriate and unfair to apply a full tax burden on income that will never be fully taxed. In such a situation, we may see a lower tax rate or, perhaps, a blend that takes into account a degree of URI.

In those businesses in which URI is not the norm and may be a serious problem, the tax tends to be at the appropriate and full rates because value is supposed to be an arm's length arrangement. However, because of the improper way that business has been run (from the perspective of reported income), it is possible that the valuation expert will deem it necessary to factor in additional risks, resulting in a higher cap rate that results in a lower value. This approach might be considered regardless of whether one were to look at this from the point of view of the business as an entity or from the angle of the owner(s)—the wrongdoer(s).

It is sometimes a short step from the preceding (dealing with URI) to the same type of consideration when the issue is perquisites (not the standard health insurance) paid by a business on behalf of its owner. As a practical matter, perquisites within a reasonable range do not raise any particular concerns and would not rise to the level anywhere near the concerns of URI. As a word of caution, what is "reasonable" can vary, depending on the extent of case law in each state. On the other hand, all of us who practice in this field have come across multiple situations when the extent of perquisites (blatantly personal expenses) paid through the business are to such an egregious degree that it is every bit as much tax impropriety (tax fraud) as failing to report revenues. These situations call for a judgment call about whether the tax to be applied to the adjusted net income should be at full statutory rates or some lesser level to reflect that the economic income has not been and may never be fully taxed. This has no simple answer, and likely, no answer to which all practitioners would agree.

Valuation Determination

As part of wrapping up our valuation, try to take a step back and see if it makes sense to us from a common sense point of view. Sometimes, that is really very difficult for any of us to do, not because we do not have common sense but because we are already wedded to the work we have done and may not be the best ones to make a dispassionate arm's length review of the numbers and be critical of ourselves. That is simply human nature. Thus, maybe we need someone else in our office (obviously of experience and knowledge of the field) to take a look at what we have done and put it through the usual sanity or smell tests. Would we be comfortable recommending that client of ours buy (or sell) the business for the value that we just concluded? If we are not comfortable making that recommendation on both the buy and sell end, then maybe we don't have as good a value determination as we should.

If our value can't get paid back in a reasonable period of time (reasonable in the circumstances), then maybe we need to take a second or third look before we can consider the job finished. If we have made one or more critical and substantial assumptions (for instance, $100,000 per year of URI), how solid is the basis for that assumption, and what would be the impact if our assumption was significantly off? Along those lines, would changing one thing make a big difference in the numbers? In most cases, it probably would make a difference (for instance, maybe changing the income would have a huge effect on value). The point is that depending on what adjustments we made or (even more difficult) did not make, if one thing would make a big difference, then review that once more just to be sure that you did not overestimate, underestimate, or miss something.

> *A LITTLE KNOWLEDGE IS A DANGEROUS THING—When performing business valuations, it can make a big difference whether or not you have the slightest understanding of the work you are doing. We were investigating and valuing a small business on behalf of one spouse, and the other spouse had engaged another CPA with no credentials, unknown to myself or any of my peers as someone who does this work. Perhaps a bit atypical, but plenty of capable people are just below the radar screen. Were that only so in this case. This CPA apparently had heard that computer programs take the pain and effort (and shall we say intelligence) out of the business valuation process. He used some canned software that spewed out 70 separate valuation schedules (that is not a misprint). At least they were consistent because not one of them was useful or correct.*

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Lifestyle Analysis

THE BRADY BUNCH TIMES TWO—We have performed quite a number of lifestyle analyses for purposes of determining the marital standard of living (how the couple and children spent their money) to assist the litigants relevant to determining alimony and support. That tends to be a fairly routine type of analysis, but of course, each one has its own quirks. We were engaged to perform exactly this type of lifestyle analysis, but this one involved a family of 17: a husband and wife with 15 children. This analysis was interesting but essentially the same as performing your standard analysis of a husband and wife and 2.1 children; the numbers just tend to be a bit bigger. We prepared our report on behalf of the wife (as did our counterpart on behalf of the husband), and then, as the case wended its way, we were eventually called to testify. The husband's attorney challenged my ability and knowledge, stating, "I don't know if you're capable of handling this type of work; how many other 17-people families have you done?" Yep, he got me. I had to admit that I had not previously performed a lifestyle analysis for any 17-people families. In fact, under his withering and insightful questioning, I had to admit that prior to this, the largest family for which I had performed a lifestyle analysis comprised only 8 people.

The relevance of this chapter may vary from state to state, but in New Jersey we have found that the system often requires significant efforts be made in determining how the family (whether it be just husband and wife, or it involves children) lived, how money was spent, or not spent. Having done many lifestyle analyses, the purpose of this chapter is to provide a wide array of issues relevant to attacking and understanding the issue of lifestyle. You will hopefully understand that it is not as easy, not as black and white as simply saying that a certain amount of money was spent out of the checking account and that constitutes lifestyle. Whether an analysis involves issues of recurring versus non-recurring expenses; dealing with savings as contrasted with spending; spending fueled by debt; the practical concerns of trying to get access to financial records; or the potential dissipation of martial assets, as well as a wide range of additional topics, hopefully this chapter will enlighten you. It also deals with how to best and effectively cull data from credit card and bank accounts, and the interplay with business related perquisites. The chapter also goes into issues of addressing net disposable income, and nuances that makes that area not necessarily self-evident on its face.

In general, in our role in a divorce case, we often need to investigate and analyze the personal financial situation of the marital unit. As all business people and professionals know, closely-held small and midsized businesses are often but another facet of the financial persona of the owners. Many times, the business is the extension of the individual, and by the very nature of that close relationship and control, the business and personal financial affairs are, from a financial perspective, two sides of the same coin.

When someone owns or controls a business, it is all too easy and common for the financial dealings and relationships between the business and personal life to mesh. If the business needs funds to purchase equipment, a common quick fix may be a capital infusion from the owner's personal financial resources instead of a bank loan for the business. Conversely, if some additional personal funds are needed (for example, to purchase a car), it is not unusual for that business owner to "borrow" funds from the business or take an advance or a bonus. No formalities, such as approval from the board of directors, are necessary. If the funds are available, they can be and are used between the business and personal financial entities.

The financial relationship becomes even closer when the business owner decides to pay personal phone or utility bills or home repair bills through the business. It also becomes closer when the business deals with cash, and some part of its income never gets deposited in the business but, rather, finds its way directly to the owner.

We have an interest in the personal financial records, even when no improper or suspicious dealings or perquisites exist and all income is reported. For example, assume that this business owner took a $10,000 bonus in the past year. It may be important for us to verify that it was deposited into known family bank accounts. Even when business improprieties are not an issue, the security of the marital funds and potential concealment of marital funds may be issues.

In the absence of a business, when we are dealing with a W-2 employee or, perhaps, a family living off savings and investment income, we still need to review the personal expenses of the family. This lifestyle analysis (LSA) is typically needed to assist in determining how the couple or family lived for purposes of determining alimony and child support.

When seeking to review the personal financial records, typically we need access to all of the family's bank records, including not just the household checking account, but also that extra checking account maintained by the business owner as a personal account, the savings accounts, money market accounts, brokerage accounts, and sometimes even the accounts in the names of the children. Except for gifts and their own earned money, virtually all money in children's accounts comes from the parents.

Generally, we review at least a period of two to three years. If we suspect divorce-planning maneuvers, our financial analysis and investigation may need to go back further. This would be the case if the marital problems were fairly well known three years ago, and we suspect either party might have started taking protective steps, such as removing and concealing cash from the marital unit.

One important aspect of a review of the personal financial lives of the parties is to support the veracity of the reported income in comparison with their financial status and standard of living. Inconsistencies raise concerns, regardless of the direction of the inconsistencies. If the marital unit has been living well above the reported income figures, or the net worth is inconsistent with the known financial affairs, there may be the need to dig further. The opposite scenario may also raise suspicions. If the family unit is spending and living at a level below what it is earning (net of taxes), there should be an increase in the marital unit's net worth. If this has not occurred, we may need to question what is happening with the income that is being earned but not spent.

Conceptual and Overview Issues

The basic idea of preparing a LSA is to provide the attorneys, perhaps ultimately the court, and sometimes the litigants with an independently developed and supportable (more about the word *supportable* later) analysis or detailing of how this married couple or, perhaps, family lived and how they spent (or did not spend) their money for some period of time. For purposes of a LSA analysis, that period of time in question typically ends at approximately the time of filing the divorce complaint.

On one level, that sounds pretty straightforward and simple, but as will be developed in this chapter, the ultimate conclusion about lifestyle contains the potential for many twists and turns, variations, and interpretations. To provide us with a sense for some of the basic issues that we need to address, consider the following:

- What is the time frame? How many years are covered by this LSA? Typically, we are asked to perform a three-year LSA. However, nothing is particularly magical about three years. In my experience, we have used as many as eight years and as little as one year (if memory serves me correctly, perhaps even less than one year by taking a partial year and extrapolating the result). This is often a practical issue and usually determined by counsel, not us.

  On one hand, the concept is the lifestyle during the marriage. On the other hand, if we've got a 10-, 20-, or 30-year marriage, just how many years back are we going to go? How relevant are the numbers 20 years ago, and as a practical matter, where are we going to get those records, and how much is the client really willing to spend for this exercise? However, multiple years are generally important because they help (when aggregated and averaged) provide a leveling and eliminate, or at least soften, distortions and variations that might occur from year to year. Also, depending on when something is paid or a decision is made to buy, there can easily be an overlap from one year to the next. Once again, the use of multiple years helps reduce such potential distortions and fluctuations.

- Recurring versus nonrecurring expenses are frequently fodder for arguments (often more heat than substance). Let's face it, one person's definition of *recurring* and *nonrecurring* may not be the same as someone else's. For example, is the purchase of a car recurring or nonrecurring? It's kind of both. It certainly happens every once in a while, which would make it recurring. On the other hand, if we isolate one, two, or even three years of lifestyle expenditures, the presence of the purchase of a car within the context of a time frame of a limited number of years may be nonrecurring. So, we have a definitional problem. What constitutes nonrecurring (for example, frequency, size, and so on)?

  The reality of any substantial nonrecurring expense is that it often comes out of savings and creates a swing in savings. More about that later. A further practical issue is the magnitude of the expense. How important is it to try to argue that in a budget of $100,000 per year, the purchase of an $800 television is nonrecurring. When taking a step back and looking at lifestyle from a distance, we might even say that it consists of a multitude of nonrecurring expenses—almost everything is nonrecurring. That is more philosophical than practical, and we're not going to get too far into that discussion.
- Typically, depth is not one of our big concerns, but sometimes, the issue comes up about how finely defined the counsel or client wants the details analyzed. For instance, is it enough to know that the family spent $12,000 on food during the past year, or is it important to know how much was spent on behalf of each member of the family? (We will leave the issue of how to do this for another day.) If one member of the family has certain dietary issues that cause the food expense to be higher than normal, is it important to define that marginal difference? If we are analyzing credit card statements, is it sufficient to know that $50,000 was spent via credit cards during the year, or do we need to define and determine the nature of the 500 transactions during the year that made up the $50,000? Does it make a difference if we are looking at a general purpose credit card such as MasterCard or Visa versus a more limited, specific-purpose credit card such as a gas company card or store card?
- One of the more complicating factors and one that often separates run-of-the-mill LSA from the more interesting and challenging LSA is the issue of whether we are dealing with a "typical" rank-and-file employee versus an upper-level executive versus a business owner. The upper-level executive often brings in complicating factors (besides a higher level of income) that might include a generous expense allowance, exotic savings issues, deferred compensation, and a series of benefits. The business

owner may bring in some similar issues but even more so in terms of a slew of potential lifestyle expenditures paid by the business as perquisite items that simply do not show up on the reported income. Going even one step further, if we are dealing with a cash business, then we have the issue of the number of lifestyle expenditures that are below the radar screen.

- From our history and perspective, savings is the Rodney Dangerfield of lifestyle. All too often, it simply does not get the respect that spending gets. Again, more about that later. The issue here that is sometimes a very complicating factor is that from a cash flow conceptual point of view, savings is very much a part of lifestyle because it's another way that money is used. In a sense, it's the same as saying how money is spent, but for this purpose, it is not spent as in gone but, rather, used for savings and investment. This area has its own multitude of particular points and complexities, including swings from year to year, concerns about the reinvestment of interest and dividends, appreciation or depreciation on investments, principal pay-downs on a mortgage, deferred compensation, and other items.
- Generally, inflation is probably more often ignored or left unaddressed than it is considered anything of substance. At least a couple of issues arise here: one being whether the LSA that was performed is current or stale when it may actually be considered, litigated, or testified. The other issue that is generally of more substance and relevance would involve the number of years being covered by the LSA and what inflation may or may not have done to those numbers over the years. Of course, the overriding issue may be whether inflation is a factor at all based on the local jurisdiction. If the LSA provides a conclusion about, for instance, how much this family spent on food, and those figures are a few years old, perhaps it is important to take into account what inflation has done to the cost of food in the ensuing few or several years. However, in this instance, a simple inflationary adjustment (say along the lines of a consumer price index cost-of-living adjustment) cannot always be used.

  On one hand, assuming inflation is a relevant issue, upward pressures will be exerted on the cost of expenses such as food, clothing, and the like. On the other hand, think telephone service or computers. Over the past number of years, the cost of those items has come down—the opposite of inflation. Over the most recent year or so, maybe they are level. So, when technology plays a role, perhaps inflation is not a factor at all; perhaps deflation should be considered. One interesting mixed breed would be a typical mortgage. Of course, the real estate tax element of the mortgage tends to go up, but the principal and interest are fixed, unless we are dealing with an adjustable rate mortgage. For most mortgages, that means that only a (small) part of it is subject to inflationary pressures.

  Then we have utilities and gasoline. That area has gone through fluctuations that defy logic, as well as predictions. Is gas going to be $2, $3, or $4 per gallon? Directly tied into the cost of fuel is the cost of utilities. Depending on the time frame, their cost has increased far greater than any inflationary adjustment. On the other hand, if we change the time frame just a little, we may come to the opposite conclusion. Thus, whether inflation is a factor needs to be considered. If it is a factor, what does it really mean about the elements of the LSA that constitute the majority of the lifestyle expenses?

- Deficit funding is a potentially very complex issue, with truly difficult aspects and, often, an unsatisfactory resolution. Also, this may be far more common and prevalent during times of recession, unemployment, and general financial adversity. What do we do with the LSA when that lifestyle has been funded by debt? What do we do when some significant portion of that lifestyle exists only because this marital unit went into debt and increased its debt to afford its lifestyle? In developing an LSA, a very interesting and difficult issue is how to treat this debt and the expenses that are funded because of that debt. Sometimes, this debt is generated by continually dipping into a home equity line, which is typically increased or fueled by real estate appreciation. As we all know from history, particularly recent history, real estate is not guaranteed to appreciate, and the consequences can be dire for those living on the edge.

  When developing an LSA, particularly when debt financing is suspected, it can be a very important step to track the extent of outstanding credit card debt from the beginning of a year to the end of the year (and to do that for perhaps three years). What will often result from this is an indication of increasing debt, meaning that the expenses paid by the credit cards, which are being used as a foundation for the LSA, were not actually paid—some lesser amount was paid. Sometimes overlooked in that process is that not only are less of the actual expenditures being paid than incurred, but the payments that are being made include interest, which is probably not being picked up in any other fashion. That interest becomes part of a lifestyle. Of course, it would be pretty much the same if the debt was more conventional bank financing or the like.

  One of the problems that arises from this type of situation is that a standard of living has been established, but it is one that cannot continue. How is that dealt with in the ultimate financial resolution of the matter? In a similar vein are gifts from family members, particularly if they are recurring and of substance to the extent that they constitute a de facto source of income. When the expenditures are funded by family gifts, in a similar sense as debt, how is that considered when going forward? Is the assumption that the gifts will continue, and where is that guarantee?
- On one hand, discovery and access (that is, basic discovery and access to the necessary records) are routine, but on the other hand, those of us experienced in the area of developing an LSA recognize that it is one of the most difficult and frustrating aspects of performing our work. When performing a business investigation, although it is not unusual to encounter certain obstructions to discovery, for the most part (putting aside some of the truly out-there cash businesses), records are available and exist one way or another. When performing an LSA, we are dealing with how the individuals and family lived. This involves personal records, not business records. As a general rule, people do not maintain personal records or give them the attention that they would

give business records. One very valid reason for that is because there is no tax reason to maintain these records.

After all, we're talking about things like bank statements and cancelled checks that would prove the individual paid utility bills, the local gym, the cleaners, and so on. Credit card statements will show that the individual went out to eat a few times and charged a vacation, some clothing, and so on. These are personal expenses with no obligation to prove them for tax purposes because they are not tax deductible or in any way tax related. Thus, an individual is not required and has no overpowering reason to retain these records other than to be able to prove that certain items were paid or charged. Once the individual is satisfied that the bank account has been reconciled and nothing is remiss (the credit card statement is correct and payment was made), then at least in theory, all these records can be discarded.

Some people do exactly that. Although totally acceptable, it makes access to these records difficult and maddening. This may often cause us to seek them from the original third-party sources, such as banks, credit card companies, and so on. This becomes more of an issue when we realize that we are trying to access records going back two, three, or even more years. Sometimes, the extent of the records we want and how far back we want to go become a matter of cost and practicality. To what extent are we willing to accept an absence of records to continue and complete our assignment? Of course, that is not to say that sometimes, these difficulties have been fabricated by one of the parties as a simple obstruction matter. Fortunately, nowadays, thanks to computers, most of these records are accessible, albeit with some time delays and expense.

The two issues of time and money often weigh heavily in our decision-making process. We are often faced with time deadlines that do not allow the luxury of what will easily be a few months of waiting to get these records; however, many times we can be successful in pushing back at the system to allow us to do the job right. Of course, the other issue is money: the cost of getting these records. Generally, the cost is not that significant, except when we are asking for copies of cancelled checks. In such cases, we could be looking at as much as a few dollars per check, which could run the cost into thousands of dollars. This raises the issue of the extent we are willing to compromise our need for various checks.

- Part and parcel of performing an LSA is to take into account federal and state income tax payments. Keep in mind that this aspect is usually illustrated on a net disposable income schedule, rather than directly in the LSA. Regardless of where they are presented, taxes are sort of a unique expense, and from an accounting theory point of view, they raise the issue of cash versus accrual basis. To put it more simply, for purposes of an LSA, the issue is whether we reflect these income tax payments based on when they are actually made (the cash basis concept) or when they are incurred and applied to the appropriate year (the concept of accrual basis).

  To simply explain and illustrate, think of a W-2 employee who has too little withholding taken out of his or her pay. The total federal tax obligation for 2010 is $30,000, but withholding was only $10,000. What that means for our presentation purposes is that if this were to be shown on a cash basis, then $10,000 in federal withholding taxes (withholding being the equivalent of payment) would affect the 2010 income, and the $20,000 balance would be reflected when paid, meaning in 2011. From a pure cash flow point of view, this would be a correct presentation.

Alternatively, the economic reality of the situation is that the $20,000 that is going to be paid in 2011 is truly against the 2010 income and should be reflected as an offset against the 2010 income. This is not correct from a cash point of view but is certainly correct from an economic and accounting theory point of view. This matter expands when we take into account state income taxes, and it can really get interesting when we talk about multiple years and, perhaps, some years having refunds. Either approach can be acceptable; they just have to be recognized for what they are. Typically, over a several year period, a leveling effect occurs. Although that might be comforting in a multiple-year sense, it still leaves the issue of potentially significant fluctuations from year to year and, for the purpose at hand, the question of which would be the more useful and accurate reflection of lifestyle. As indicated, both are used, and either one can be acceptable and applicable.

- One of the practical concerns in performing an LSA is cost effectiveness and, in general, the overall cost. Several factors weigh heavily on cost and, depending on the ultimate goal of the LSA, cost effectiveness. A few of the key aspects affecting cost are as follows:
  - — As a rather simplistic statement, the more years to be covered, the more expensive the exercise. The critical issue here is to attempt to strike a reasonable balance between the appropriate number of years and the attendant cost. One year would be a lot less expensive than five years, but one year may not give us enough of a view of the lifestyle, and five years may be overkill. That's probably one reason why three years has become the accepted norm.
  - — Just how detailed do we need this LSA? In some cases, it's desired to break out details about how much was spent for, or on behalf of, each member of the household. That is far more expensive than simply performing an LSA based on the overall family. If the extent of the information needed is to determine expenses by person, there are going to be quite a number of assumptions and guesstimates, along with a greatly increased level of expense. If we have a family that makes use of a dozen different credit cards, to what extent is it desirable to go through those credit cards line by line to break out the nature of the expense versus simply calling it credit card expense? Does it make a difference whether they're general-purpose credit cards such as MasterCard, VISA, American Express, and so on or store or gasoline credit cards?
  - — As with so many aspects of expert assistance in divorce cases, will the LSA be performed by one neutral expert on behalf of both sides, will one side allow the other side to perform the LSA and just review it, or is each side going to perform its own LSA? Obviously, costs will vary widely. In theory, with perhaps the exception of a difficult business situation involving perquisites or

cash, or both, one would expect that an LSA based on a fairly straightforward accounting analysis of financial activity, checking accounts, and credit card statements would be the same regardless of who performs it. However, interpretive issues exist, as well as different approaches toward dealing with certain records, the absence of records, and so on. Furthermore, many times, the LSA is used to assist in the development of the initial financial disclosure required of each spouse, which is another reason why each side might want its own financial expert and LSA.

- One of the common reasons for a divorce action is that one or both of the married parties had something on the side. Sometimes, that also means they spent money on behalf of that friend or paramour. Often, it's not quite that nefarious but, rather, more solo vices, such as drugs or gambling. In either of these two broad senses, one concern in the development of an LSA may be an illustration of marital dissipation. By the way, this is also a reason why a neutral expert may not work, at least in the eyes of some litigants and attorneys. Regardless, the assumption here is that we have a situation with some allegation of the improper use of marital funds. This will come out in the development of the LSA, whether by natural curiosity of the accountant or from direction or suggestion from the client.

  This type of concern also brings in issues such as the following:
  - How many years back are we willing to research in regard to affairs or other human shortcomings?
  - If we are a joint expert or even if we are only working for one side, we also have the issue of the allegation that marital funds were improperly used. Clearly, some such conclusions would have to be founded by reliance on the client to advise that there was a paramour or something along those lines.
  - To make this a bit more complicated, would it matter if the expense that was on behalf of an alleged paramour was an expense that served both the spouse and paramour (for example, a hotel room on a vacation)? The spouse is entitled to the vacation; arguably, that would not be a dissipation issue. On the other hand, the paramour would be a dissipation argument, but the hotel room was not more expensive simply because a paramour was also there. Yet, there might have been no vacation were it not for the appeal to spend time with the paramour. How far do we go in splitting hairs on that type of item?
  - Maybe the argument is that the expense was extravagant. Once again, this can be a subjective issue. By whose definition was it extravagant, and are we even sure about the nature of the expense?
  - What if the expense was on behalf of family (for instance, helping elderly parents)? Would that be considered marital dissipation or a child's normal obligation to a parent? At least that type of expense tends to be fairly easily identified as such.
- Over the past several years, the use of a home equity line as an alternative checking account has become more and more common. This has been particularly the case

when people assumed that their homes would always increase in value; thus, they would regularly tap into these lines of credit. From an LSA point of view, a home equity line can be used either to simply replenish a checking account (drawing a check against the home equity line and depositing it into the checking account) or as a checking account to directly pay expenses. Of course, it could be used in both fashions. In the former, it's basically a matter of us just tracing the flow from the home equity line to the checking account to address the home equity line issue. In the latter situation, it's a bit more complex because we have another source for lifestyle expenditures. Either way, it brings in another source for the flow of funds. It also brings into play the issue of debt, and how it might fluctuate from year to year and affect and distort the lifestyle.

- Ideally, an LSA should rise or fall on the documentable and concrete support obtainable through various sources such as bank accounts, credit card statements, invoices, and the like. However, many times, we need to rely on the client's input versus concrete documentation. The softer, gentler type of client input is when we have evidence of an expenditure but aren't exactly sure what it is and need the client to tell us. That's the easy issue; we know we have an expenditure, and it's just a matter of classification.

  Of more difficulty is when we are dealing with, for instance, cash withdrawals from a checking account, and we don't know how they were expended. Even more difficult is when allegations of cash from a business exist, and we are told that the nanny, landscaper, or other service people are paid with that cash, which leaves no trail. Judgment and discretion are necessary in this area because there is often no way around that deficiency. Obviously, there has to be a level of logic and common sense, but what is possible and logical have a fairly wide range.
- When performing an LSA of a corporate executive (generally anyone from midlevel and up), that executive often has a panoply of taxable and nontaxable benefits that play into lifestyle one way or another. These benefits can greatly complicate getting a true lifestyle picture, and they could also represent a significant portion of that person's income. These benefits typically include the usual hospitalization and medical insurance, group term life insurance, 401(k) plan matching contribution, and so on. However, they may also include far more exotic benefits that are often more difficult to quantify in regard to value, such as deferred compensation arrangements, restricted stock units, stock options, thrift plans, matching plans of various types, and so on. A common benefit such as a cafeteria plan does not factor into this concern because it is effectively money moving from one pocket to another. However, it should not be overlooked that the expense being paid through the cafeteria plan is coming out of that individual's compensation and, thus, constitutes an expense. There will be more about executive benefits later.

Lifestyle Proves Income

Sometimes, the need for an LSA is not really for the purpose of understanding how the marital unit lived but, rather, to back into a real income number. In situations involving either unreported income (URI) or heavy perquisites, the judicious use of an LSA can help prove that one or both of these items exist, even if the full extent (particularly when URI is the issue) may not be definitively determined. An additional benefit is that if a business is involved and it is being valued, then the results of what has just been described will also serve the purpose of assisting in the determination of the income of that business, which in turn will likely help drive or at least affect the value of that business. However, the purpose of this chapter is income and lifestyle issues, not value.

This aspect of developing and using an LSA relies on the common sense and obviousness of certain things (for instance, food), as well as knowledge gained from input from a client (for instance, family vacations). These two examples are illustrated as follows:

1. Say we have a family of four, and for this illustration purpose, we know that they should be spending approximately $1,000 per month on food. Besides being common knowledge, information like this can also come from governmental statistics. Regardless, $1,000 per month is, give or take, a reasonable expectation of this family's food bill. Yet, in going through the documentation in support of lifestyle (checks and charges), we find virtually nothing evidencing the purchase of food and have also determined that the reported income is fully accounted for. If we know that we are dealing with a cash business that is supporting this family, we have probably solidified a supportable conclusion of URI. How else and from where else is this family's food bill being paid?
2. Vacations are not so obvious because each and every family has a different style of taking vacations, and a vacation can cost from a couple thousand dollars to as much as tens of thousands of dollars. This is when a client interview (put aside the issue of credibility) can be very informative. If we are convinced that this family takes two vacations per year, one for a couple thousand dollars and one for several thousand dollars, yet this expense doesn't show up anywhere (again, going through cancelled checks and charges), then the only likely answer is that the vacations are paid through the business by perquisites or URI. For our purposes, it probably really doesn't matter because each one represents additional income and lifestyle expenditures.

The preceding are but two examples of a potentially wide range of expense items that we would expect to see as lifestyle expenses. If we don't, that suggests that they are being paid from another source. For now, set aside the possibility of other types of explanations (for instance, the family being investigated can't really afford this, and they have some rich relative covering that expense). For discussion purposes here, assume that other source is going to be either perquisites paid by a business or URI coming from the business. What we have done is make a clear determination that another source of income (something not apparent on the surface of the tax return) is enabling this family to live the way it does.

In this fashion, we have used our LSA to prove additional income. The things missing from that lifestyle are proving that this family is enjoying a greater income than it is reporting. Thus, by the judicious use of the known supporting sources of expenditures (typically, checking account and credit card statements), in combination with the reported income via the tax returns (and perhaps from other sources) and in further combination with understanding how this family lives (typically meaning some degree of interviewing is necessary), it is possible to prove additional income.

When we get down to it, we might even raise the basic question, why bother with an LSA in the first place? After all, when we cut through all the issues and get down to the essentials, isn't lifestyle as basic as saying take the gross income, subtract taxes, and what is left is lifestyle? Indeed, for the more basic situations, the classic, simple W-2, that is probably sufficient and will do the job, except that it doesn't tell us about how this couple or family lived financially—it only gives us, in effect, a one-number summary. Depending on the needs of the litigants and court, that may not be enough. However, it is one simple sense of a lifestyle. When we start getting into larger, more complex situations involving upper-level (and even midlevel) executives, business owners, and those with complexity in their financial lives, especially when perquisites or URI, or both, exist, that simplistic overview approach discussed previously has many deficiencies.

Procedure

We have dealt with the various aspects and concerns of performing an LSA, including a variety of practical issues. We will now address the actual process of preparing an LSA. It should be kept in mind that this is intended as a broad overview and direction for how LSAs are performed. Conceptually, there is usually little difference from accountant to accountant, but procedurally, everyone has his or her own style. Further, no one format is required by any sense of accounting standards; thus, as a general statement, any presentation that provides information in a clear format without distortions is probably an acceptable presentation.

The following is a list of recommended steps to consider, in order, when preparing an LSA:

- Once it has been determined that an LSA is needed, as well as having determined the scope of the project (refer earlier in this chapter to matters such as the number of years, extent of details, and so on), it is typically helpful to interview one or both of the litigants. If we are a neutral expert, interviewing both parties should never be a problem; if hired by one side, well, you know the routine. There is no definitive requirement about when any such interview should happen. Some prefer to conduct it at the very beginning of the investigation, and others prefer to conduct it after some work has been done, and they've had the opportunity to get familiar with the lifestyle and have a sense about the types of questions to raise. As indicated, either one works.

  The interview can serve several purposes, including the following:

  — Explaining the concept to the client in order to enlist the client's assistance, when appropriate. Unlike various other work that accountants perform, an LSA is one of the easier things to explain to a layperson and for that layperson to grasp.

  - — Setting the stage to let the client know that it is virtually inevitable that we will need that client's assistance in understanding the nature of various expenses and the flow of funds.
  - — Addressing some of those questions at the onset or, at least, getting a better sense through a discussion with the client about what kind of questions will likely arise later on. A basic concern would be along the lines of getting explanations for checks payable to various payees about which the accountant is unfamiliar. This is commonplace, and we need to look to the client to explain the purpose.
- In the work that we do in developing an LSA, in this day and age, the exception to the rule is when we have a family or marital unit without at least two or three credit cards. Almost everyone nowadays, certainly in the income and financial range common to LSAs, has at least one or two general-purpose credit cards (MasterCard, VISA, American Express, Discover, and so on) and, typically, one or two store or gasoline credit cards. On one level, detailing the credit card expense can be very simple. After all, typically, the evidence of the payment of the credit cards comes in the form of a check from the checking account made payable to the credit card company for payment of the current month's bill. In some cases, we don't need to go any further; our LSA will simply have a line for credit card payments or, perhaps, one line for each credit card.

  An obvious shortcoming with that approach is that it tells us virtually nothing about the expenditures other than they were made through a credit card. Particularly in regard to a general-purpose credit card, those payments could have been for virtually anything, and simply listing a credit card payment doesn't help in truly understanding how the family spent its money. In the case of a limited-type credit card, it may not be unreasonable to reflect the payment purely as credit card payments and go no further in the analysis. For instance, typically, gasoline company credit cards are used only for automobile-related expenses. In that regard, simply knowing that a gasoline credit card was paid may be sufficient in terms of understanding the purpose of the payment.

  In a similar vein but less so is when the card is a store credit card. Some stores are more limited; thus, we can fairly well deduce what was purchased at that store. However, many general-purpose stores of substance exist where consumers can purchase a wide range of items, including clothes, food, toiletries, housewares, and so on. In such cases, once again, merely having a line to reflect store charges tells us almost nothing about the money that was spent.

  Of course, when it comes to general credit cards, virtually anything can be purchased. In such cases, in order to make the LSA meaningful, we need to review the monthly statements (annual detailed summaries can expedite the process) to determine, line by line, what was spent. This can be a very time-consuming process, particularly when families might use a certain credit card 50–100 times per month or when they have multiple cards. This process can be shortened a bit when a minimum dollar threshold is established, but of course, that has its own shortcomings and deficiencies. The reality of the situation is that in order to provide reasonable details, we need to go through the statements essentially line by line.

A further complicating factor that can make a big difference or, perhaps, be ignored, is when the credit cards are not paid in full, but payments are made on account. It is fairly commonplace to see credit card statements showing a $4,000 balance from the prior month, which in theory is supposed to be paid off in the current month, and a $5,000 charge for the current month, with only a $2,000 payment against the balance. If we look at the checking account, we would only see a $2,000 expenditure. The credit card will show us $5,000 for that month and $4,000 for the previous month, which is the month for which the $2,000 was being paid.

Thus, on at least two fronts, the simplistic picking up of a credit card account payment from the checking account without having the details from the credit card statement fails to provide us with a solid understanding of the lifestyle. Not only do we not get the details from the checking account, but we don't get to appreciate that this family unit spent far more than what it paid (that is, it created debt). That issue is very relevant within the context of discussing credit cards.

If we are dealing with any one particular year of credit card use, and the balance outstanding at the beginning of the year is approximately the same as at the end of the year, then for that year, the payments and charges will be in an approximate balance. More typically, we will see changes from the beginning to the end of the year, and those changes can go in either direction. If the credit card balance increased during the year, that would mean payments were less than what was charged: the true lifestyle was greater than the payments. Conversely, if the balance went down during the year, then the payments exceeded the actual lifestyle. When we factor in the potential for a few to several credit cards and outstanding balances that might vary significantly during the year and from year to year, this area can become extremely complex.

Making the credit card analysis as useful and relevant as possible when significant differences exist between what was charged and paid during a particular year or a term of a few years can be no mean feat.

- In a way similar to that previously described regarding credit cards and, in particular, multiple credit cards, we have similar but somewhat more difficult issues with bank accounts. This is particularly so when multiple bank accounts exist, as well as money market and brokerage investment accounts. Our concern is when these accounts are used in a fashion that creates the flow of money, or the appearance of the flow of money, for consumption as part of a marital lifestyle. Similar to that as described for credit cards, what we need to do is review these accounts, analyze them, and determine how money was spent. Often tied into that is to get a comfort level about the money that was deposited into these accounts and, sometimes, the sources of those funds.

  Before we get into how money was spent, let's first address what comes before that: the money coming into the account (the source of the funds). Most of the time, this is no biggie because money of any consequence is coming from one or more of the parties' compensation. We will typically see direct deposits or payroll checks on a fairly regular basis. Obviously, this type of situation can have many twists and turns, particularly when the case involves a business owner; thus, the payroll may not be so routine, automatic, and consistent. Also, there can be expense reimbursements. More about that a little bit later.

The issue of money going into the checking account is not typically a concern or an issue because most families tend to have one main, operational checking account. The more difficult element for us is the matter of how the money was spent. When we request bank statements and cancelled checks, it is not unusual for us to receive the bank statements but not the cancelled checks, which is the most problematic and common discovery issue that we face when performing an LSA. In part, that's because various banks do not return cancelled checks, but that's not the end of the story. A pretty much obvious problem is that although the bank statements will tell us, by check number, how much was spent and when, they do not give a clue about the purpose of the expenditure.

Think of your own checking account, then imagine an account having 40 checks written in 1 month and a bank statement with 40 numerical postings but not one iota of information about the payees on those checks. To determine how the money was spent, we need the cancelled checks or, at least, a printout of the digital images of those cancelled checks (typically six or eight per page) providing us information about the payees. At the very least, if we have no alternative or as a practical matter for cost-effective purposes, we could use the check registers, but they come with many sins and deficiencies. The practical concern is that depending on the bank and its system, we can be looking at a substantial cost, as well as time delay, to secure those documents.

One relief from the problem of not having copies of cancelled checks or even a check register is that some accounts are structured so that a description of the check or disbursement is provided on the statement. Thus, if 40 checks were written during the month or perhaps a combination of checks and debit memos and transfers, for each line item evidencing the clearing of a transaction, there will be a description indicating the amount, payee, and perhaps certain additional information. This often goes a long way toward providing the necessary information and making the lack of cancelled checks a nonissue.

It is not unusual to be faced with multiple accounts, such as multiple checking accounts often in combination with savings and money market accounts. In some situations we also have people who use investment or brokerage accounts as checking accounts because of the check writing facility attached to that account. These practical day-to-day aspects of how people handle their funds can greatly complicate our ability to perform an LSA.

On one hand, all it simply means is that we are pulling information from multiple sources rather than 1. To a degree, pulling 1,000 pieces of information from 4 sources is really no different than pulling 1,000 pieces of information from 1 source. Granted, the multiple sources make it a bit more time consuming, as well as present certain additional discovery issues, but overall, that usually doesn't really create significantly more work. However, we do have the issues of being aware of these accounts; making sure that multiple accounts are taken into account; and not to be overlooked, the movement of money between accounts.

- A very practical aspect of attempting to perform an LSA is getting check details for a period of a few years. As previously mentioned, all too often, what we find is that the litigants did not keep their bank statements and cancelled checks. This presents us with various practical issues and the need to make certain decisions. Unless the decision is to get copies of everything regardless of the cost (a waste of money and time), we need to make subjective calls to expedite the process. This is often done with the joint concurrence of counsel and clients, but it is often left to the CPA to make the decision about what would be reasonable. The critical issue here is the cutoff or threshold below which we are not going to seek copies of checks. Depending on what we see running through the checking account, when we are faced with this need to ask for copies of checks only above a certain amount, it's not unusual for us to use an amount in the vicinity of $500 or $1,000 as our cutoff. If we are dealing with higher income and net worth individuals, that cutoff could be as high as $5,000 or even $10,000.

  What we observe through access to the statements may dictate a reasonable cutoff for securing copies of checks. To a degree, this could all be avoided if at least we had a check register – then for all its faults and possible arguments of manipulation, and often handwriting and accuracy issues, we can at least get a fairly decent understanding of what was written. Unfortunately, those are usually discarded as often and frequently as the bank statements and cancelled checks themselves.

  A variation on that issue is that sometimes, we will have bank statements and cancelled checks from, perhaps, only 8 or 9 months of one year and 10 months of another year, and a decision has been made not to try to get them from the third party because it's too difficult or, sometimes, the banks may have folded. In those cases, it is sometimes acceptable to use what we have, take an average, and then extrapolate that result to a full year. This is also done with other expense sources, such as credit cards. This approach has obvious shortcomings. How do we know that those months were representative? How do we know that the missing months did not have something unusual? Different times of the year entail different costs. Nevertheless, as the clichés go, it's better than nothing, or what's our alternative?

  Arguably, this type of extrapolation is very difficult to justify if all we have are a few months out of the year; it's recommended only when we have several months of the 12. Regardless, the reality is that sometimes, a decision is made that there is little other choice, and we need to have something upon which we can rely, even if the data source is sparser than we would like.

- Particularly for mid- and upper-level executives, the expense reimbursement area can be quite interesting and significant relevant to lifestyle. The issue here is that when working for corporate America, particularly in the upper levels, it's not unusual for one of the litigants we are investigating to have an expense allowance or account or be in a situation in which the job involves activities that cause out-of-pocket expenses that are reimbursed or paid directly by the employer. Although the mechanics are different, the economic operation is essentially the same.

In regard to expense reimbursements, that is often another type of flow into the account, particularly when executives use their own credit cards and get reimbursed by the company. This is one of those areas that is easy to overlook, but it must not be overlooked. After all, if we have a midlevel executive who is, on the average, running up approximately $2,000 per month of reimbursable expenses but is putting that reimbursement aside instead of depositing it into the family pot, we are looking at approximately $20,000–$30,000 per year that is not going into the marital estate. At the same time, that amount of expense would give the impression of a lifestyle that is not as substantial as it seems.

We need to recognize that because this $20,000–$30,000 of expenses is reimbursed by the company, it does not represent real expenses of the family unit. However, a much more interesting question is, Does it represent an element of lifestyle, and if so, to what extent? Even though it's not costing the marital unit anything because of employer reimbursement, the money does represent a method of spending what someone is either earning or entitled to.

If what is of relevance here is no more than one of the litigants, because of his or her employment, driving to various customers and getting reimbursed for the mileage, attending a local conference and getting reimbursed for the conference fee, or even having an occasional business lunch that is paid by the company, then these types of expenses can be readily acknowledged as irrelevant to the lifestyle and not a factor in our work. On the other hand, it is quite different when the litigant's employment involves multiday conferences in resort areas, frequent lunches and dinners that are business related, a company car, and so on.

In these situations, even accepting that the expenses are all legitimately business, we are faced with the economic reality that a lifestyle is created by the employment (for instance, that five-day conference in a resort with an extra day or two added, fully paid by the employer), as well as living expenses that are covered by the employment (such as those frequent business lunches and dinners). To what extent, as part of an LSA, do we need to take into account that the lifestyle includes traveling to interesting places and getting a vacation-type benefit because of legitimate employment needs? In a similar though perhaps more obvious vein, to what extent do we need to take into account that meals (everyone needs them) are covered by the business? Such meal expense does not show up on an LSA generated only from the family's own financial records. Further, those meals do not show up in any form of reportable income (legitimately so).

Nevertheless, they are all elements of a lifestyle enjoyed by the litigants. The quantification of this element of lifestyle and the degree to which that quantification plays a role as a lifestyle element (versus a business-related expense) present many interesting issues. After all, by virtue of employment, the individual has the ability to eat various meals and travel, all of which are tangible elements of lifestyle that are paid outside of his or her reported income.

On the other hand, these elements are also entirely or substantially accepted as existing primarily, perhaps exclusively, because of employment. By way of example (allow for this purpose), the meals are unquestionably legitimate business purposes. Nevertheless, a personal benefit is derived. Marital funds were not expended for that same expense that would have assuredly been spent (perhaps at a lesser level) on the personal end. To complicate this issue a bit, these reimbursements legitimately do not show up as this employee's (litigant's) income. The business is entitled to expense the reimbursements as truly business expenses and not treat any portion as income to the employee. Thus, what we have in a very real economic sense is legitimately and properly untaxed income to the individual. Whether the extent of that income and the degree of difficulty in determining it becomes part of an LSA must yield to practicality on a case-specific basis.

- We just discussed the potential effect of company-paid expenses on lifestyle, which also might be considered to have an effect on income. However, that analysis was looking at these types of company-paid benefits from the point of view of a noncontrolling employee: your typical rank-and-file employee in corporate America (even if it's smaller corporate America). Of far more complexity and time-consuming concern is when we are dealing with someone who owns a business or a piece of the business, and that business provides benefits in the form of perquisites, which is not all that unusual in closely-held companies. Such perquisites have elements of personal benefit and, therefore, lifestyle impact, but they go beyond that. Often, they are not merely partially business and partially personal benefits, but for all intents and purposes, they are truly just personal expenses being run through the business that commonly take the form of the following:
  - A personal car (or two or three) fully paid for by the business (even for people who don't need a car for business)
  - A meal or two or several per week charged to, and paid for by, the business or a two-week vacation that is deducted as if a business trip, often without even a modicum of an attempt to have pseudo-support to make it look like a business expense
  - Repairs to the home that are treated as if repairs to the business

  Going further than that, a few simple examples include college tuition paid by the business and buried in its expenses; the purchase of land treated as if it were cost of goods sold; the nanny on the company's books; and URI, which is the ultimate pure and simple benefit.

  The concerns here mirror the concerns previously expressed when it's only an arm's length employment relationship, but the concerns are magnified, and the potential effect on lifestyle is much more significant. The result of a forensic analysis that addresses these concerns is often the add-back of potentially significant personal benefits in the form of perquisites received by one or more owners of the business via what is typically referred to as normalization adjustments. This then translates into an element of lifestyle.

When a closely-held business in which one of the litigants has an interest is involved, in order to do true justice to an LSA, a forensic examination of that closely-held business is often necessary. That examination can add considerable time and cost to any matter. Fortunately, the importance or relevance of such examination in determining income and, perhaps, ultimately value is often of far greater relevance than what it does to help further flesh out an LSA.

- Sort of in its own world and a very substantial item for some families is the use of checks payable to cash or the simple withdrawal of cash from a bank account via the use of ATMs. It tends to be irrelevant to us whether this type of cash expenditure is by check or ATM; either way, it represents the unidentified use of cash. One difference that often does not amount to anything of consequence is when cash is taken out by a check because it's pretty certain who wrote the check. On the other hand, when cash is received by the use of an ATM, sometimes, we can tell who took the cash through, perhaps, a unique ATM code or the location of the ATM. Other times, we simply cannot tell, and all we know is that cash was taken. In either case, determining the nature of the expenditure tends to be imprecise and based on anecdotal input from one or both of the litigants.

  The typical uses of this type of cash are for customary things such as pocket money, allowances for the children, the commonplace off-the-books nanny or housekeeper, and any other number of possibilities. Sometimes, it is also for someone to build up a cash hoard, sort of a kitty on the side to hide from the other spouse. This area becomes a greater concern when the amounts are substantial. I've seen my share of lifestyle situations when checks payable to cash and ATM use ran into thousands of dollars—even thousands of dollars at a time—accumulating to tens of thousands of dollars in any one year.

  The simple reality of categorizing this type and extent of cash usage is that we tend to have two choices: either one (or both) of the litigants tells us how that cash was used, or we simply lump it as "cash." Of course, it's virtually inevitable that when we use the input of one of the litigants regarding the purpose of the cash, the other litigant has a different take on how that money was really spent. Regardless, there is a practical limit about what can be done when there is no better record of the expenditure other than "cash."
- Many times, the area of nonrecurring expenses turns out to be one of the more contentious aspects of an LSA presentation, and that really should not be the case. The issue at hand here is that money was spent (no denying that), but it was spent on something that is nonrecurring, tends to occur less often than annually, or tends to occur annually but in significantly varying amounts. Each of these is similar (money was spent), but of course, each is different.

In the area of nonrecurring expenses, we have such items as weddings and bar and bat mitzvahs. However, are they really nonrecurring? How many children are involved, and are more weddings or bar or bat mitzvahs in the offing? In the category of expenses recurring less often than annually, we have the purchase of a car because we know that a car is going to be purchased every so often. Of course, what *so often* means is variable based on the individual or family. Nevertheless, whether it's every few years or every several years, a car is going to be purchased, and sometimes, two or even more cars are going to be purchased. In the category of expenses occurring annually but in significantly varying amounts, we have vacations and furniture. Once again, they occur regularly, but the amounts vary significantly from year to year.

Some accountants break out these nonrecurring expenses as a separate section, and some even go further and somewhat ignore them by including them as a footnote reference only. Of course, some accountants treat them as just another element of lifestyle for that particular year. Arguably, any and all of these approaches can be correct, but the critical issue on which we could all agree is that however these are presented, it needs to accomplish a reasonable job of fairly and properly reflecting the lifestyle of the litigants.

A problem with ignoring these expenses is that they actually did happen, and many of them are only nonrecurring in the sense that they don't happen every year or at a level rate from year to year. That doesn't make them any less a part of the lifestyle than food, utilities, or clothing. Also, arguably, if that wedding did not happen this year, then the money that was spent on the wedding would have been spent otherwise, probably by being put into savings. Thus, one way or another, it was either spent in the form of a consumed item, or it was spent by putting it into an investment.

This gets a bit more complicated with a car when we might experience either no car purchased during the time frame being analyzed for the LSA, or a car (or even two) was purchased during that time frame. If no car was purchased, it doesn't give us the green light to ignore that as a lifestyle item; it must be recognized that nothing was expended for such an acquisition during that time frame. For instance, if it was the family's habit to buy a car every four years, and we only analyzed two years that did not include a car purchase, then as a lifestyle expenditure, we are missing the purchase of a car or, perhaps, the amortization of the purchase of a car.

The amortization may not be a problem if, rather than it being purchased, we had ongoing payments for a lease or note. In such a case, the absence of a car being purchased in that year may not have any effect on our LSA because the family unit is in the habit of financing its car purchases in the form of a lease or note. If no such financing exists, then logically, in any year when no car was purchased, money should have been available to be saved instead of spent on the purchase of a car. The point is that from a finite pool of money (roughly defined here as income), if some of that money was not spent on a car, then it should have been available for some other marital expense, including savings.

When it is important to reflect the purchase of a car, even if it's in the sense of amortizing that cost over several years, that can be done in the form of making such an estimated expense, clearly footnoting it as such, and repeating that over what would be a reasonable life span at a reasonable cost for what the family is used to buying. Complicating this area a bit more, our concern is when an assumption is made about an expense to provide a better understanding of what is typical in a lifestyle but when that expense did not actually happen. Perhaps a negative savings is needed to reflect that whatever savings might have happened that year were more than would have been the case had a car been purchased or a real amortization expense occurred. The assumption of an amortization forces a withdrawal or reduction of what is otherwise savings, which therefore constitutes a negative savings for that year.

This area has the potential for a great deal of complexity and confusion and, perhaps, a lot of noise for very little result. By way of example, just how far do we carry the need for amortizing expenses (leveling items) or treating things as nonrecurring expenses? For instance, furniture, appliances, and roofs have to be replaced at some point in time. Assume that in the three years of the LSA that we've performed, there were no purchases of appliances or furniture, and the roof didn't need replacing. Do we factor into our LSA some reasonable amount for an annual amortization or replacement of these items, or do we simply expect those expenditures as part of the event? Arguably, either approach would be correct, but the creation of an amortization opens the door for challenges and error. For instance, over how many years do we amortize these items, and what cost is going to be amortized? We can reasonably argue the number of years and different costs.

- One aspect of preparing an LSA that is all too often more fluff and outright conjecture than substance (and sometimes even ludicrous representations) is when it was deemed relevant to attempt to construct the equivalent of a sub-LSA within the family. That is, someone made the decision that it's not enough to have an LSA for three years for the family but that it would serve some function to have that LSA allocated or categorized by person. This typically means separating the expenses into categories for the husband, wife, and children (sometimes even by child). Although there can be utility for such an approach, most of the time, this exercise does little more than provide greater detail and a thicker report (and more fees) for little to no actual benefit.

  The concept in this approach is to treat each family member (perhaps treating the children as if one unit) as a separate expense area to try to determine how much of the total family expenditures were represented by each particular person. One argument here is that in terms of maintaining a lifestyle, if it can be illustrated that the lifestyle of one of the litigants is considerably less (or materially more) than the other litigants, then a position can be made for that spouse needing less (or more) in the area of support in order to maintain that lifestyle. Although theoretically interesting—undoubtedly, this will provide useful information and relevant allocations in a number of situations—for the most part, what we wind up with is taking a fairly objective analytical process and then breaking it into two or more components that are partially and, sometimes, substantially founded on assumptions and conjecture. Further, we go from what is substantially unchallengeable and agreeable by all to different people interpreting the same data differently.

To illustrate some of the issues and, perhaps, bring a smile or smirk to our face, consider the following:

- Do we allocate mortgage or rent per capita, by the size of the individual, or by how much time that person spends in the house? Also, the cost of the housing premises is not directly affected by either the litigants or children. Yes, perhaps if there were no children in the house, we would have a smaller house or apartment; conversely, if there were more children, we would have to have a larger house or apartment. Just what does that do for understanding the marital lifestyle?
- Somewhat similar to the preceding, but utilities could have a bit more fun in it. Presumably, if you spend more time at home, you use more utilities. However, does it matter if you're the type who likes to keep the house cold or warm? How does that affect the cost of utilities depending on the time of year? Should the cost of utilities be treated differently for children who are active in sports and, therefore, bring home more dirty clothing that needs to be washed more often?
- Food can probably be fairly well estimated, but that's all it's going to be: an estimate. How are we supposed to come up with this allocation? For instance, this would require estimating how much more a teenager might eat than a grown man or woman or younger child. Also, does it matter if the children or, perhaps, the parents are sociable in the sense of having friends over who, in turn, eat food? Presumably, we would have to allocate those friends to the specific individual.
- Clothing starts out pretty straightforward; we allocate the cost of the clothing to the person who is going to be wearing it. However, how do we allocate hand-me-downs? Does it matter that, many times, a man will wear a suit for years, perhaps wearing it 40–50 times, but a woman might wear a dress only a few times per year for only a couple years? Does any of that matter at all? If it does matter, just how much guesswork are we supposed to take into account regarding who wears what clothing and when and how they wear it?
- Do we allocate vacations per capita? Do we assume that if the children share a room with the parents, the room does not cost extra; therefore, the cost is purely on the parents? Does it matter who wanted that vacation or who chose that location or that maybe one of the spouses would have preferred someplace cheaper or more expensive? What about the activities during the vacation? Do we need to allocate those based on who actually did them?
- Assume that one parent has a sports car, and the other parent has a big SUV that is suitable for hauling around the three children and their friends. I'm sure that we don't even have to go into this one for us to appreciate some of

the difficulties with any logical (it is probably inappropriate to say that anything in this context could be logical) allocation of the expenses between the parents, let alone including the children in this one.

We could have more fun with this area by giving further examples, but you get the idea. Presumably, the point has been made, and the inherent illogic (in most situations) of such a per capita allocation is rather evident.

However, if this per capita allocation is to be done, a lot of extra work will be necessary, as well as the need to receive significant input and interpretation from one, if not both, of the litigants. What happens when the litigants don't agree?

Net Disposable Income

Often but not necessarily, the preparation of a net disposable income (NDI) schedule and backup analysis is part and parcel of performing an LSA. The concept of NDI is to illustrate the disposable income of the family unit (often meaning cash flow) over whatever time frame is consistent with the LSA or, sometimes, on a somewhat different time frame based on information available or the needs of the particular case. Besides the NDI analysis providing a useful illustration of some of the in- and outflows of the family's income, it is often helpful in correlating that income or cash flow with the expenditures detailed on the LSA.

Usually, we find that these two related analyses—LSA and NDI—do not neatly reconcile, and they sometimes vary by significant amounts. Logic would dictate that they need to reconcile; after all, NDI provides a sense of the amount of cash flow available to the family, and LSA explains how it was expended (including savings). In theory, cash in equals cash out. The reality and practical aspect is that it is far more common that these figures will not agree. The only real concern is when they disagree by significant amounts; typical reasons for this imbalance include the following:

- Timing issues involving when an income item is actually received or deposited versus when an expense item is actually paid with a cash outflow. However, this should level out over a period of a few years.
- Not having all the elements (for example, one party's checking account) that account for the flows.
- Differences in timing between an expense posted to a credit card and when that card is paid, although this tends to relate to the first item regarding timing and leveling out over a span of a few years.
- When the LSA is based on expenses that have not been paid, such as a credit card situation when the balance is not paid in full each month; once again, this tends to tie into the first item regarding timing.
- Not taking into account the ebbs and flows of debt, whether by build-up or reduction of outstanding credit card balances, home equity lines, or other debt vehicles.
- Not fully taking into account movements of money into or out of savings.
- Income items that are not necessarily cash flow.

- Cash flow items that might have come out of a prior year's income and are not correctly recognized in a particular year.
- A paycheck in which part of it is taken in cash rather than deposited, and that cash is overlooked.
- Estimated tax payments or payments made with the tax return that are relevant to one year's income but paid in a different year.
- Tax refunds typically received the year after taxes are withheld or paid, meaning the refunds are relevant to that prior year's income.
- Failure to recognize an income item that wasn't a cash flow item or when the amount of the cash flow differs significantly from the income item. An example of this might be income through a Schedule K-1 in which the distributions relating to that income differed significantly from the amount of the income.

Clearly, many possibilities exist to explain why the NDI and LSA won't be a perfect match, and some very good reasons explain why they won't even be close to a perfect match. Sometimes, the reasons are errors of one form or another, and sometimes it is because of a shortage or inadequacy of the documentation. Although these shortcomings can virtually always be addressed and rectified, we are also typically facing the reality that to do so, particularly for relatively minor amounts of money, might be time consuming and above and beyond the value of what that fine-tuning would contribute to the exercise. For example, if we are dealing with a 3-year NDI that reflects an annual average cash flow of $200,000, and our LSA shows a 3-year average of $185,000 (or $215,000), for this purpose, does it really matter that we are off an average of $15,000 per year for 3 years? The answer is that it probably matters in some cases, and it probably doesn't matter in other cases.

A number of fine-tuning points can make what would otherwise seem like a simple process of developing NDI not so simple. Some of these issues or areas include the following:

- Withholding taxes are current and directly tied in to the timing of the receipt of income. However, quarterly estimates are not so simple; the fourth quarter estimated payment is due in January of the year following that to which the income applies.
- Virtually by definition, a balance due on a tax return or a refund due from a tax return are paid or realized in the year after (for some people, a couple years after) the income event. After all, from a cash flow point of view, if you owe $10,000 on your 2010 tax return, you will typically be paying it in April 2011. If NDI picks up and reflects your tax obligation based on your tax return (which is typical), but the LSA is based on the actual cash flows during 2010 (which is also typical), then there will be a $10,000 disconnect.
- In a similar vein, we have the refunds issue, but that can be a bit more complicated. Once again, if in the filing of your 2010 tax return you had a $10,000 refund due, receipt of that refund would probably happen sometime in June or July 2011, and in that sense, it would represent an additional element of cash inflow in that year. However, the income that generated that refund came in 2010, and the tax burden was reflected in 2010. At least in regard to proper timing recognition, this can get a bit

more complicated when the litigant believes in that poker game Let it Ride (that is, leaving the overpayment in to be applied against the following year's taxes).

- Stock market activity, including mutual funds and other investment vehicle situations, tends not to be so much the purchase of securities but, rather, the sale of securities. The purchase tends to be straightforward: a check is cut from the family checking account to a brokerage house, and in turn, the investment is purchased. The trail on this one is generally pretty clear and doesn't have any real effect on NDI. However, assume that stock in a brokerage account is sold during the year for $50,000. First, recognize that the gain or loss on that sale is irrelevant because we're looking at cash flow, not whether a profit or loss was realized. Thus, for this purpose, it doesn't matter whether the tax return shows a gain or loss because we're interested in cash flow, not in a net result versus a purchase that might have happened some years ago. However, even the so-called cash flow of that transaction (the stock sold for $50,000) may be irrelevant. Typically, unless the money is needed outside of the investment pool, it is fairly routine to see that when stock is sold, the funds are retained within that brokerage account, perhaps moved into a money market account, or perhaps used for the purchase of another investment. Thus, this sale presents no actual cash flow for our purposes because the $50,000 of cash inflow generated by the sale was consumed by a $50,000 cash outflow for the purchase of another investment. The net result is a wash.
- We face the same situation when we are accounting for dividend income (for example, in a mutual fund) that is reflected on the tax return. Very often, that does not represent any cash flow because many people have their mutual fund dividends automatically reinvested. Thus, to the extent that a dividend from a mutual fund represents income or potential cash flow, it is typically also consumed as a savings factor by being reinvested.
- Almost everyone is familiar with the concept of 401(k) and 403(b) plans. If we have a client with a $100,000 W-2 who elects to have $5,000 of his or her pay put into a 401(k), on one hand, that individual has a $100,000 income and cash inflow; on the other hand, $5,000 of that income was never physically received but was withheld at the source to go into the 401(k).

  The first question that arises is, which income item is picked up in NDI? If it is box 1 of the W-2, it's going to be net of the 401(k) withholding, but that's not an accurate reflection of that person's income. However, if we pick up the income prior to the 401(k) elective withholding, we will be wrong concerning disposable income and also the LSA if we don't recognize that from an economic and cash flow point of view, what we have here is $5,000 of income that was set aside and invested. Ideally, NDI will reflect the full amount of the income, and the LSA will reflect a $5,000 savings expenditure.
- Although for the most part, we only see options, restricted stocks, and other executive benefits in the higher income cases, they do make the NDI (and by extension the LSA) concept far more difficult and complex. A typical example of what we are faced with is an executive who receives a restricted stock award that has a current

value (provided by the company) of, for example, $50,000. That amount is generally included in the executive's W-2 unless certain vesting restrictions exist (versus 100 percent immediate vesting but exercise timing restrictions). Also, it might have been a restricted stock that was issued two or three years earlier and became taxable in the current year.

This is definitely additional compensation, but it's also typically not in a cash flow form. At the same time, this is an investment, albeit an involuntary one—that is, subject to whatever restrictions, this person has been given (earned) additional compensation that he or she is not at liberty to utilize at the current time. In order to reconcile this income item with the LSA, we might show this as a reduction on NDI or, alternatively, show it on the LSA as an investment.

- Taking the preceding one step further, assume this same executive received a restricted stock award 3 years ago that was worth $50,000; in the current year, the restrictions are lifted, the stock has increased in value to $75,000 (perhaps it has decreased in value to $25,000), and the executive cashes in that stock. The easy part is that we've got some kind of a cash flow in the current year; the hard part is trying to define the exact nature of that cash flow. If we are dealing with stock appreciation, it's unlikely that it's something we would consider part of the recurring income stream. This is also the case for an investment loss situation. Regardless, the point is that it's necessary to reconcile the NDI and LSA issues.

Net Disposable Income and Cash Flow

	For the Years Ended December 31,		
	2010	***2009***	***2008***
Income per Tax Return			
Wages	$297,617	$476,100	$269,940
Taxable Interest	695	1,338	1,109
Ordinary Dividends	2,289	2,101	2,088
Business Income[1]	5,219	7,320	2,743
Capital Gains (Losses)[2]	(5,432)	10,184	35,600
S Corporation—Schedule K-1[3]	86,295	127,430	78,107
Total Income per Tax Return[4]	386,683	624,473	389,587
Adjustments			
Elective Deferrals to 401(k) Plan[5]	11,000	10,200	10,500
Cafeteria Plan[5]	4,000	4,000	4,000
Employer 401(k) Plan Match[6]	10,179	1,268	6,311
Capital Gains (Losses)[2]	5,432	10,184)	(35,600)
Proceeds From Capital Gains (Losses)			
(not reinvested)[2]	20,480	—	10,264
Business Income—Depreciation[1]	3,654	6,372	1,993
Business Income—Equipment purchase[1]	—	(8,500)	—
S Corporation Income[3]	(86,295)	(127,430)	(78,107)

S Corporation Distributions[3]	100,000	100,000	50,000
Total Adjustments	68,450	(24,274)	(30,639)
Adjusted Pretax Cash Flow	455,133	600,199	358,948
Taxes[7]			
Federal Withholding Tax	107,258	178,605	110,632
Social Security Tax	5,264	9,970	9,732
Medicare Tax	5,794	7,051	4,066
New Jersey State Withholding Tax	25,839	46,461	22,002
State Unemployment Insurance	100	263	434
Payments (Refunds)[8]			
Federal Payment (Refund)	—	(9,948)	318
New Jersey State Payment (Refund)	(3,688)	(246)	—
Taxes, net	140,567	232,156	147,184
Net Disposable Income and Cash Flow (Annual)	**$314,566**	**$368,043**	**$211,764**
Net Disposable Income and Cash Flow (Monthly)	**$ 26,214**	**$ 30,670**	**$ 17,647**

[1] *Business income (Schedule C)*. Adjust this by adding back depreciation (noncash flow item) and subtracting actual equipment outlays.

[2] *Capital gains and losses.* These come from Schedule D that reflects the net result of that year's capital (stock market) transactions. Again, this figure is listed here to provide a reference point to the tax returns, recognizing that the net income or loss in itself is meaningless in regard to truly understanding NDI. For reflection of cash flow, adjust this out and substitute sales proceeds to the extent not simply reinvested.

[3] *Schedule K-1.* This item comes from Schedule E and is typically for partnership and S corporation interests. Also, typically, this number is only a starting point and does not represent cash flow. To represent cash flow, remove the income figure and replace it with the actual distributions.

[4] *Income per tax returns.* Use the tax returns as your starting point for NDI because they represent the best single source for a good summary of the income of the individual or family. The best way to use the tax returns is to start off with the components of the income as per the tax returns, detailed as stated on the tax returns, so that you have an easy comparison base from which any adjustments can be made.

[5] *Elective deferrals to 401(k) and cafeteria plans.* Because these types of elective deferrals directly reduce the taxable wages reflected on the tax return, you need to add these back to more accurately reflect the real income of the individual. These items will be offset later on because the 401(k) plan deferral is a savings item, and the cafeteria plan deferral is a medical expense. If you omit this type of adjustment, you would be understating income and, at the same, time understating the use of funds (savings and expenses).

[6] *Employer 401(k) plan match*. This one is not as easy as the others because it requires information that is not necessarily in the direct control of the individual for whom this NDI is being developed. If an employer match exists, typically, this can be discovered and might be considered for inclusion here. However, because this is an item over which the employee has no direct control and is certainly something that the employee does not directly receive, it is also reasonable to make an argument that it does not belong in NDI. Nevertheless, an argument can be made that it constitutes another form of savings and needs to be reflected somewhere.

[7] *Taxes.* NDI is intended to show cash flow available to the family unit after providing for income and related taxes. Ideally, you take these tax numbers directly from the W-2s. That is more useful than trying to take them from the tax returns because of various factors, including the tax return itself does not directly reflect such withholding items as Social Security taxes, unemployment insurance (in those states where the employee contributes some part), and the like.

[8] *Tax payments and refunds.* These figures are taken directly from the tax returns, and they typically reflect a one-year lag—that is, a balance due that is reflected on the 2010 tax return is paid in 2011, and a refund due that is reflected on the 2010 tax return is received in 2011. These pay and receipt dates assume the normal tax return filings. Those dates can be pushed back one year or more if someone doesn't file on time or files at the end of the extension time frame in October. As explained elsewhere in this chapter, this issue of tax balance or refund due is one of those items that can distort a true year-by-year cash flow and can be handled in different ways.

Family Lifestyle Expenditures			
	For the Years Ended December 31,		
	2010	***2009***	***2008***
Shelter			
Mortgage and Real Estate Taxes	$ 33,156	$ 34,552	$ 32,978
Condominium Association Fees	1,750	2,246	1,458
Repairs and Maintenance	1,436	651	5,278
Cable	1,083	1,001	853
Electric and Gas	5,808	6,618	5,104
Water and Sewer	164	521	449
Garbage Removal	368	368	368
Snow Removal and Lawn Care	2,094	3,326	2,865
Telephone	3,710	3,102	3,202
Equipment and Furnishings	2,638	5,438	9,939
Computer and Internet Charges	949	597	527
Total Shelter	**53,156**	**58,420**	**63,021**
Transportation			
Auto Lease[1]	6,960	5,656	6,768
Auto Purchase[1]	44,622	63,482	—
Auto Insurance	2,945	2,473	1,685
Gas and Maintenance	6,791	8,506	4,414
Total Transportation	**61,318**	**80,117**	**12,867**
Personal			
Alcohol and Tobacco	2,769	404	984
Bank and Finance Charges	3,698	6,525	8,049
Cash Withdrawals[2]	25,705	24,432	30,480
Clothing	7,199	10,254	6,181
Club Dues and Memberships	10,159	27,342	8,259
Contributions and Donations	4,325	8,174	3,142
Dental	4,371	638	2,871
Dry Cleaning	1,564	1,216	1,473
Entertainment	2,167	3,853	4,919
Equity Line Payments	10,221	35,670	20,234
Home Food and Household Supplies	7,537	5,812	6,692
Gifts	2,473	3,430	2,796
Hair Care and Nails	1,185	913	686
Insurance	9,284	9,697	9,238
Medical (Exclusive of Psychiatric)	2,311	474	1,349

Miscellaneous Purchases[3]	16,903	21,730	24,883
Newspapers and Periodicals	536	660	500
Pet and Veterinarian Expenses	1,272	875	1,294
Prescription Drugs	789	666	1,353
Psychiatrist and Psychologist	—	1,625	1,125
Restaurants	7,950	8,193	7,694
Savings and Investments[4]	67,984	53,439	(23,197)
Sports and Hobbies	1,740	1,293	2,171
Vacations, Travel, and Lodging	8,594	8,669	8,086
Total Personal	**200,736**	**235,984**	**131,262**
Total Expenditures	**$ 315,210**	**$ 374,521**	**$ 207,150**
Monthly			
Shelter	$ 4,430	$ 4,868	$ 5,252
Transportation	5,110	6,676	1,072
Personal	16,728	19,665	10,939
Total Monthly	**$ 26,268**	**$ 31,209**	**$ 17,263**

[1] *Auto lease and purchase.* Of course, this could just as well be considered auto loan payment. As discussed previously in this chapter, this is one of those items that requires extra thought and consideration and can be handled in a couple different ways. In this situation, the handling was fairly straightforward in regard to one of the two cars because it was under lease; therefore, we had a simple recurring payment. However, for the other car in the family, we had a purchase during one of the three years being reviewed, which at least for that one year made it an atypical expense.

[2] *Cash withdrawals.* As with many other people, this sample couple make frequent use of either an ATM or checks payable to cash. Because there was no better or supported fashion for describing these items other than as cash withdrawals, we left them as such. Certainly, attempts could have been made to allocate the withdrawals (for instance, food, pocket money, or the like). Any such attempt would add a subjective element and another area for disagreement or contention between the parties. To do so would not really improve the value and merit of this analysis.

[3] *Miscellaneous purchases.* In this example, we had payments out of the checking account for which we could not get an answer concerning the purpose. Of course, our worksheets and supporting papers would provide the extent of specifics available (that is, date, check number, payee, and so on), but for the purpose of our report, these items are simply considered miscellaneous because of the lack of solid information.

[4] *Savings.* As previously discussed, in adjusting NDI, elective 401(k) plan withholdings are a form of savings and are properly reflected as additional income and accounted for under the expense category as a savings item. This would be similar for the employer match (if that information was available) and, of course, any other direct additions to savings. A common addition to savings is when the family has dividend income (perhaps with a mutual fund), and those dividends are reinvested. We would have reflected the dividend income as part of NDI (those numbers taken directly from the tax returns) and then reflected the disposition of that income in the form of additional savings in this part of the report. You will note that in the column for 2008, savings is a negative figure because in that year, the family dipped into savings to maintain its lifestyle.

Savings

One of the more contentious issues in developing an LSA is fully and properly taking into account the issue of savings. This becomes even more complex when we are faced with the ebbs and flows from year to year of increases, and let's not forget decreases, in savings. To compound this, it is this author's experience that savings gets less respect (sometimes much less respect) than spending. That is, despite savings being an element of lifestyle, we have seen, both at the judicial and the attorney levels (and as for the attorneys particularly when representing the major breadwinner), an often almost disregard for savings as one of the elements of lifestyle.

The practical problem we face here is fairly easy to understand. Assume the ever-present theoretical 2 identical couples (families) earning $300,000 before taxes and $225,000 after taxes. At first blush, putting aside any special issues and looking at it strictly from this limited financial point of view, we would think that the LSA and ultimate alimony and support issues would be pretty much the same. However, if 1 of these 2 families spends all of its money (expensive vacations, expensive cars, private school for the children, and so on), and the other family is far more frugal, managing to save $50,000 per year of the $225,000, it is almost a guarantee that we are going to see different positions taken relevant to the lifestyle and what the to-be-supported spouse is going to need. It is almost a guarantee that the to-be-supported spouse is going to get less alimony in the latter (savings rich) illustration than in the former (extravagant spending) illustration. Dealing with the equities or inequities in this matter is not the subject of this chapter or book and is not in the province of the CPA—leave that to the judges and lawyers.

However, it does become an important issue to properly account for the savings, if for no other reason than to bring the connection between income and expenditures to a closed circle. Let us briefly deal with some of the interesting nuances that we will experience in this aspect of our financial analysis:

- Generally, paying down the mortgage is not really an issue because in a sense, paying the mortgage is a replacement for rent and just another recurring expense of the marital unit. However, this might be viewed differently at the tail end of the mortgage or with a very short-term mortgage (essentially similar to being at the tail end). If we are dealing with a situation with just a couple years left on the mortgage, that means most of what is being paid on that mortgage is principal, rather than interest. That also means that, in a sense, reducing the mortgage liability is a form of savings.

  From an economic perspective, it is not unreasonable to consider the pay down of debt to be the same as savings. When you are in the early stages of a 30-year mortgage, and the principal pay down is very modest, this is irrelevant. At the end of a mortgage, when the principal amounts are significant, and the interest is minor, this may not be irrelevant. On the other hand, going back to the issue of whether we call it a mortgage payment, savings, or the like, it's another element of lifestyle. Does it really matter? Also, along these same lines, with a short term left on the mortgage, we know that in a few years, the mortgage will be paid off, and that monthly expense (aside from the real estate taxes) will no longer exist. To what extent, if any, does that factor into the current LSA, as well as looking forward?
- For some, options, restricted stock, and other deferred compensation benefits can represent a very significant portion of their income. At the same time, they typically represent some form of savings because this element of income is not currently or

readily accessible in the form of cash flow. Generally, this needs to be treated as additional income, albeit restricted in some fashion. Depending on the specific nature of the benefit, one might think of this as compensation being put away in an untouchable savings account—at least untouchable for a few years or more. This area adds an extra layer of complexity in the form of compensation; once received, compensation is part of the marital lifestyle, and until it is available for expenditure, it is (forced) savings.

It is not unusual to have this area challenged by being told that it's either income to take into account for support, or it is an asset to take into account for distribution, but it cannot be both. Actually, it can. Think of it as just another form of compensation. If instead of being given $50,000 of restricted stock, a client received $50,000 as a simple bonus check. No one would be arguing that it did not represent $50,000 of additional income. If the family took that bonus check and put it into a mutual fund, then an asset (investment) is available for distribution. This item is not being counted twice in this illustration; it is an element of income that, in theory, will be recurring. How that income is spent (savings here counts as a form of spending) is a separate issue. By virtue of it being saved, that past income is an asset available to both litigants. Economically, it's a fairly simple concept.

- A 401(k) plan match is usually not a big item, but especially for the lower middle and middle class clients, this can be a significant item, particularly within the confines of the amount the family experiences as savings. Assume one of the litigants has 401(k) contributions withheld from his or her pay; as previously mentioned in this chapter, it is both an income and savings item. What about the employer's match that is often in the vicinity of $0.50 on the dollar? That match does not show up anywhere on an employee's W-2, and many times, it is elective by the employer. On the other hand, it is one of the benefits of employment but only if one makes elective withholding contributions to the 401(k) plan.

  Do we treat the employer match as additional compensation, additional savings, or both? To what extent is it valid that with a divorce coming, this extent of elective withholding cannot continue (two cannot live as cheaply as one); therefore, the match should not be considered part of the recurring income stream or recurring savings created out of that income stream. When income is at a higher level, the likelihood of this continuing even after divorce is greater; at the same time, in regard to higher income levels, this match element tends to be less important in the development of NDI or an LSA.
- One of the more complex (some would argue just confusing but not complex) elements of dealing with savings within the context of an LSA is changes from year to year; in some years, savings increase, and in other years, savings decrease. For instance, assume a family that saves $50,000 in 1 year; in the next year, it takes $40,000 out of savings to buy a car, go on a particularly big vacation, pay for a wedding, and so on. Within the context of reconciling dramatic changes in expenditures from year to year, the explanation can sometimes be found by delving into what happens with that family unit's savings. Thus, as part of the LSA, just as we have a line for savings,

that same line for some years may need to reflect a negative savings—a reaching into previous savings to pay for a particularly large or unusual item.

This concept is probably fairly straightforward and easily grasped, but the practical illustration and application can be complex and time consuming. By way of example, it probably means arriving at a determination about what existed in a variety of savings vehicles (such as mutual funds, savings accounts, money market accounts, and the like) at the beginning of a year and what cash flow changes (excluding market value changes) happened during that year. This would include fresh funds being infused into savings, as well as liquidations and money moving out of these savings vehicles. Further, it's not unusual to see funds moved between savings vehicles (for instance, from a money market account to a brokerage account). For our purposes, those movements are nonevents. Yet, they represent a tracing issue that might add a layer of complexity to our analysis. The ultimate issue that we have to deal with in this arena is that of the net inflows and outflows.

Marital Balance Sheet

Sometimes, one of the areas that we are engaged to address is that of the marital balance sheet or net worth. Depending on the completeness of the balance sheets prepared by the parties and counsel as part of their financial disclosure (typically in accordance with the local jurisdiction's financial disclosure requirements), it is not unusual for a CPA, as part of a more expansive engagement or as the major or sole purpose of the engagement, to be asked to develop a marital balance sheet. For accountants, this is fairly routine, especially on the business entity side. Typically, less often, we are involved in developing a personal balance sheet, but even when we are, it tends to get done with the help and cooperation of the clients and their implicit or explicit desire to be as all-inclusive as possible and put the clichéd best foot forward. This is not necessarily so in a divorce environment. Often, one spouse has (unstated of course) a desire to understate the balance sheet, omit certain items, understate certain values, and so on. Of course, it is a fair argument to suggest that the other side has a desire to inflate the balance sheet, but generally, the greater concern for likely distortion is on the downside.

Particularly if we are dealing with one spouse (or perhaps both of them) who works for corporate America and is a mid- or upper-level employee, in terms of fleshing out a complete marital balance sheet, insist on getting current and complete statements reflecting the extent and type of benefits that spouse has with his or her employer and whether those benefits are paid by the employer or employee. Is there life insurance (even if there is no cash value)? What about options, restricted stock units, a thrift plan, or any other type of benefit the employer may offer or provide? Sometimes, we can access this information online, although it requires the help of the litigant who is the employee of the company and almost invariably requires secured access codes. Alternatively, we could certainly have that litigant or, sometimes, one of the attorneys make the appropriate demands on the company. However, that depends on the company's level of cooperation and can stretch out the process months, particularly if the company is not located in the state in which the divorce was filed. Think of a family living in New Jersey, but one of the spouses works in New York for a company that is located only in New York. The counsel in New Jersey has very limited ability to make demands on the New York company.

Two types of documents tend to be helpful in getting started in the development of the marital balance sheet: existing personal financial statements and, in the absence of such, the last couple years of personal tax returns (as well as the business tax returns or financial statements). As far as existing personal financial statements, it is hardly unusual (and often quite true) to be advised that no personal financial statements exist because there was never a reason to prepare any. However, what is overlooked in that response—sometimes intentionally, sometimes not—is that more personal financial statements (or perhaps pseudostatements) exist than many people realize. For instance, within the last few years has that marital couple applied for or taken out a new mortgage, financed an existing mortgage, applied for a home equity line, and so on? Any and all of these almost guarantee the existence of a financial statement of sorts. It may not be as detailed as we'd like, but at the very least, it is a good starting point. Thus, make it a point in your discovery and documentation request to include demands for those statements. Also, in regard to such documentation, it is not unusual to be advised that the couple never kept a copy of the application. That is often true, but what is also true is that more often than not, a copy exists that can be secured for us with a little effort. Press the issue, and demand that the applications with financial disclosure be requested from the lending institution, which certainly has retained a copy.

Tax returns are also very helpful in this regard. On one level, tax returns may give us cause to seek the type of documentation just described: financial disclosures used for lending purposes. For instance, look on Schedule A and see what has happened concerning mortgage interest. If we see a major change, it might mean a new loan was taken out, an old loan retired and refinanced, maybe a new home equity line came into being, and so on. Perhaps Schedule E lists a newly acquired piece of real estate, along with a mortgage interest expense. Once again, these are telltale signs of the preparation of some form of financial disclosure used to secure the mortgage or other debt.

Besides giving us a sense of direction for demanding third-party records, by themselves, tax returns serve as a crude beginning or framework for the establishment of a personal balance sheet. Some of the information that we can readily glean from a tax return, which will directly affect our development of the marital balance sheet, includes the following:

- *Page 1.* Request all W-2s to see if any have indications of participation in a retirement plan, contributions to a 401(k) plan, and so on.
- *Page 1.* Tax-exempt interest is an indented box, and the number does not get carried forward to the taxable income or show up on Schedule B. However, its existence means that the litigant(s) owns some municipal bonds or the equivalent.
- *Page 1.* If IRAs or pensions are taken into income (or rolled over), that indicates the existence of this type of an asset.
- *Page 1.* Having a deduction in the simplified employee pension plan area or other contribution deductions means an asset exists (similar for a Keogh plan).

- *Page 1*. Although typically not that substantial, a medical savings account or similar medical plan does represent a potential asset, and over the years, this may become a bigger issue.
- *Page 2*. A refund or balance due is a potential asset or liability.
- *Schedule A*. Real estate taxes imply ownership of real estate, sometimes more than perhaps just the marital home. If you have any doubt, make sure that you understand on what property the real estate taxes were paid.
- *Schedule A*. Investment interest tells us that both a liability and, likely, an asset exist. Clearly a liability exists; that is why interest expense exists. However, because it is investment interest expense, it likely means that an asset is also attached to it to justify its deductibility.
- *Schedule A*. Mortgage interest is obviously a liability (and is attached to an asset).
- *Schedule A*. Miscellaneous deductions, such as union dues, a safety deposit box, and so on. Union dues means that union benefits need to be taken into account, and a safety deposit box deduction tells us that we might need to have that safety deposit box inspected.
- *Schedule B*. Interest income comes from some form of an asset. Whether it be a savings account, money market account, bonds, or the like, an asset should be connected to each and every line item (watch for multiple accounts at the same institution lumped on one line).
- *Schedule B*. Dividends are essentially the same as the preceding regarding interest. Here, though, we are typically looking for stocks, mutual funds, and brokerage house accounts.
- *The bottom of Schedule B*. If "Yes" is checked for a foreign account, some form of a banking relationship, brokerage account, or the like exists in a foreign country. Once again, we are going to need full disclosure.
- *Schedule C*. Need I tell you that this signifies a business? Even if it is a side business and assumed to be worth nothing, do not ignore the business. Maybe that business has valuable equipment or a separate bank account that has substantial funds.
- *Schedule D*. The presence of this schedule almost guarantees some form of a brokerage account. Again, that is discovery that we are going to insist on because in all likelihood, it means that assets need to be included in a marital balance sheet.
- *Schedule E page 1*. Rental income signifies that rental property exists; we need details.
- *Schedule E page 1*. When royalty or similar-type income exists, typically, some form of an asset is the source of that income.
- *Schedule E page 1*. Depreciation expense tells us that assets are being depreciated. Generally, for real estate, it might be as simple as the building, and we already know that exists because of rental income. On the other hand, there may also be significant appliances or other items within the rental units that are not as readily known and might be overlooked.
- *Schedule E page 2*. Partnerships and S corporations are another one of those no-brainers. If any kind of an entry exists here, we are definitely going to want discovery,

maybe a lot of it. What kind of business exists that generates the Schedules K-1? Realize that sometimes, it is nothing more than a minor passive investment (for example, a master limited partnership interest in which the investment is relatively minor, and the K-1 exists simply because of the tax structure). That is okay, and it is better that we are inquisitive. Of course, for this purpose, it does not matter whether a gain or loss is reflected here; we need to have a better understanding of some kind of asset (think business).

- *Schedule E page 2*. Even if estates and trusts are not part of the marital balance sheet and not up for grabs in the divorce, if we see entries here, it is certainly something about which we are going to want to become grounded. Furthermore, it is also very possible that an estate or a trust might be part of the marital estate, and it is something that we would not want to overlook.
- *Schedule F*. A farm tends to be one form of a business. Treat this form no differently than we would treat Schedule C. What is the underlying business, and what are the assets of that business?
- *Form 4562*. If depreciation exists, assets have to be depreciated. We are going to want full details, including a depreciation schedule.
- *Form 8283*. Noncash contributions are usually going to be nothing more than the couple giving away some old clothing. However, every once in a while, this includes something a little more exotic: a car, an interest in a privately held enterprise, artwork, and so on. You get the idea; giving away something like one of those items suggests that there may be other such items around. At the very least, we are going to want to inquire and flesh out our understanding of what collectible or similar tangible assets might exist.
- *Form 8582*. Passive activity loss carryforwards are typically not thought of as assets. Let's face it; it is hardly unusual for some taxpayers to have hundreds of thousands of dollars (sometimes millions) of loss carryforwards. These are assets or, at the very least, potential assets.
- *Supplemental schedules*. These can be just about anything, but one that comes to mind includes net operating loss carryforwards. Conceptually, they are treated the same as the preceding passive activity loss carryforwards—a potential asset.

The preceding makes it clear that the tax returns of the family can be very helpful in fleshing out a personal balance sheet. Also, as you develop the personal balance sheet, refer to the most recent one or two tax returns to see if those returns suggest something (whether asset or liability) that should be on the balance sheet you are developing. Maybe we have missed something, or maybe the disclosure we have received is not all that is should be.

Consider requesting the homeowners (if appropriate, renters) insurance policy. Look here for, perhaps, a rider or floater for items such as jewelry, furs, and collections. Also, if the policy covers multiple addresses, make sure you are aware of the various addresses and what items exist at each one. If collectibles or other tangible assets, we very well are going to need a list, as well as an appraisal. As far as the appraisal, typically, the insurance companies require one every few years. So, if the item is covered under the insurance policy, it is almost guaranteed that an appraisal was performed in the last few years.

A more difficult item is a 529 plan; it goes by different names, but essentially, it is a college savings plan. Unless we have very good cooperation or a trail, what makes this somewhat difficult is that these accounts tend not to show up anywhere on a tax return, other than if they apply to a state tax return that contains a deduction for contributing to such a plan. For this, unless some other flag exists, we will need input from one or both of the litigants. Also recognize that 529 plans are technically not the child's asset because they belong to the parents. Of course, the parents face potential penalties and taxes if they access or liquidate the 529 plans, but that is a separate issue.

Typically, as part of developing the marital balance sheet, we are also going to want to interview one or both of the litigants. For the purpose of a personal balance sheet, this might most effectively be done twice: once at the very beginning, so that we can focus on where our efforts will be fruitful and what we should expect, and again after we've made significant progress and think that we are 90 percent finished. At that point, we might want to share our findings with one or both of them and find out what is missing and what they might be concerned about. I prefer to ask my clients for their feedback before I provide them with a status report about what items I have addressed. I prefer my clients' minds be open to whatever strikes them, rather than tell them what I have and let them address whether it's complete.

Do not overlook the children's tax returns and assets. If assets exist that are truly assets of the children, they may not be part of the marital estate; however, that decision is better made by legal counsel than us. Let our role be to determine that the asset exists and secure documentation in support of that asset. Leave it to the attorneys to then argue about whether that asset gets pulled into the marital estate or remains solely the asset of the person whose name is on the account. What was previously discussed about information that could be culled from tax returns also applies to the children's tax returns.

In terms of developing the martial balance sheet, we might even want to approach the issue of the wills of the parents (perhaps even grandparents) of one or both of the litigants. This tends to be a bit of a reach and may be something to which we are not entitled. Nevertheless, there may be reason to address this area. Perhaps the parents or grandparents are elderly or in poor health, and an inheritance is soon likely. Is that a potential asset for consideration within the marital balance sheet? The potential inheritance probably would not be included in the marital balance sheet because it is not yet an asset, and we all know that wills can change; however, perhaps it warrants at least a footnote stating that this potentially large (multimillion dollar?) asset exists and that one or both of the litigants can be reasonably expected to receive this inheritance within the next few years. Granted, this may not fly, there may be jurisdictional issues that will not allow it, we may not be able to get these documents because the parents and grandparents are not party to the divorce, and so on. Nevertheless, it is something to keep in mind, and the exception to the rule may prove to be important.

JUST CHARGE IT—In a case in which we were the neutral expert, we got a somewhat unique eye-opener about the pervasive ease by which people can get credit cards. This was a small classic Mom and Pop business, and because of a combination of economic issues beyond their control, as well as the style in which they lived, this couple kept the business afloat through the judicious use of some credit cards. You might ask what I mean by some credit cards. Without exaggerating, they had 52 credit cards, all of which were maxed out. Pretty much, as long as the marriage stayed intact, they were able to continue this float game, staying one step ahead of disaster. They lost that footing when the divorce action hit.

10

Final Stages

LET'S SIT DOWN AND BREAK BREAD, OR SOMETHING—Along the lines of truth is stranger than fiction, our client (the wife) was an attorney, and the husband had a Master's degree; therefore, presumably, both people were of above-average intellect. We did our thing; we valued the wife's law practice, all the numbers were resolved, and the parties came to agreement on everything and were ready to get divorced. However, they could not agree on who was to get the dining room table. One can only imagine what kind of sentimental value that dining room table held, that it meant so much to the two of them that they couldn't come to an agreement on a few sticks of wood. The entire agreement blew up in their faces, and the case went to trial. That dining room table must have been worth $40,000 because that's what they spent litigating a case that had already been settled.

The goal of this chapter is to help fellow practitioners address the issues of assisting in bringing a case to conclusion – whether it be through a negotiation or trial. The prior chapters got us to the point of doing our job in the sense of producing an analysis, a report or whatever product was desired relevant to representing your client, or both clients if you are the neutral expert. The idea now is to take that result and help to fashion a settlement, or to be ready to defend it at trial. This chapter, among other aspects, covers such things as the battle of the experts (where there are at least two financial experts and there are significant differences between them); dealing with deposition and ultimately trial; practical aspects of trying to help settle a case; issuing a report (included is a pre-issuance review checklist); and providing certain practical suggestions for sources of funds to help accomplish the closing of the matter. I also provide certain observations as to matters such as the extent that alimony might be impacted by a return on investments; the ever present current events changes as contrasted with the date of valuation; the often overlooked interest on equitable distribution; and the practical matter of planning for life after divorce.

Alimony Affected by Investments

To what extent, if any, does or should the dependent spouse receiving investable funds affect that spouse's alimony entitlement? Whether the investable funds should affect alimony, whether they should be dollar for dollar (each dollar of investment yield reduces alimony by one dollar), and whether the appropriate return on such investable assets is to be used in the process of addressing the effect on alimony are all relevant points.

A fundamental question that arises within the context of this issue is, to what extent should alimony be affected by the assumed return on investment? Are we talking dollar for dollar or some lesser amount? What is fair or reasonable under the circumstances? If the dependent spouse needs $100,000 per year to live, and if that spouse is going to have a pool of investments that will yield $40,000 per year, then the necessary standard of living can be met with just another $60,000 per year from alimony, with the return on investment kicking in the other $40,000.

However, this means that the investment yield is going to be consumed by daily living needs and will not enable that spouse to further augment his or her investments. Further, there would be no inflation protection for that person's investment portfolio. If we assume an $800,000 investment portfolio structured to yield 5 percent ($40,000 per year), in theory, that investment portfolio will stay stagnant at $800,000. As the years go by, the value will be eroded by inflation. Normally, when reasonably well invested, the ravages of inflation are covered by the investment yield, so that in one simplistic sense, what would be today's $800,000 of buying power will still be $800,000 of buying power 10 years down the road. Without the investment yield or, in this sense, by consuming the entire investment yield, 10 years down the road, inflation may make today's $800,000 tomorrow's $600,000. Thus, an argument can be made for only a partial or no offset of investment yield against alimony.

A related issue of equity is that by providing this type of offset, the supporting spouse is ultimately placed in a stronger financial position by being left with more disposable and discretionary income (the result of having to pay less alimony). That extra income gets invested, further increasing the investment pool of that spouse. In addition, in theory, because the supporting spouse is earning sufficient funds to support himself or herself and pay alimony, that spouse's equivalent investment pool (that spouse is also walking away with $800,000 of investable assets) will benefit by having its yield untouched, thus allowing it to be reinvested and provide a level of inflation protection. The result is that the supporting spouse will benefit in two ways: that person's investment portfolio will not be drained and will keep up with inflation, and that spouse will have a lower alimony payment obligation, which will provide additional funds for investment and long-term security.

This brings us back to the fundamental issue that the purpose of alimony is to provide the dependent spouse with the ability to maintain the marital standard of living. Within the context of all other financial elements, wouldn't it be inherently fair that if the dependent spouse can maintain the marital standard of living, in part, from the return on investable funds, then it should be done in that fashion? That spouse has a lesser need for alimony, and the supporting spouse is entitled not to make payments when they are not necessary in order for the dependent spouse to maintain the appropriate standard of living.

If it is accepted that there will be some offset, we need to determine the appropriate yield or rate of return on the investable funds. Connected with that is the financial knowledge or education, risk tolerance, age, and various other factors of the spouse at issue. Taking those factors into account, no resolution is simple. Is it most appropriate to use a conservative rate of return, such as we would get from a 20-year Treasury note, essentially providing the holder with no risk and a very modest guaranteed return? Is it reasonable to go for something such as a high-yield corporate bond rate, a medium-quality corporate bond rate, or long-term market return? Is it appropriate and reasonable to expect that spouse to engage a money manager? Also, if that spouse is assessed anything more aggressive than a conservative rate of return (recognizing that the issue here is dealing with a dependent ex-spouse), what happens if that somewhat optimistic assumption doesn't come about, and that spouse loses principal and receives a lower yield? How will that lower income and, likely, loss of principal (value) be made up? Who will reimburse him or her?

Allocating Business Value

One of the beauties of an equitable distribution state is that, at least in theory, the allocation of the various assets is done in a fashion other than mechanical rote. Equities can be taken into account. When it comes to allocating the value of a closely-held business in which one of the spouses is active (a situation we run into every day), generally, even for a long-term marriage and when the nonbusiness spouse made modest contributions to that business, a 50/50 allocation is virtually never done. Typically, we see allocations between 30 and 40 percent. What is the justification for this apparent incongruity? Elsewhere in this book we address the matter of the double dip. Putting that aside, there are probably a few other possible justifications (rationalizations may be a better word) for same. We will not address the matter of the extent of the spouse's contribution, or the length of the marriage. Rather, just two specific issues – the tax impact, and what we have heard from some judges, the burden of getting up each day, combined with the risk of running the business.

An argument we have heard on more than one occasion is that it is fair to leave the business spouse with more than 50 percent because the business spouse needs to get up every day to deal with that business and carries with him or her the risks of that business. Getting up each day is more of a personal and emotional issue, and we are not going to get into that other than to comment that in so justifying a disparate allocation, it implies that it is distasteful and undesirable to get up each day and go to work.

Instead, we will address the financial issue of the business spouse having to live with the risk of running that business. When we as experts, value a business, one of the factors considered in the valuation and a significant item in the development of the cap rate or multiple is risk. In our calculations, we take into account the risks inherent in the business, including losing a customer, facing competition, or any multitude of normal or abnormal (case specific) business risks. Risk has been taken into account in our ultimate valuation conclusion. Therefore, it is perhaps inappropriate to justify a disproportionate carve-out on the basis that the risk remains with the business owner.

Sometimes, one of the reasons for carving out less than a 50 percent share of the value of a business for the benefit of the nonbusiness spouse is that it is done to compensate for the tax burden on the value that remains with the business owner. If the value of a business is $1 million, and if we assume for the moment that it is all taxable (it has zero tax basis), when the nonbusiness spouse gets bought out of that interest in the form of cash (sometimes a trade-off with other assets—put aside any tax issues), that spouse walks away with a defined amount of money free and clear of taxes. The business owner retains his or her business interest and, along with it, all the taxes attached to that expressed value. Thus, at least in some camps, it is considered reasonable and appropriate when determining the percentage of that business interest to go to the nonbusiness spouse to reduce it somewhat in recognition that the entire tax burden on the value will remain with the other spouse—the business owner.

Assuming that the reasoning for the lesser than 50 percent share is related to taxes, it needs to be appropriately quantified. This is a complex area, and this potential tax burden has many aspects, such as the following:

- What is the amount of built-in gains that are subject to tax? If a business is worth $1 million, that is not the same as saying that the sale of the business for $1 million will result in a tax on the $1 million. There will only be a tax on the difference between the value ($1 million) and the cost or tax basis of that business, which can be as low as zero or even exceed $1 million.
- No one knows when the tax will be incurred, if at all. Unless the business is actually in the process of being sold, or a sale can be anticipated, this tax burden might fall into the realm of hypothetical and potential, rather than actual. Thus, we do not know when or how much tax is at issue.
- Related to the preceding, even if we could reach agreement on the amount of tax, a time issue still exists; as previously indicated, we don't know when the tax going to

happen. Therefore, is it fair to impact in today's dollars, via a lesser allocation, a tax that is not going to be paid for some undefined number of years?

- Related to the preceding, we do not know the amount of the tax. Will that business be sold as a capital gains transaction, an ordinary income transaction, or some blend? What will be the tax rates when it is sold? Of course, none of this can possibly be known at the present time.
- To give such a discount on the carve-out in effect gives the business owner potentially years of cost-free use of that other spouse's share of the tax burden.

All of the preceding notwithstanding, there remains the point that to some degree and fashion, the value comes encumbered with a tax, assuming that the value of the business is in excess of the cost basis, and there would be a tax had it been sold at that price. Thus, isn't it fair when dividing up that asset that its value net of built-in tax obligations be used as a basis, rather than its value without recognition of the built-in tax obligations?

To put into context the real impact of this tax concern, let's take a simple hypothetical that assumes the business is valued at $1 million; its tax basis is $300,000; and it has a built-in gain of $700,000. Further, assume that the appropriate blended tax rate (federal and state) is 30 percent, meaning an ultimate tax of $210,000. If we consider the value less the tax burden, we have a "real" (net of tax) value of $790,000—50 percent of which would be $395,000, which is 39.5 percent of the total asset. Thus, if the rationale is taxes and if it is fair to apply the entire estimated tax currently, a carve-out of 35 percent is not far off.

Let's use a slightly different illustration of a business worth $1 million and a tax basis of $800,000, meaning a taxable gain of $200,000. Further, assume that with favorable terms, the blended tax rate is 25 percent, which is $50,000. Thus, the net of tax value of this business is $950,000—50 percent of which is $475,000, which is 47.5 percent of the total value. A carve-out of 35 percent because of taxes doesn't make sense.

Battle of the Experts

Not infrequently, an issue arises about the advantages and disadvantages of using a joint expert versus each side having its own expert. One of the major advantages to using a joint expert is to avoid what has sometimes infamously been described with a degree of bitterness as the battle of the experts. Simply put, the business owner's expert concludes that the business owner is earning $400,000 per year, and the business is worth $1 million; however, the spouse's expert concludes that the business owner is earning $600,000, and the business is worth $4 million. These dramatic differences between the experts happen all too often and create this battle. Generally, when experts come in fairly close to each other, both sides recognize the merit of either simply splitting it down the middle or compromising in some other way. It is when the differences are significant, such as in the example just referenced, that there can be little to no justification in simply averaging the 2 numbers. It would seem that one of these experts (potentially it could actually be both of them) has made a serious mistake or a series of mistakes and has grossly overstated or understated income or value, or both.

One of the theories in the investigative accounting and business valuation process is that two reasonable, competent, and equally well-informed experts should conclude not all that far apart in regard to income and value. Indeed, that happens many times. However, it is also not uncommon to see two experts very far apart. The result is that the attorneys, clients, and sometimes the judge throw up their hands in disgust and wonder what is going on. In almost all cases, the reasons for the differences can be fairly easily isolated, even if the underlying problems cannot be easily addressed. However, if we can at least determine where and then why the experts differ, we have a much better chance of addressing, perhaps narrowing, and maybe even resolving the differences. Let us briefly focus on the likely, most common areas that tend to generate differences. We will first deal with the income area because income is what tends to drive value and then move to the valuation area.

When addressing the matter of the income of a business, there tend to be only a few areas that generate differences of consequence:

- Perquisites (personal benefits) derived from (paid through) the business. The experts may differ on which items are business and personal and what percentage should be applied to various expenses (that is, travel, entertainment, and so on) to accurately reflect the personal element. It can be as simple as a couple trips that one expert is considering personal, and the other is considering business. In part, that may be because they got different stories from their respective clients.
- Large differences can arise as the result of unreported income (URI), which is a problem of the cash business. By its very nature, the calculation to determine URI is almost always an estimate. As such, assumptions have to be made, and tests have to be performed, with the result that reasonable people can conclude differently. One of the experts may have assumed major URI because of feedback from one of the spouses or certain tests, or both, but the other expert made no such assumptions or conclusions.
- At times, we receive different information. In theory, the expert working for the business owner has better access to the financial records and, therefore, may know more than the expert for the spouse. On the other hand, the expert for the spouse may have the benefit of representing a spouse who is aware of the business, knows what's going on, and actually took financial records and provided them to his or her expert. This is information that the expert representing the business owner did not see, and it would never be provided by the business owner who has his or her own agenda.
- Various other possibilities exist, including time differences; income shifting by the business; and normalization adjustments, such as reasonable rent and the like. Too many possibilities exist to list each one, but the point is that they should always be identifiable and, thus, able to be addressed.
- In all cases, we (the experts) need to be well grounded in the basis for our numbers and the reasons why the other expert's numbers are wrong. We also need to be candid with ourselves and our team when the other expert is right.

The other broad concern involves the value conclusion. Again, we typically find that just a few areas generate substantial differences:

- Because value is generally driven by income, we need to look at the starting point: what income did each of the experts use to determine value. By itself, this item may give us essentially our entire difference. However, the starting point of income may not be that clear-cut because of the next referenced area of difference.
- Reasonable compensation (replacement salaries) is often one of the most critical adjustments made by valuation experts. How far apart are the numbers used by each of the experts, and what support do they provide for their conclusions? One expert may have used a number of third-party sources, but perhaps the other expert has opined based on what he or she thinks is reasonable. We may have a business owner who works 80 hours per week but is treated by one of the experts as if he or she just worked an average number of hours.
- Income taxes usually are not an issue. However, did one expert use the typical statutory rate of 40 percent, but the other expert used some other tax rate? If that is the case, what is the reasoning and justification for using the different tax rates?
- After all the adjustments have been addressed, we have the issue of what income is used to ultimately determine value. In theory, we can have two experts concluding with five years of reconstructed income that is virtually identical, but the experts approach the use of that data in different ways. One expert might take the most recent year as indicative of what he or she expects for the company going forward, but the other expert might use an average of those five years, expecting that to be most reflective of the future of the company.
- Most income-driven valuations are performed with the use of a capitalization (cap) rate. How far apart are the experts' cap rates? Maybe we used a 20 percent cap rate, and the other expert used 15 percent. That is a difference between multiples of 5 and 6⅔. On $300,000 of capitalizable income, that represents a difference of $500,000 in value. Once we know the difference between the cap rates, based on the information provided in the reports, we can then see how the cap rates were determined. Did the other expert use different small- or specific-company premiums or an industry-specific risk when we did not? Finally, what growth rates did we use versus the other expert? That can often have a significant effect on the eventual cap rate.

The preceding are just some of the highlights of where the most likely differences between experts can make a significant difference in the ultimate value conclusion. Only a few highlights and examples have been illustrated, and certainly, many more opportunities (good and bad and credible and noncredible) exist for experts to differ.

Sometimes, an effective way for the attorney to handle such a situation is to bring in a neutral third expert. Granted, this will mean additional costs, but it may also save on costs in the long run. This is not a guarantee, and we don't know which way the neutral expert is going to go. However, when this process works correctly, it serves as a useful and cost-effective tool of bringing the numbers closer together, either to a conclusion that both sides may feel comfortable using or to a range from which both sides can then reasonably negotiate. In addition, it is sometimes very difficult to get two experts who are far apart to sit down and agree on where one or both of them made mistakes. Further, it may not be a mistake but a matter of a different interpretation. The use of a neutral third party with no ego built into either conclusion may work very well. Also, the extra cost incurred by engaging this third expert may turn out to be modest in comparison with the costs if this case were to be battled out in court.

Current Events Versus Date Valuation

I don't know about you, your practice, and your peer group, but in my situation, the stock market debacle of 2008, combined with the recession that, depending on specific geographic area, spanned late 2007 into 2010 and beyond, raised a whole bunch of conceptual issues and self-doubting within our peer group. The connected issues here dealt with concerns over the value of the business as of the date of complaint (DOC) or, based on your jurisdiction, the date of valuation versus something much more current (in the depths of the recession). Tied into this is the extent to which we accept a current recession's negative effect on operations affecting a long-term value determination. These types of issues are really not new, and in a sense, they always existed; the magnitude and severity of the recent recession made us all a bit more aware of, and concerned with, this issue.

Assume that the company being valued has had a history of profitability and growth, but the last couple of years have not been as kind because of the recession. What do we consider for valuation purposes? What is our starting point? What income are we going to choose? What do we expect for the future? None of this is new because these were always concerns; however, these concerns have increased because of the recent recession. Was the last year or two simply a blip in a long history of upward movement? Was the effect of these years more serious? Do those years set a standard for a new reduced future? Is the company either financially precarious or a newly established company; thus, the recent poor years, even if the economy turns around, may have been just too much for this company to take and the recovery to the "good old days" just not likely? These are all interesting issues that, to varying degrees, we need to address in our analysis and valuation.

An interesting angle with all this is that an arguably strong company, particularly one with a long history, that is likely or proven to be a survivor may actually have the recent adverse economic situations enhance its value. After all, we can expect a shakeout within the field or industry that leaves the surviving companies in a better competitive position and stronger than they were before the recession. Keep in mind that this concern has many angles. For instance, although the surviving company may be stronger within its field than before the recession, maybe its field is smaller or less profitable than it was a few years ago—thus, the proverbial bigger slice of a smaller pie. Again, in concept, none of this is different; but in real-life application with a much greater current awareness of adverse economic conditions, this is a new reality.

Inexorably, part of these connected concerns is what was known or knowable as of the valuation date. At the same time, depending on the jurisdiction in which we operate, that may not matter a heck of a lot because it is not unheard of for a judge to accept a breach of valuation protocol to bring in current or more recent information, often for the very good reason of trying to equitably treat the litigants.

The concern about the recession's effect on a company's earnings and whether that is to be considered somewhat permanent is connected to the development of the cap rate. As we all know, the cap rate is a reflection of risk, and one of the most relevant aspects that needs to be considered is the likelihood or expectation that the income being used for capitalization purposes will continue. If the business being valued has already had its income negatively affected by one or two years of a recession and if that level of income is what is being considered (regardless of whether it is averaged), don't we have a reduced level of risk relevant to a comfort level that the level of income will continue? If so, we have lower risk factors and, in a sense, a greater multiple, which might still result in a lower value, resulting from this exercise.

It has always been a possibility to hear things along the line of, "If you think that's all it's worth (if you think it's worth that much), then I will buy it from you (sell it to you) at that price." With the recession's effect on the numbers, that type of reaction, at least from the spouse that is not involved in the business, has become a bit more commonplace. It is harder to foist upon a nonbusiness spouse a position that says, "If you think it is worth that much, why don't you buy me out?" After all, that spouse likely does not have experience running this type of business and would not be the type of buyer who would be paying that price. However, that defensive argument from the one to whom the business is being "put" is not the same or as strong as the argument from the same spouse making a "call" on that business. After all, even if that spouse has no familiarity with running the business, assuming that the financial terms are reasonable and adequately secured, would the counter defense be, "I will buy it from you at that price"? Under limited circumstances, it would hardly seem unlikely for this approach to be carried to its ultimate conclusion. For those business owners and their experts who might be taking advantage of the current recession to push the envelope downward on valuations, it hardly seems unlikely that we will be witnessing such an approach – which might be crudely defined as "be careful what you wish for, you might get it."

Dealing With Our Counterparts

Unlike attorneys who, because of the adversarial process, learn early on how to interact with other attorneys, accountants do not have that same experience until we get involved in the litigation arena. For us, it becomes very important to establish relationships and relate to our fellow CPAs in a way that is comparable with what attorneys are used to doing all the time. Generally, the community of CPAs who truly and regularly function in the litigation arena is small, even more so for those who concentrate heavily in divorce. Although there will always be a new entrant and an occasional dilettante, the likelihood is that we will be running into the same people all the time. Thus, it will be to our benefit and our client's benefit to establish relationships and deal in a cordial manner with our peers. We will also establish a network of fellow CPAs who will be able to help us understand very quickly the better competitors versus the ones who simply do not know what they are doing or, even worse, cannot be trusted. Also, as a practical matter, it is almost inevitable that we will run into conflicts and not be able to take on a case. We will be in an advantageous position if we can refer that case to a "friendly" CPA who, in turn, will be in a position to refer to us when he or she runs into a conflict.

Deposition

Like trial testimony, being deposed puts us on some level of official record because we are testifying. Even though it is a deposition rather than a trial, we are typically under oath or affirmation; we have entered into a far more formal process than simply chatting with one or both sides about the numbers of the case. On the whole, it is my experience that deposition is the exception to the rule in divorce practice but certainly not an aberration. For the most part, we need to be as prepared for a deposition as we are for a trial, but differences exist.

Generally, a deposition is one-sided, and we will be in a purely defensive position. A deposition process is somewhat akin to cross-examination, although we can often expect it to be along the lines of fact finding by the other side, rather than attack. Even though a really bad performance in a deposition might serve the other side well in the sense that because of that poor performance, it is decided that we do not go to trial, the expectations of that deposition are generally not to knock us out (though some do approach it in that fashion) but, rather, to understand what we did and why and for the other side to avoid being surprised at trial.

Also, one aim is to have us commit to certain steps, processes, and conclusions. For instance, if we are asked in a deposition if we considered "such and such" as part of the process, and we answered that we did not, simply now knowing about it might improve our knowledge and position, but we already committed that we did not consider "such and such," and that may work against us later on in trial. On the other hand, if we answered that we did use or consider "such and such," we can expect a follow-up question along the lines of asking us in what way. Once again, the likely aim of the other side is to get us to be boxed in to something in a way that will preclude us from going outside of that box or presenting something different at trial.

On the other hand, in a deposition, we may very well want to expand widely on our answer. This is in contrast to trial where, during the typical cross-examination, we will either want to or be forced to limit our answers to "Yes" or "No" or be stopped from propounding a bigger and better explanation that provides fuller information. Typically, in trial, we will get the opportunity to remedy any such shortcoming when the attorney with whom we are working returns to give us the opportunity to redeem ourselves in redirect testimony. In a deposition, we may get (and probably should try to get) the opportunity to give a fuller answer when we perceive that it will benefit us. If we are put into a position in a deposition in which we give an answer that is not the best answer or puts something in a light that is unfavorable when a more favorable viewpoint exists, we may want to continue our explanation (at least until you are stopped). The reason here (check with counsel on this) is because to not do so will give the other side the ability to refer to and cite our deposition transcript as part of our cross-examination when this matter goes to trial, which will limit us to acknowledging that we indeed said that in the deposition. The premise here is that what we said was not necessarily favorable to our report or side. Granted, in all likelihood (assuming your attorney is paying attention), we will get an opportunity to remedy that when we go under redirect testimony, but the damage may have already been done because the deposition record only has this negative, and any correction now may give the impression that we have had an opportunity to consult with counsel to help us not look so bad.

With respect to being ordered or subpoenaed into a deposition, the matter of getting paid is very important. Unlike the typical situation in which we testify in the trial, and are there because our side wants us there, when we are deposed, it has nothing to do with our side wanting us deposed. It has everything to do with the other side demanding that we make ourselves available for deposition testimony. Remember, it is not our client who is asking us to render these services. So, who is going to pay us? Usually, when we are deposed, the side demanding to depose us (that is, the other side) has to pay us, but we only get paid for our deposition, not preparatory time.

It is my practice, and I make it an absolute rule, that I get paid in advance by the other side, or I simply do not show up. Now, the practicality is that at times, we can accept assurances that a check will be waiting for us when we arrive, and it will be filled out and given to us at the end of the deposition, especially when we trust the other side. I have found that works most of the time, but I caution you to know who is committing to make that payment. In the absence of either prepayment or such a guarantee with which you have comfort, I would urge (once again, check with counsel and know the local jurisdictional procedures) that you refuse to participate in such a deposition.

We do not want to be in a position in which we have to bill the other side in order to get paid. This is not our client; this is the other side's client. Depending on the tenor of the case and the attitude of the other side, they may even be the functional equivalent of our enemy. They have little to no interest in us and no reason to keep us in their good graces. They are not going to be calling on us for future service (certainly not in this case); therefore, why should we be in a position to have to chase them to get paid? Simply put, extending credit under these circumstances is not only inadvisable, but we have the right (once again, this can certainly vary from jurisdiction to jurisdiction) to get paid either prior to, or concomitant with, the service we provide. The other side has the right to depose us, but they are obligated to pay for that deposition.

One final aspect regarding depositions is the matter of legal representation. An interesting nuance with depositions is that typically, the attorney with whom we are working on behalf of our client is present. However, that attorney does not represent us; he or she represents our mutual client on whose behalf we are testifying. Because the deposition is a legal process, should we be and do we need to be represented by our own counsel? This is a point for consideration.

Helping Settle a Case

Once we have experience under our belt and a good reputation, we can expect to be asked to participate in a settlement conference or negotiations. We may even possibly meet with the other accountant and try to come to a common understanding about income, value, and so on. Generally speaking, it is advisable to keep in mind that in this process, the attorney is the boss. Typically, we (as accountants), are in a supporting role. Unless we are given the green light to clearly take the lead (you will only see this when you are experienced and working with a less-experienced attorney or an experienced attorney who does not have a big ego), we should know our team's ground rules before sitting in on such a settlement conference. Understand our side's target and how much leeway we can afford and allow. Know the sensitivities of our clients and the risks of offering a compromise that hasn't been agreed to in advance. It is very helpful to give thought to where you are going in advance of any such meeting and, perhaps, how to make the numbers work.

It is all well and good that we have a number for the business and maybe even worked out a mutually agreeable compromise with the other accountant. Regardless, our biggest contribution may be in trying to strategize how to whack up the marital pot. What this means is that if the business is worth $1 million, and the nonbusiness spouse is going to get bought out for $400,000, from where is that money originating? In divorce, the answer often is some degree of a trade-off with other assets, such as the marital home and maybe a carve-out of a retirement plan. The importance here is that we should know this in advance of sitting in on any such settlement conference or negotiation; we should have ideas about how we are going to make the numbers work. Elsewhere in this book, suggestions are provided for generating funds or liquidity as part of the process of settling the case. Understand in advance which ones apply to your case, your options, and the parameters of the financial resources.

It is certainly not unusual to have the accountant assist in the settlement and negotiation process. Typically, our input and financial knowledge are going to be desirable to craft the right settlement for our client (obviously) but also one that makes sense because a bad settlement, even one that favors our client, is only asking for problems down the road, which serves no one well. Even when we are not directly involved in the face-to-face settlement process, it is also typical that a draft of the agreement (for example, a marital settlement agreement, property settlement agreement, divorce agreement, or the like) is often passed by us for our input. Once again, our understanding of numbers and finances is often (and probably should always be) sought as part of the process of finalizing such an agreement.

One aspect that is overlooked too often is that of a sense of balancing the tax issues. Since the Tax Reform Act of 1984, the tax concerns in divorce have generally become much less of an issue, and that is recognized even by most attorneys. However, the creation of Internal Revenue Code (IRC) Section 1041, which essentially means that the movement of just about anything between spouses as part of the divorce action is a nontax event, did not eliminate tax concerns; it only eliminated the immediate tax effect of the movement or transfer of assets between spouses. Nonaccountants too often fail to understand that in the allocation and division of marital assets, it is often not enough to simply balance the numbers (whether equally or in some percentage); it is important to recognize that different assets are often accompanied by different tax consequences. Thus, it is important when dividing up the assets that attention be given to the underlying tax consequences of the assets and that the appropriate (whatever that might mean for your case) allocation of the tax burden be part of the process.

Interest on Equitable Distribution

We don't hear about this issue very often. Perhaps the reason is that in many cases, it is believed that the amount at hand is not worth making a big production over, or it is simply, in a sense, subsumed within the eventual negotiated conclusion. It is very likely that neither one of these is accurate. You may be surprised at the substantial interest or interest equivalent, and it is questionable whether an interest factor is considered within the context of a negotiation. In our experience, it is also extremely unusual to see it expressed within any judicial determination. This issue is predicated on the fact that what is being distributed is based on a DOC value, not a date of dissolution value.

Let's deal with the justification for this heretical idea. Assume here that value is fixed as of the DOC. It is at that point in time that typically, the CPA valuation expert determines the value (as-of date) for the business. This is notwithstanding that the process happens several months or one year or more afterward. The clock has stopped, and barring something very unusual, it is as-of that date the value to which a percentage is applied is based on whether the business goes up or down after that date. However, we all know that the typical divorce process results in a delay from several months to one or more years between the filing of the complaint (and then the determination of the value) and the actual distribution of that share of value. In the interim, the business owner continues to run that business and reap its benefits or suffer its ills. Yet, during that time span, typically, we are expecting the nonbusiness spouse to accept nothing in return—just let the business spouse continue in the business for some period of time and pay the equitable distribution share in old dollars.

Assume that the nonbusiness spouse's interest in the business is $500,000, which is hardly a startling figure and one that most readers have probably experienced on a number of occasions. Further, assume that it takes 1½ years from the DOC (the date of valuation that determined said $500,000) to the date of distribution. Should the nonbusiness spouse receive a return on that $500,000, and if so, at what rate? Should it be something along the lines of a safe investment with a modest return of 4 percent or 5 percent? Perhaps the rate should be something closer to a midgrade corporate bond yield of 6 percent. Maybe it should be 8 percent, the long-term yield of the stock market in general. Perhaps 20 percent might be a return that is appropriate for the "investment" at hand (that is, a relatively risky closely-held business).

Assume that 8 percent is the appropriate rate of return. Because 1½ years have passed since the valuation date, this equals 12 percent. Because the spouse is entitled to $500,000 as his or her share of the business, and it has been determined that 12 percent is the appropriate additional interest factor to apply, we are looking at another $60,000. That is hardly insignificant, and this is hardly an unusual illustration. Yet, how many times have we actually seen this happen? One can imagine how substantial this issue can be if we are talking about a share in excess of $1 million and, perhaps, 2–3 years in the waiting.

Of course, it would be possible to update the value of the business to a point in time very close to the actual distribution date, which is the norm in various states. Particularly in states that use value as of the DOC, that would tend to be expensive (a moving target requires a lot of extra work) and illogical and simply add more time and stretch out the issue. Thus, it would seem that the fairest way to handle this in a DOC environment would be to apply a reasonable rate of return and then add that rate of return to the value otherwise determined for the appropriate time span. Accepting the equity in this approach, the only question that arises is that of the appropriate rate of return – the interest factor that needs to be applied.

Negotiating a Settlement

After we have established a following and reputation, we can expect to be asked to assist in negotiating a settlement, especially for those attorneys with whom we have a good working relationship and who understand the value that we bring to the table as CPAs. That assistance may take the form of participating in a live settlement conference or providing feedback in response to a draft of a proposed agreement. Either way, it is an excellent opportunity to provide our team (do not overlook that it also speaks well of you to the other side) with the benefit of our financial and tax thinking, as well as elements of common sense. Relevant to working out a settlement, the following are some thoughts that we might want to keep in mind:

- *Should the alimony be deductible?* The typical and almost universal knee-jerk reaction to, and understanding of, alimony is that it is deductible by the payor and taxable to the payee. However, as CPAs fully understand, that need not be the case because the tax law provides a virtually unique opportunity to decide that the alimony shall not be deductible and taxable. Although the majority of the cases are likely going to fall along the traditional lines, there will be opportunities when it makes sense to be a bit more creative and when both sides will benefit if the alimony is treated as a nontaxable event. For instance, perhaps the payor has a cash business and simply does not report enough to make a deduction worthwhile. I am not suggesting that you advocate the nonreporting of income—only recognize the practical and historical reality. Perhaps it is nothing so questionable; rather, the payor is well sheltered in other areas and has no need for the deduction. By careful crafting of the terms, both sides can benefit.
- *Alimony versus child support*. Be careful here in terms of child support being disguised as alimony and the potential negative tax consequences if things backfire. However, from a straight tax planning point of view, opportunities exist here to play one off against the other for the mutual benefit of both sides. The typical concerns are that alimony can last almost forever, except for remarriage, but the terminus of child support is almost always clearly defined.
- *Transfer of assets*. We all know that under IRC Section 1041, we can move virtually any assets (as well as liabilities) between spouses, regardless of whether they are getting divorced, and realize no immediate tax consequence. However, that does not mean that the transfers are without tax consequence; they are just not immediately recognized. Thus, in the process of allocating and dividing up the assets, do not overlook that different assets can be burdened with different tax costs. Try to accomplish the economics of the asset division in as a posttax balance as is desired.
- *Bankruptcy protection*. Although the laws have recently become a bit more favorable toward the recipient of the payments (typically meaning the wife), concerns still exist

that a time payout of equitable distribution or community property asset allocation (think in terms of payments over several years, with a balloon payment at the end) may expose the recipient to the risks of the payor declaring bankruptcy, sometimes coincidently just before a major payment has to be made. Generally speaking, this risk can be avoided or, at least, minimized by having language in the divorce agreement that recognizes that any such payments constitute part of or, perhaps, are even in lieu of alimony or other support payments. Because support payments are not dischargeable in bankruptcy, such language can go a long way toward providing a comfort level and can be a tremendous benefit in the case of bankruptcy.

- *Tax knowledge*. Obviously, it is important that we know taxes, and certainly, it is expected of CPAs. To give an illustration of how this helped in a very practical way, I was involved in a case in which the major asset was a very large IRA account. I represented the husband who had the IRA account, and I was working with the counsel and client to try to divide up the assets. His soon-to-be ex-spouse was several years away from age 59; thus, she was not in the position to be able to draw against the IRA without a penalty. A key factor was trying to work out the finances to their joint satisfaction, with her issue being that in her eyes, the alimony numbers were not going to be the magnitude that was needed. We were able to favorably resolve this by pointing out that she was entitled to invade the IRA in an annuity-like withdrawal process, regardless of her age. Because of the size of the IRA, this was going to be a fairly significant amount of annual withdrawals, which would make a difference in terms of her meeting her living needs. That it was going to be taxable was not the problem; it was the extra 10 percent penalty that was an issue. We were able to give comfort that she would be able to accomplish her living needs without the 10 percent penalty, as long as she met the rules of IRC Section 72(t). Of interesting note, which stood well for us, the other accountant involved in the divorce case (a very capable individual) was not aware of this tax "loophole" and was only able to provide a conditional agreement, subject to researching the matter further.
- *Be prepared and informed*. This one is a little too obvious, but it never hurts to be reiterated. When going into a settlement conference, be as informed as you can about the assets and liabilities that are involved in the martial estate and, perhaps, their relevant tax basis. Also, be aware of the assets and their respective liquidities, so that you can creatively and intelligently provide assistance in making the settlement work.
- *Sale of the marital home*. Often, as a direct or indirect outgrowth of the divorce, the marital home is sold. None of us would overlook the $250,000 per person exclusion, but be aware of the timing of the divorce in respect to the sale of the marital home. If it is going to be sold after the divorce is consummated; and if more than $250,000 is gained; and if it is desirable to have as much as possible sheltered from taxes, then perhaps keep both spouses on the property until it is sold. Imagine the distress if we have a $500,000 gain; no one pays attention to the realities of transferring the property; and only 1 person is eligible for the exclusion. The result could be $250,000 of gain that is taxed but should never have been taxed. Either emphasize the need to sell

the property before the couple is divorced, or urge both spouses to remain on the property until it is sold, even if there needs to be protection for the spouse who is keeping the house that he or she will receive all the proceeds.

Planning for the After (Divorce) Life

Depending on our role in the case and the extensiveness of our services, we may be able to do our client (and perhaps even the other litigant) a great service by planning out certain financial issues. Usually, this is a concern only when we've got a spouse who has not worked for quite some time or has been employed part time. Essentially, that person has not really been making a living and is now facing a life likely supported by alimony and, maybe, some investment income. By the way, this could apply to both spouses; after all, we are now splitting this family into at least two units, and one of those units is likely going to be paying alimony. With that in mind, sometimes, both parties need this type of financial foresight.

As part of our service, it might be very helpful to one or both of the litigants if we project future cash flow. Again, depending on the scope of our engagement, we might find it a worthwhile exercise to create a long horizon, multiyear spreadsheet. Start off with the known or anticipated sources of income, which would possibly include alimony, full- or part-time work, investment income, and some form of retirement benefit. Also, depending on our client's age and how many years we project, don't forget Social Security. Even for a younger divorce client, we might want to extend this analysis into the Social Security time frame, especially if we are concerned that the alimony might stop around the time when the payor is likely to retire. Next, we have to factor in expenses. If, as part of the divorce process, we have gotten into the lifestyle of the litigants or we have a reliable financial statement disclosure, that may be an excellent starting point for determining this person's expenses going forward. By the way, children factor into this and make this a far more complex issue. However, recognizing that a number of assumptions (inevitable for this type of exercise) are going to be made, we can be in a position to provide a valuable service, detailing a long-horizon expectation of cash flow. Depending on how the negotiations proceed, this may be a critical factor in helping a client accept or reject a certain settlement. It may also serve as an illustration to the other side of why a certain proposal will not work.

Rebutting

Working with and coordinating matters with the other CPA in the case raise some very practical issues. Keep in mind, as previously referenced, typically, we are working in a small professional community, and are going to run into the same person again and again. This issue takes on heightened practical importance when we realize that it is very likely that we will be involved in a case in which another expert will express an opinion or prepare a report that concludes significantly differently than ours, or we may be brought in specifically for the purpose of responding to and rebutting that other expert's report. Further, although we all hope that we will typically see a quality report with legitimate differences of opinion and judgment, sometimes, we will see what could only be kindly described as junk, and other times, even when the report is good, we will take issue (sometimes strenuous issue) with certain approaches and conclusions.

Generally speaking, a tempered response is the best one. It will be rather easy to respond strongly. It often takes restraint to formulate a tempered response, and it raises our hackles when we read a severe criticism of our work. Keep in mind the need for interaction. If our rebuttal is along the lines of "What that other CPA did lacks common sense," or something akin to "There isn't a scintilla of logic or support for that approach," versus "I believe a better approach would be," or "The majority of our peers and the literature support a different approach," our professional lives may become strained. However, we will be called upon to comment critically and conclude differently. Be prepared to do so, and keep in mind that just as we are responding or rebutting, the other expert will do the same (and probably has already been asked). Sometimes, the other "expert" is no expert or is out of his or her league and area of knowledge. In such cases, arguably, a scathing critique not only is warranted but may be doing that CPA a favor by sending him or her the message to stay away from that which he or she does not know.

In responding to or rebutting the work of another expert, it is generally advisable to stick to the key areas of difference. Yes, sometimes, especially when the other report is so bad, it may be advantageous to rip apart every page and paragraph, particularly if the aim is to illustrate how that other expert is, in fact, not an expert, and his or her report should simply be outright disqualified. However, in the more common situation, dealing with the key areas—the ones where we and the other expert have the disagreements of most quantitative magnitude and the ones that will really make a difference in our conclusions—is the best approach. The following two reasons illustrate why this is the best approach:

1. First and foremost, it makes it easier for the attorney with whom we are working to put his or her hands around the issues and focus on what is going to make a difference. It makes it easier for everybody to zero in on the real important differences. Also, many attorneys do not fully understand the work that we do and the theories behind it. Thus, limiting the number of areas for our attorney to fully grasp, for us to explain to that attorney, and for that attorney to use in cross-examination is best for our team.
2. A very practical self-defense reason exists for a fine-tuned response. Simply, the more we say (the more items we attack), the more for the other expert to counterattack. If we go on and on, we are inviting the other expert to do the same, and are also giving that other expert an opportunity to find fault (sometimes minor) with various matters, which will only exacerbate the situation and provide the other side with more attack points against us.

Report

An issue that may arise from time to time or, perhaps, even frequently is that of whether we are to issue a report, and if so, how complete of a report. The good news is that Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, vol. 2, VS sec. 100), in regard to litigation such a divorce action, puts no burden, restriction, or mandate on us relevant to issuing a report. Take the lead from counsel. Generally, in divorce, it is my experience that a full written report is almost always used (if you're not sure, you certainly will want to clear this with counsel). However, subject to what counsel or the client wants, although we need to do all the work (depending on whether it is a conclusion or calculation of value), we can give a report as short as one page, but this probably wouldn't do the job in a litigation matter. Nevertheless, it will not violate our standards. In fact, we can give no written report but only a verbal report. To the other end, we can give our standard 30- or 100-page report.

As far as the presentation of the report, although typical common sense issues exist, no mandated (per our standards) form or sequence of presentation exists. Certainly, logic usually dictates that the order is going to be a cover page, table of contents, and accountant's letter. After that, although most of us have a fairly routine process and order, the report can be in any order that we wish. Also, there is the question of financial data which could run several pages in various reports. Financial data usually appear as exhibits or appendixes at the back of the report. However, if our style is that we'd rather have that information in the center of the report, that is our prerogative. For what it is worth to you, I have found over the years that my report format has evolved roughly in the following sequence:

a. *Cover page*.
b. *Table of contents*. Make sure that the titles listed on the table of contents, as well as the page numbers, agree with your report.
c. *Accountant's letter*. Typically, in my case, this is no more than two pages unless I have certain special issues that I need to bring to everyone's attention, such as severe scope limitations, lack of cooperation, or the like. It is my feeling that the cover letter should be reasonably brief, state essentially what you have done and certain limitations, and present your conclusion.
d. *General information, such as the purpose and scope of your engagement*. This is pretty much self-explanatory. Typically, this area will also include data considerations, such as the documents you reviewed.
e. *Company profile and background*. If you are going to value a company, you probably should explain the company. I have seen this section be as brief as 1 page and as long as 10 or more pages. It will typically vary based on the size and complexity of the company; the degree of cooperation you receive; and what you, in your judgment, deem to be relevant and important to include as a narrative. Typically, you will have at least a brief description of the company and its history and some detail about its key personnel. You might go into pages on these issues by including customers, the sales process, how the back office works, and so on.
f. *Macroeconomics*. This is background information about what is going on in the country and the overall big-picture economic scene. Too often, we see this information dumped into a report taken verbatim from some reliable third-party source. There should be at least an attempt here to connect the meaning of this analysis to something that you have done in your report. By way of simple example, if the economic scene is talking doom and gloom, you better have a

very good reason for projecting a 10 percent growth rate into the future for this company.

g. *Industry economics*. Again, this is self-explanatory. When this information is available, which is true in many cases, it tells something about the specific industry. If you are valuing a local retail store, although it might be interesting to know what is going on in the United States in general and what the Department of Commerce is predicting for the future, it is probably far more relevant to understand what is important to that specific business. If it is a retail clothing store, the clothing industry, how the store buys its products, and the store's sources are far more important than knowing that the U.S. economy is expected to grow 2 percent next year.

h. *Local economics*. In some cases, you can get information that pinpoints the local area. If you are dealing with a manufacturing operation that sells across the country, then what's happening within the 10-mile radius of its location is often not relevant, or if that information is relevant, perhaps it's very low down in the ranking of importance. On the other hand, if you are valuing a medical practice, local retail store, or local service business, what is going on locally in that community is typically very important. If that information is available, try to include it.

i. *Financial analysis*. The extent and depth of this can vary widely, being as little as a few words and as much as several pages. The point here is to highlight and discuss various items relevant to the specific company that you can glean from its tax returns or financial statements. This may also include ratio analysis; a discussion of multiyear history; and whatever you feel is helpful to the reader to understand the business, as well as develop the strength of your report.

j. *Normalization adjustments*. This is probably where we spend the biggest block of our time, making adjustments to the reported figures. It is here where you may run on for pages, with a few, several, or numerous normalization adjustments for URI, adding back personal meals or car use, removing moving expenses, addressing nonrecurring items, and so on.

k. *Valuation methodologies and approaches*. Here, you might want to briefly or not so briefly explain the concept of valuation and the different approaches to valuation. Typically, this is boilerplate language that will be repeated from report to report. Review it every once in a while to make sure that it is appropriate for the specific matter.

l. *Valuation methods employed*. Often, this is an extension of the preceding item; it is a matter of now taking the theoretical that you just expounded upon and explaining how you applied it to the specific matter. Typically, you will also indicate when you did not use an approach and briefly explain why not. For instance, you did not use the cost approach because it is a successful ongoing business; you did not use the market approach because you could not find suitable comparables.

m. *Discounts and premiums*. If you are using fair market value versus fair value, you will want to present your analysis of this area and foundation for arriving at whatever discounts you deem appropriate.

n. *Conclusion*. Regardless of whether the actual word is *conclusion* or *calculation*, this is where you will present, often in just one page, your determination of value.

o. *Appraiser's certification, limitations, and so on*. This is another boilerplate area, as many as four pages or so, that simply states that you did a quality job and are independent.

p. *Exhibits or appendixes*. You will note that essentially, all the previous parts contain no specific financial detailing, balance sheet, or income expense statement—just a lot of narrative and some numbers that go along with it. As indicated earlier, I and most of our peers have gotten to the point where the financial guts are presented in the back of the report under the thinking that it makes reading the body of the report smoother and easier. Whether you accept that is your call. The following will be items that we typically list as exhibits or schedules.

q. *Balance sheets*. This includes one or several years of reported balance sheets of the business, regardless of whether you are using a tax return or financial statement presentation. Some of us also like to provide common-size analysis: the balance sheet, as well as the income and expenses, with each line item expressed as a percentage. Whether you find this useful and effective is a personal judgment call. It is my belief that for many small and midsized businesses, particularly if you are doing this exercise before normalization adjustments, it is of limited utility. Its greatest use may simply be to show that the reported numbers are inconsistent with the industry norm. That by itself may be helpful; it may also be irrelevant.

r. *Income and expenses*. Similar to the preceding, this contains one year or several years of reported profit and loss of the business.

s. *Normalized or reconstructed balance sheet*. This is self-explanatory, and it should reconcile with the narrative in the earlier part of the report.

t. *Normalized or reconstructed income and expenses*. This is similar to the balance sheet just described.

u. *Development of the cap rate*. This is self-explanatory.

v. *Valuation*. This includes one or more schedules applying your valuation methodology.

w. *Expert's or appraiser's qualifications*. Some of our peers have an ego issue and get carried away by including more pages here than in the rest of the report. Unless you are required to list everything you have ever done since kindergarten, most of us can present ourselves fairly well in two or three pages.

x. In addition to all that, plenty of situations will arise in which additional schedules will be needed, or the facts and circumstances of the specific case will call for additional calculations, illustrations, and so on.

Regardless of how we like to present our reports, essentially, it has to be presented in a logical and commonsense fashion. We need to be careful that we do not have inconsistencies or mistakes, especially arithmetic mistakes. We've included a preissuance review checklist here as an example of the level of detail that should be considered prior to issuing a valuation report. Even a benign arithmetic mistake might have us challenged under cross-examination along the lines of, "So, you have acknowledged that mistake, what other mistakes are in your report?" We also need to check our wording carefully to make sure we avoid things that

VALUATION REPORT
PREISSUANCE REVIEW CHECKLIST

This checklist is to be prepared by the report writer and then submitted to a reviewer for a final inspection.
Client: ______________________________ Date of Report: ____________

	YES	NO	N/A	EXPLANATION
1. Is the report in our standard format sequence? Does it contain the table of contents, accountant's report letter, narrative introduction, balance sheet information, profit and loss information, adjustments, explanation of adjustments, additional information and statistics, valuation approaches, conclusion about value, certification of independence, and limitations?	☐	☐	☐	
2. Does our report letter clearly state the following:				
• The purpose of our assignment, specifically what was valued	☐	☐	☐	
• The as-of date	☐	☐	☐	
• The type of value	☐	☐	☐	
• The conclusion	☐	☐	☐	
3. Does our report detail any limitations or restrictions placed upon us?	☐	☐	☐	
4. Does the narrative and introduction give adequate insight about the following regarding the subject company:				
• Its history	☐	☐	☐	
• Management	☐	☐	☐	
• Key personnel	☐	☐	☐	
• Key products	☐	☐	☐	
• Major issues and concerns	☐	☐	☐	
• Outside financial forces affecting the company	☐	☐	☐	
• The company's future prospects	☐	☐	☐	
• Its competition	☐	☐	☐	
5. Does the narrative appear to be unbiased?	☐	☐	☐	
6. Does a concern exist that the type of business or location is out of our field of expertise and unduly exposing us?	☐	☐	☐	
7. Are our adjustments adequately explained, and is our documentation for these adjustments adequate?	☐	☐	☐	
8. If there are no or only a few adjustments, was this area adequately addressed?	☐	☐	☐	
9. Was the balance sheet adjusted, and if not, why not?	☐	☐	☐	
10. If was concluded that unreported income exists, does it appear we have adequate support for such a conclusion?	☐	☐	☐	
11. If it was concluded that unreported income does not exist, were reasonable efforts made to ascertain whether that seems logical?	☐	☐	☐	

	YES	NO	N/A	EXPLANATION
12. Do the adjustments appear to be unbiased?	☐	☐	☐	
13. Were the personal financial records analyzed?	☐	☐	☐	
14. Are you satisfied that the personal financial situation is consistent with our findings?	☐	☐	☐	
15. Was outside industry source information used, and if not, why not?	☐	☐	☐	
16. In regard to the outside industry source information, was it adequately referenced, and does it appear appropriate and reasonable for the subject company?	☐	☐	☐	
17. If ratio analysis was used, was it applied correctly (versus merely filling up paper) and explained?	☐	☐	☐	
18. If the subject company has significant fixed assets, was an equipment appraiser used?	☐	☐	☐	
19. Was reasonable compensation addressed, was it adequately researched, and does adequate support exist?	☐	☐	☐	
20. Was there adequate recognition regarding the depth of management and key person risks?	☐	☐	☐	
21. Was the choice of the use of pretax versus post-tax net income figures appropriate?	☐	☐	☐	
22. What income was chosen for capitalizing, and does it appear appropriate based on our normalized income conclusions?	☐	☐	☐	
23. Was more than one method of value used?	☐	☐	☐	
24. Were the methods of valuation that were used reasonably explained, and was the choice of weighting logical?	☐	☐	☐	
25. In regard to the cap rate, was it adequately explained?	☐	☐	☐	
26. If less than 100 percent of a company was valued, was the matter of a discount or premium addressed?	☐	☐	☐	
27. Were there any sales of interests in the subject company, and if so, were they referenced in our report?	☐	☐	☐	
28. If a buy-sell agreement exists, was its effect considered and referenced?	☐	☐	☐	
29. Was subsequent information used, and if "Yes," was it justified?	☐	☐	☐	
30. If our conclusion was that no goodwill exists, should liquidation value be considered?	☐	☐	☐	
31. Was the business site visited?	☐	☐	☐	
32. If the answer to the preceding item is "No," what is the comfort level about the valuation and our position on the stand? Explain.	☐	☐	☐	
33. Was the report cleared with the client regarding its factual accuracy?	☐	☐	☐	
34. Is the report readable to the layperson (judge, attorney, client, and so on)?	☐	☐	☐	

	YES	NO	N/A	EXPLANATION
35. Does the conclusion pass the smell test? Would you buy, sell, or recommend it to a client?	☐	☐	☐	
36. Are you aware of anything subsequent to our valuation date that is significant about the subject company that might render our conclusions illogical?	☐	☐	☐	
37. Is the file in good order? Is it ready for trial?	☐	☐	☐	
38. What is the status of money due to us from our client? Should we be holding up the report and pressing for money?	☐	☐	☐	
39. Does the reviewer believe that anything would require holding up the processing and issuing of the report?	☐	☐	☐	

Report Writer Who Prepared This Checklist: ______________________ Date: ____________

Reviewer Who Reviewed This Checklist: _________________________ Date: ____________

might get us into trouble. Generally, absolutes will get us in trouble or have the potential to do so. We are better off with qualifying wording like, "In my opinion," "Based on what I have seen," "It appears that," "It is likely," and so on. In contrast, the words *always* or *never* have the potential to box us in during cross-examination. Also, make sure our report is written in good English. As absurdly obvious as that sounds, it is embarrassing to read some reports. It is as if the ability to write coherently and logically is no longer a fundamental requirement for our profession.

Separate Property

For a slightly different twist on the separate property issue, assume no dispute exists but the property is separate, has been kept that way, and our client is not going to get any piece of the property. However, also assume that the property is a fairly substantial asset, such as a trust, that has been providing tens of thousands or hundreds of thousands of dollars of income per year. As we know, our client is not going to get any of that. Depending on the jurisdiction and relative income positions, our client may not even get any of that counted toward support.

One potential angle is that when the income flow has typically been substantial, it can amount to a significant potential recovery for your side. How were the taxes on that trust income or any other separate property income paid? It is hardly a stretch to have a situation with this type of trust income that as the income is received, it is put into a spouse's separate account or, perhaps, even deposited into the general joint marital account (none of this should affect the separate nature of the underlying asset). Then, depending on the magnitude, as well as other sources of income, when it comes time to pay the family income taxes, those payments are made out of a joint account. Due to many factors, it is possible that under this type of scenario, the marital estate has paid part or all of the taxes on the income generated from the separate property. Depending on how long this has been going on, the marital estate—with us performing the complete tracing job—might have a claim of many thousands of dollars or more.

Settling Your Differences

Particularly after we have established ourselves, when we have a case with one of our counterparts on the other side, and the two of us have differences of substance between us, it is not unusual to be asked to sit down with that other CPA and see if the two of us can work out our differences. In theory, this is a very good concept but one that is often difficult to effectuate. Unless one or even both of us have clearly made a mistake that is pointed out, and pride does not preclude us from acknowledging it, because of the nature of who we typically are, and the nature of the work that we are doing which blends factual with judgment calls, it is simply very difficult to acknowledge the points of the other side; ego and pride often get in the way, as well as the inability to see when the other side's argument is stronger than ours.

For instance, in making normalization adjustments, one of us has added back 50 percent of auto and entertainment expenses, but the other has added back 10 percent. In part that is because of feedback from our clients, and it is a judgment call about what seems reasonable or appropriate. In determining reasonable compensation, maybe we came from 2 different source materials, and in addition, one of us treated the business owner as working a so-called normal workweek, but the other believes that owner works 60 hours per week and is entitled to some premium. In the development of the cap rate, maybe one of us believes that the growth rate is fairly defaulted to the long-term inflation expectations of 3 percent, but the other one believes that the company's history calls for a 5 percent growth rate. Other than splitting our differences down the middle, which hardly calls for us to talk to each other, each one of us likely has a sound or reasonable foundation for the steps we took and the assumptions we made.

Another concern with this attempt for the CPAs to work things out is that many attorneys are uncomfortable with that concept because working things out is their job. Thus, the degree and extent of freedom and latitude that we are given in any such meeting may vary considerably. It is dissatisfying when one CPA agrees to a compromised number, but the other one says, "Let me take it under advisement and talk to my team." Despite all those issues and especially when each of the CPAs is comfortable with his or her skill level and each other, a lot can be accomplished that not only serves the client well but also saves one or both of us some potential embarrassment on the stand, discomfort, and the like.

Source of Funds for Buy-Out

In some of the larger situations, particularly when a very substantial share of the marital estate is the business, it is not unusual for us to run into the practical problem of insufficient liquidity for effectuating the buy-out. It is all well and good that we have reached a conclusion about value and a consensus about the nonbusiness spouse's share; however, how is that person going to get paid when liquidity simply is not there?

Before we throw up our hands and say liquidity doesn't exist, maybe we have overlooked some possibilities, such as the following:

- *Home equity*. Because most of the time, the nonbusiness spouse is also the one getting the home, this probably will not work. However, perhaps the business owner is keeping the house. Maybe he or she can refinance it, pull out a lot of equity, and use those funds. One of the problems is that if the business is worth millions of dollars, often, not that much equity is available in the house.
- *Home equity*. Instead, consider the usual situation of the nonbusiness spouse keeping the house; pulling as much out of the house as possible for refinancing; and that cash going to the nonbusiness spouse, with the business spouse assuming the responsibility for the mortgage. Yes, concerns and risks exist, but perhaps the obligation can be collateralized in some way.
- *Other real estate*. What else is in the marital estate that possibly can be mortgaged or sold to free up cash for the nonbusiness spouse?
- *Retirement plans*. There is no sacrosanct 50/50 split. Subject to accessibility and built-in tax issues, consider a disproportionate allocation of retirement plan monies, perhaps including future retirement assets.
- *The business*. Sometimes, the business is relatively free of debt and has the creditworthiness to be able to borrow. In such a situation, that can be a substantial source of funds.
- *Potential inheritance*. This is reaching a bit, but maybe the business spouse is looking at a potential inheritance of consequence, and if the conditions are just right, he or she can borrow against it.

Of course, sometimes, none of these work, and the only way that liquidity is going to happen is with installment payments over a period of time. To compound that situation, many times, the only collateral is the underlying business itself. Another consideration might be for the two of them to stay partners, but that is fraught with many problems. When a fair degree of trust and lack of animosity exist, perhaps a deal can be carved out in which the nonbusiness spouse continues some kind of interest in the business, such as a note buy-out of some kind, on the payroll, keeping a percentage for a future benefit, and so on—whatever can be done creatively to make the buy-out work.

Testifying

Books have been written about how to testify and what to do and what not to do when testifying. The best teacher is experience. It doesn't matter how many books we read or who we listen to; if we do not experience testifying by going through at least one good cross-examination, then trial testimony does not have any meaning to us. Of course, we already know the usual standards, such as dress accordingly (this is not a casual event), be very prepared, know our file, tell the truth, do not lie, try to be as decisive and firm as possible, answer the question and little or nothing more, and so on. We have probably heard or read this before, and it is all true.

Perhaps the most tension-filled aspect of our work is testifying, regardless of whether it is in a deposition or at trial. It is an aspect of our services that should never be taken lightly. To testify effectively, it is almost always advisable to discuss what is expected of us and our testimony in-depth with counsel in advance of the trial. Even those of us who are heavily experienced in this area and have testified numerous times truly appreciate and need never overlook the importance of this type of preparation.

Recognize that when we go to trial, we are getting set up. First, we go through direct examination, which is essentially a friend in a preplanned environment asking us questions that we have perhaps already rehearsed, are totally expected, and are tailored to fit us and our report. When we get through that direct examination, whether it is 10 minutes or 1 or several hours, we are sitting pretty because we have said all the right things, made our points, and it was our friend asking us the questions. We are now comfortably sitting back and waiting for that other attorney, who we know does not have a prayer of upsetting or tripping us, to ask us the cross-examination questions.

The good news is that many attorneys do not know how to effectively cross-examine a financial expert. The bad news is that plenty of attorneys do know how to do that, and even if they do not know how, they know the cross-examination process better than we ever will. Even when we have done a superb job, it is hardly unusual for a cross-examining attorney to raise some questions, do some damage, and needle us in some way. A question that challenges us begins along the lines of, "Isn't it possible that …?" Of course it is possible; almost anything is possible. Another question is, "So you performed a test sample of 20 percent of the transactions? That means that you didn't test 80 percent of them, correct?" Of course the answer is correct, we all know the simple arithmetic involved. If we get a chance, we are going to immediately explain that 20 percent is more than statistically valid for your purposes. However, we may not get that chance because the question posed to us requires only a simple "Yes" or "No" answer; we were not asked to explain ourselves. Even if we get the chance to explain, keep in mind that the person we are trying to impress is the judge, and judges are traditionally lawyers, not numbers people. Thus, the judge will fully understand that it means that we did not test 80 percent of the universe; the judge may not understand that 20 percent is a valid sample.

When meeting with the attorney for preparation, the basic idea is to plan out our direct testimony. Both parties need to have a comfort level about what kind of questions the opposing attorney will be asking us and, perhaps as importantly, what questions that attorney will not be asking us. Some attorneys and systems will give us an opening and allow us to just keep on talking. Others will hew to a very tight line of narrow questions and answers. If we have any doubt, certainly, the attorney with whom we are working should be able to give us a solid understanding of what is likely within the specific system or locality where we are testifying.

As part of this preparatory process, we also should be going through what to expect under cross-examination. Although most attorneys are probably inadequately trained in understanding finances and, thus, do not know or understand a lot of our work anywhere near the extent they should understand it, many of them fully know how to cross-examine and can make even the most self-assured expert have some doubts and be uncomfortable at some point in time. The good news is that there is generally no comparison between the opposing attorney's knowledge and how well we know our numbers and the process of getting to those numbers. The bad news is that any degree of complacency will lull us into a false sense of security. By the way, during this preparation period, it is prudent to emphasize the need to be given the opportunity to remedy our testimony, if the other attorney draws blood under cross-examination. The attorney with whom we are working needs to be ready to help rehabilitate us in the eyes of the judge or jury, or both. It may be that under skillful cross-examination, we are boxed in to a narrow answer that really is only half the truth or a degree of distortion of the reality or simply leaves a bad (not necessarily wrong) impression. Try to anticipate those areas and our weaknesses and prepare with our attorney in advance how to address those areas.

Typically, part of the trial experience is also assisting our team both in advance and, often, at trial with what to ask the other expert. Just as counsel prepares us in advance for our testimony, part of that process will also involve us assisting counsel and developing the types of questions to ask the other expert. We will need to get a sense from counsel about whether that attorney's approach to these things is to cut to the quick and deal only with the issues of substance or whether that attorney is the type who wants to pick apart every line item. Regardless, our job is to assist in that process. Recognize that what we might take as an obvious and a given, even experienced attorneys may not realize as a mistake, such as the other expert made a truly bone-head mistake in the development of the cap rate by adding the growth rate to the discount rate rather than subtracting it. In general, they often do not know what really makes a difference in terms of areas to attack or where to find the mistakes. Thus, depending on our and counsel's style, we may prepare in advance a rebuttal, memo, or fact sheets about issues, flaws, and the strengths of the other expert's report.

During the trial, it is hardly unusual for the financial experts to be present and sitting at the counsel's table taking notes about how the other expert testifies, with particular focus on where that expert can be challenged, where he or she made a mistake, and so on. We can expect to be asked to fill that role in order to assist our team in the real-time cross-examination of an expert. This would involve us listening during both the direct testimony, in order to set up a series of questions and challenges, and cross-examination, in order to make sure that our team is going in the right direction and for us to be able to provide counsel with follow-up questions. After all, the other expert will likely come up with a good response to cover a mistake or respond to a question with a judgment call or opinion that side-steps an issue. The other expert might also give a response that is flat-out wrong, perhaps a wrong response to cover what that expert knows is a mistake. In any case, our role is to assist. A caution here—we have to assist quietly. It is unacceptable to be talking to counsel during the trial right in front of the judge's eyes; it is also rather disrespectful. Instead, we should be quickly writing down some useful notes and feeding them to the attorney. During a break (sometimes you are going to want to ask for one), would be the time to actually chat. In some cases, effective assistance along these lines can be more useful and valuable than our own testimony.

We need to keep a slew of things in mind about effectively testifying, such as actions to take or not take, ways to conduct ourselves, and the like. Fortunately, most of these involve varying degrees of common sense and normal and sound business practices. The following is not in any particular order and is intended to highlight some but not all of these issues:

- *Clothing*. Need anyone be told not to dress flamboyantly? That should be easy; after all, we're accountants. Although typically that means dark suits for men and dark dress outfits for women, that is not necessary (unless this is one of those rare divorce cases going before the Supreme Court of the United States). For most if not all jurisdictions, a complementary sports jacket and slacks for men and pantsuits for women should certainly be fine.
- *Timeliness*. Despite the fact that the system often does not respect our time, and waiting around and cooling your heels is unfortunately a routine aspect of being in court, if you are told to be there at 9:00 AM, that would suggest 9:15 AM is late.
- *Direct testimony*. This is your shot at getting in your side of the story. If you are given enough latitude, roam as freely as you can and as far as counsel wants.
- *Cross-examination*. You can certainly try the preceding, but expect that you are not going to get that shot. Generally, when answering the question, you will respond briefly and factually. Certainly, do not volunteer extra information under cross-examination.
- *Observing*. When you are in court to assist counsel rather than testify, you need to be as respectful of the court as possible, and that means minimizing any conversations. Certainly, when the judge is on the bench, talking would be the exception to the rule, and you need a really good reason to be talking.
- *Tell the truth*. Need this one even be mentioned? However, for a little reemphasis, do not twist things and open yourself up to one of the worst possible experiences on the stand: being caught with less than a truth. The proverbial outright lie is not even necessary because a gentle distortion is bad enough.
- *Pay attention*. Particularly during cross examination, pay attention to what you are being asked, and then answer that and nothing more. Also, do not be surprised if the question that you are asked under cross-examination is something that you have already answered, or the words are couched in a way that implies you said something you did not say. Pay attention.
- *Pause a little before answering*. Especially during cross-examination, do not rush to give an answer. In part, this is to give your attorney a chance to raise an objection. You do not want to be answering a question that your attorney does not want you to answer. It also gives you a chance to properly and fully think about how you are going to answer the question.
- *Stick to the facts*. Do not speculate or guess. If you do not know the answer, simply indicate that you do not know. If you are asked to speculate on a so-called hypothetical, that's a different story—as long as everyone understands it is a hypothetical.
- *Do not argue*. As tempting as it is to engage in a debate with the cross-examining attorney and as much as you are in a great position to really show him or her how that person is wrong, that's not why you are there. Answer the question and even disagree

when appropriate or necessary, but do not argue. At the same time, do not let an attorney bully you while you are on the stand.

- *Calm demeanor.* Along with the preceding comment, save your excitement for a ball game. On the stand, you are to be calm, cool, and collected. If you become rattled, your value diminishes precipitously, as well as your credibility.
- *That question again.* Attorneys will routinely ask you the same question or variations on a theme again and again. In part, it is because they are hoping to trip you up and get you to say something that is contradictory to something else that you have said. Again, take your time, listen, and think. Also, if your attorney feels the same way, you can expect an objection to be raised along the lines of asked and answered.
- *During an objection.* If you are asked a question in cross-examination and counsel raises an objection, do not talk, and do not answer during the back and forth between counsel and the judge. No one is asking for your opinion at that time (unless someone actually does ask for it), and by all means, no one is expecting you to give an answer during an objection. Even if you think you can help educate those poor, uninformed legal experts, that is not your role.
- *I do not understand.* Nothing is wrong with saying, "I don't understand." If an attorney asks a question and you don't understand it or believe it contains any potential ambiguity, respond along those lines, and ask for a clarification. Indeed, questions are sometimes specifically crafted to be ambiguous; other times, the question is not crafted at all, but perhaps the attorney does not understand our technical field. By the way, never assume that in advance because it is also a very good possibility that the attorney knows very well what he or she is asking and why and is maybe crafting the question in such a way to elicit a certain response. As a general rule, you will never go wrong by overestimating the other side's abilities.

IF YOU CAN'T STAND THE HEAT, STAY OUT OF THE KITCHEN—The highlight of one trial was during the husband's (my client's) testimony involving the theft from the marital home of heirloom silverware that he inherited from his parents. Apparently, the silverware was stolen a couple years earlier, and a police report was filed. When he described the silverware and its loss, his voice cracked with emotion. At that moment, clearly annoyed by her estranged husband's testimony, the wife stood up, interrupted the testimony, and berated him for inaccurately describing the silverware. To prove her point, she reached into her purse and pulled out two pieces of this (stolen) silverware.

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Concepts

COURTROOM HUMOR—It's truly a pleasure when you experience a light-hearted moment in the courthouse, particularly when it's created by a judge with a particularly candid sense of humor. We were dealing with an orthopedic surgeon and his protestations of a support order. He argued before the judge that he only made $150,000 per year and could not afford the pendente lite order that the judge had imposed on him. The judge listened attentively and asked the doctor to please approach the bench. When the doctor did so, the judge half stood up, leaned forward, and extended his hand, eventually shaking hands with the doctor. The judge then sat back with a contented look on his face and said (please keep in mind that this was all on the record), "Now, not only can I say that I shook hands with Ronald Reagan but also with the only orthopedic surgeon in the U.S. making under a quarter of a million dollars a year." Credibility before the court was not this doctor's strong suit. Oh, by the way, the doctor seemed to have an unusual number of payments for supplies, with the checks made payable to Beat Industries. Our investigation revealed that it was really Beat Meat Industries; the doctor was paying his family's food bills through the medical practice as if they were supplies.

In doing this work year after year, and in particular through interaction with my peers, various interesting, sometimes you might even say esoteric, issues arise. Many times these are great in concept, but as a practical issue can only truly be addressed in a big money case where someone is willing to spend the money for one of us to go off on a splendid tangent. Other times these are concerns that might arise only infrequently, but have the potential for being very interesting. Chapter 11 tries to present some of those issues that I have noted over the years. This includes such common type concerns as arguing active versus passive; as well as what has gotten a fair amount of play in our field, that is the double dip issue. I also provide insights into perhaps some less obvious or less frequently occurring matters such as addressing the build-up of retained earnings, whether or not we experts or our peers are appropriately independent, and even the esoteric type issues of human capital and marital momentum.

Active Versus Passive

This is one of the areas that has tremendously interesting potential and is also abused on occasion. Is it appropriate and supportable to characterize a change in value as active or passive. Depending on the case, this ties in to whether it is separate property (premarital or inherited or gifted) and what kind of change has happened during the marriage or after the date of complaint (DOC). Let us briefly summarize these rules for an equitable distribution state:

- All marital assets are in the pot, unless a specific reason exists to exclude them.
- A passive asset that is in the marital estate is valued as reasonably close to the distribution or dissolution date as possible.
- An active asset that is in the marital estate is valued as of the DOC.
- A premarital or inherited or gifted asset is not in the martial estate, except to the extent that appreciation during the marriage is attributable to active participation.

Those few facts have the potential to bring into play some interesting issues, such as the following:

- Was a spouse's involvement during the marriage in a premarital or inherited or gifted asset an active involvement or one of merely a passive outside investor?
- Was appreciation subsequent to the DOC the result of active or passive efforts?

For illustrative purposes, in New Jersey, the *Ciasiulli v. Ciasuilli* case brought out, to an extreme, the issue of determining active versus passive appreciation subsequent to the DOC. It involved what was without question a martial asset, but the ultimate trial determining value issues happened approximately 9 years after the DOC. During that time frame, the business appreciated significantly. If that appreciation was active, then (under New Jersey law) it would be fair to say that the nonbusiness spouse would get none of that appreciation. It would also be fair to say that the nonbusiness spouse would be entitled to get some reasonable return on his or her share of the value at the time of the DOC. However, if the appreciation subsequent to the DOC was passive, the nonbusiness spouse (in this case, the wife) would be entitled to share in that appreciation.

The resolution of that case was a legal and political compromise. The court assumed that the appreciation was both active and passive and then awarded the wife a portion of the passive appreciation, which was interesting, convoluted, and possibly unsupportable in any clearly defined fashion. Notably, all the experts in that case agreed that they could not precisely define the portion of the appreciation that was active versus passive. Nevertheless, a guesstimate was made, and the case was adjudicated on that basis.

A school of thought exists in business valuation, particularly in regard to closely-held entities versus larger public entities, that all appreciation has to be considered active because without the active, hands-on involvement of management, the business would fall apart. Averages do not matter when the business cannot be treated as the equivalent of a bank account that could just coast.

Perhaps we found a benchmark (exceedingly unlikely) that the average company within that industry grew by 5 percent in a certain time frame. If the subject company at hand grew by 15 percent, we might argue that the 5 percent average constitutes the passive element, and the 10 percent better-than-average spread constitutes the active element. This is an interesting hypothesis, but that 5 percent average was accomplished, at least in part, by the active involvement of management. Therefore, some part of the average is also the result of active involvement.

In this area of active versus passive, another consideration may be the percentage of ownership of the subject party or, perhaps more importantly, the assumed extent of involvement and contribution to the company's performance. At least on one hand, ownership interest is irrelevant. It is feasible to have a company owned 100 percent by the subject party, but he or she contributes nothing and is hands-off and absent; it is also possible to have a company owned 5 percent by the subject party, but he or she works 60 hours per week for that company and is the key employee who is responsible for all of its success. These are elements of the active/passive issue that add to the complexity.

What about a real estate venture that increased at a rate greater or less than the average rate of increase of real estate in that specific area and of that specific kind? Is it a valid argument that any additional increase is the result of active participation versus just the passive appreciation of the market in general? Would it make a difference if we were dealing with a 5-store strip mall versus a 4-unit residential apartment building versus a 200,000 square foot white-collar business commercial building?

What about an investment portfolio? Assume that the marital estate has an investment portfolio of $2 million, and during the pendency of the divorce litigation, consistent with how this was handled during the marriage, the wife continues to invest the funds. Further assume that during a 2-year litigation span, the wife's investment shepherding succeeds in growing that $2 million to $3 million (a 50 percent return in 2 years) during a time frame in which the overall market went up 10 percent. Thus, the wife's investment style resulted in a 40 percent greater than market return on an original $2 million: an extra $800,000. Is that extra $800,000 an active asset? Even if the answer is "Yes," is it also a reasonable argument that she was able to do that by using the husband's money that he allowed her to continue to use; therefore, he lost the opportunity to do the same.

Build-up of Retained Earnings as Marital Savings

Have any of your cases involved a business that, over the years, especially over the last several years, built up a very substantial investment or cash position far and away above what it needed for operations? If so, that might have been a situation in which retained earnings were built up (that is, an increase in equity), meaning that the company retained a possibly substantial portion of its income above and beyond what would appear to be its operating needs, rather than distributing it to the owners in the form of increased compensation or dividend distributions. Depending on various factors, that may mean that marital savings were disguised. The company kept the income, rather than giving it directly to the marital estate.

A first blush reaction might be to the effect of, "So what?" However, when we recognize that depending on the jurisdiction, marital savings may be considered a component of lifestyle, we can see how "hiding" some of that lifestyle by not giving the family unit a chance to spend it might effectively distort that family's lifestyle. In addition, as a practical matter, because the nonbusiness spouse often gets less than 50 percent of the business in equitable distribution states but, generally, 50 percent of the family savings, this is not only a lifestyle and support issue but also one that might have a significant bearing on equitable distribution.

Before assuming that every build-up in retained earnings or equity is a proxy for marital savings, recognize that this is generally a subjective area, and there can be solid business explanations for a build-up. The following are among the concerns we need to address before we can conclude that a build-up is marital savings:

- *Liquidity*. A build-up in equity is not necessarily synonymous with a build-up in cash or investments. This argument generally doesn't go very far when the build-up is not in liquid form but, for instance, is invested in plant and equipment.
- *Ownership interest*. This is kind of an easy one if the interest at issue is a 100 percent ownership interest or at least greater than 50 percent. However, if it was a 10 percent interest, the argument would likely be much weaker. It is unlikely that a 10 percent interest had the ability to dictate whether the company was going to retain those earnings and when and if it was going to distribute them.
- *Size of the company*. As a general comment, a small company tends not to need much in terms of a build-up of funds, but a midsized or large company may have the need for a build-up.
- *History*. Not that this is determinative, but it might be relevant if the company has a history of distributing substantially all of its income by compensation or dividends and then changes that in the last few years or vice versa.
- *Growth*. In general, all other things being equal, a growing company has a greater need to retain income to fuel that growth than does a stagnant or shrinking company.

As the expert, if we can make the case for such a build-up because of excess liquidity or nonoperational assets, then in the typical income or even market driven approach to value, we will likely have additional value. Thus, we not only get a bump up in the martial standard of living but also something extra on the value end and an argument for a better carve-out for the nonbusiness spouse.

Celebrity Goodwill

Probably for good reason, we are not going to see much about this because in relatively few situations would this appear to be appropriate, although a number of people would argue that it is never appropriate. How real is this area, and how fleeting is so-called celebrity goodwill? The determination is fraught with issues, not the least of which is benchmarking the celebrity goodwill against some reasonable compensation when appropriate, projecting a type of income into the future that is reliant on personal efforts that are actually somewhat unique, and so on. Are we dealing here with fame or, perhaps, notoriety? The latter may not last as long as the former, but then again, who knows? Also, the age of the person might be very relevant, as well as the specialized element of fame or the basis for any value or income determination. Besides the valuation issues, we are also faced with allocation issues. If it is reasonable to allocate 40 percent of a business's value to the nonbusiness spouse, what do we do with celebrity goodwill?

This area not only involves the generation of some kind of salary or recurring income but also income that can be generated from speeches, books, film production, and so on. One of the problems with these areas is that, more so than with most other types of revenue sources we are asked to value, these tend to be more unique and nontransferable. In the area of speeches, information is in the public domain about the going rates for different types of speakers (that is, football stars, political stars, motivational speakers, and others). Books and films might lend themselves to a contingent arrangement, with the other spouse sharing into the future. Of course, that brings in a whole other set of issues.

An interesting question in this area is, what constitutes celebrity, and just how far can that concept reach? For instance, the easy one is that a movie star or rock star has some level of celebrity. A major political figure who is prominent in the news, visible, and recognizable is a celebrity. Also, an athlete and, maybe, a major author are celebrities. Using an author as an example, although the author's name is instantly recognizable and, thus, carries some celebrity cachet, an author, unlike various others just mentioned, tends to be not as visible—recognized not by face, rather by name. To what extent is that relevant in the concept of celebrity? Can this area be extended a bit further by including high-level corporate executives who regularly get into the news?

Double Dip

A particularly sensitive issue with attorneys is the concern over a possible double dip. This is a practical issue in addressing the interconnected issues of alimony and distribution of the business value. The essential concern that creates the double dip is that in the classic approach to business valuation, the valuation expert determines reasonable compensation in order to determine the economic income of the business. The economic income, typically through a capitalization of income approach, is used to determine value.

The income taken out of a business often exceeds the determined reasonable compensation. By one line of thinking, that means that the lifestyle enjoyed by the family was made possible by some or even all of the same economic income of the business that is being used to determine its value. Thus, this spread (the excess of what was actually taken as income versus reasonable compensation) is being used both to establish a lifestyle and support and as part of the calculation that determines value from which the nonbusiness spouse will be receiving his or her share in distribution. Hence, the double-dip conundrum.

Based on the preceding, does a double dip exist, and even if it does, is it really a problem? One of the arguments for the existence of a double dip is that it is overtly obvious from an economic point of view that part of the income generated by the business is being used both for support and valuation purposes. This would not be the case if the business was being sold at arm's length because the buyer in a commercial transaction would not have the responsibility to also pay support payments to the seller. The following are a number of responses and counters to the concern of a double dip:

- The double dip previously referenced was created because the illustration of the value included a determination of reasonable compensation. Every financial expert knows that it is sometimes possible to value a business without determining its economic income and reasonable compensation. We might use total net income before compensation to the owners as the benchmark, or perhaps the sales or top line is the benchmark, with no need to go through a determination of economic income. In that case, no foundation would be evident for assuming a double dip.
- The argument in favor of recognizing the double dip quandary would probably be stronger if we were looking at a 50 percent allocation of the value of the business to the nonbusiness spouse. In some equitable distribution states, the nonbusiness spouse (typically, the wife) often gets less than 50 percent of the value of the business. For example, in New Jersey we see something in the range of 30 to 40 percent. Arguably, a percentage that low takes into account a number of factors, such as an assumption of a built-in tax, which sometimes does and sometimes does not exist; perhaps the double dip; perhaps a built-in bias in favor of the business owner; or perhaps a recognition that the business owner will continue with the business, which carries a much higher degree of risk than the cash buy-out that is likely going to the nonbusiness spouse.
- Studies have shown that the aftermath of divorce tends to leave the major breadwinning spouse (typically, the husband) in a considerably better financial position as the years go by than the dependent spouse (usually, the wife—often with the children). Assuming that these studies extend beyond merely the W-2 earner to include business owners, even if we are to successfully argue the concept of a double dip, where is the financial harm in that double dip versus what would certainly be the more likely financial harm if that double dip was given the financial respect its advocates posit?

The preceding notwithstanding, assume that the issue of a double dip gets a favorable reception; thus, it has been agreed that it needs to be compensated in some financial manner. This can be done in the following ways, although they all have shortcomings:

- We simply cut back on the percentage of the business allocated to the dependent spouse. In that fashion, an economic trade-off has been made, taking away some part of an asset through the distribution process in compensation for the double dip. Referencing an earlier comment, perhaps that wouldn't be terribly unreasonable if we are starting with a 50 percent carve-out factor. However, in an equitable distribution state (for example, New Jersey) typically, we see property distribution shares on a business in the 30 to 40 percent range. This alternative might reduce the carve-out to the 20 to 30 percent range. At what point do we start having a social policy problem? How unfair is this to the dependent spouse? Further, not that this is etched in stone, but often, what is unfair to the dependent spouse invariably becomes intentionally or unintentionally unfair to the children. The logic for this trade-off is clearly that the alimony is at such a level that a double dip exists; therefore, a rationale exists for balancing the economics by taking something away from the property distribution. What happens when that former spouse remarries, and the alimony stops? That spouse now has not only lost the income flow of the alimony but never got his or her fair share of the property distribution. The concern over the double dip has proven to be ephemeral.
- An alternative is to compensate for the double dip by taking it out against the alimony. Instead of giving the dependent spouse a smaller share of the business, simply pay less alimony. It is not too difficult to figure out that this approach comes with its own set of problems, including potentially pauperizing the former spouse, which negatively affects the children, and creating another form of a social policy problem.
- Another possible approach may be to do some kind of a blend under the concept that, as an example (this won't work all the time), if the business was capitalized at a 20 percent capitalization rate, the inherent economic assumption is a 5 multiple: 5 years of income of that business constitutes value. In this simplistic sense, perhaps the alimony will be reduced for only 5 years, representing that time frame for which one might argue the double dip existed. Perhaps the business owner gets a 5-year free ride of no payments for the buy-out of the share of the business (or some economic equivalent). These approaches present their own problems, including insufficient funds to the dependent spouse for reasonable support; forcing the dependent spouse to wait years to receive his or her fair share of the business; the risk of that business in some way being sold, destroyed, or the like; and that money not being there.

Even if we believe that an economic double dip exists, when all factors are taken into account, does it matter? Does it truly present a financial burden to the business owner? Does the system as it is currently constructed implicitly take all of that into account; therefore, no problem exists or, as it has been phrased, it is a permissible double dip?

Human Capital

The concept here is the anticipated postmarital disparate economic relative positions between the now former spouses and to what extent, if any, that should be taken into account in the divorce process, whether through alimony, property distribution, or both. For ease of illustration, assume the stereotypical situation of the husband being the major breadwinner and business owner, and the wife is the classic dependent (even if only semidependent) spouse. Deepest apologies to all of our female readers.

At least in theory, the financial results of a divorce are supposed to put the wife (often with the children) on some roughly equivalent financial footing with the husband, in regard to both income and assets. Concerning income, that means that the alimony the husband is paying to the wife (along with child support) and also with what the wife will be earning in the job market will make them, if not equal, at least relatively equal or in some way that is considered equitable. A problem with this concept is that the marriage was an economic partnership, with each spouse contributing to that partnership in some roughly equivalent fashion (the husband with money from the outside world and the wife with household and child-rearing services, possibly a supportive role in business matters, and possibly some level of outside employment). As a result, the marital unit grew and prospered. Each party—although this is generally much more the case with the wife—sacrificed something in terms of future employability, employment rewards, and the like by working for that marital partnership within the context of what was implicitly or explicitly agreed to or just generally assumed through traditional gender roles.

However, after a 20-year marriage, when the husband has established himself in the corporate world or some similar fashion, and the wife has not, no matter what one does through alimony, outside employment, rehabilitative alimony, and so on, the wife will not likely achieve the level of financial success of the husband. Further, she will likely continue to have—this is the key concept—a relative disparity that will not only continue, which is not necessarily bad economically because, in theory, the alimony compensates for that, but actually widen. This is so because, in general, that is the way careers go. This is also so because if we assume some ongoing percentage increase in income, the husband, having a larger base to start with, will get a greater dollar increase than the wife, even with the same percentage increases. To compound the matter, this directly translates to discretionary income. It is far more likely that the husband will have more money than he needs to live (discretionary income). Thus, growing the overall income by greater dollars (even if by the same percentage) will give the husband proportionately more discretionary income, more savings, a higher comfort level, and so on. Compounding this issue, typically, the alimony is at a fixed amount. Therefore, the wife will only see an increase on the portion of her income generated by outside employment, leaving what can be a relative substantial base (the alimony) fixed and without growth.

In a similar sense is the matter of the pension element of the property distribution. Of course, not every case is blessed with a retirement benefit to be allocated between the spouses, and some of them are very modest IRAs or other retirement plan accounts in which the employment will have no bearing on the rate by which they will increase. However, for some people, especially those who are with a company that has a defined benefit retirement plan, the likely future rate of increase will be far greater than what the wife, now employed, will be able to experience, assuming she will experience any kind of retirement benefit. The husband, having already established his career and with a solid employment base, has a much greater chance of not only general raises and inflationary adjustments but more substantial merit raises, which will in turn provide greater increases and retirement plan benefits in greater dollar amounts and greater percentages than the wife could possibly hope to experience. Thus, even after allowing for a qualified domestic relations order (QDRO) allocation of pension benefits and assuming equivalent investing, in all likelihood, the husband will experience a (possibly significantly) greater increase in retirement plan benefits.

Now that we know that a future disparity is in the offing (it is the premise for this section), the next issue is how to address the disparity, if at all. Addressing it can mean very different things to different people. From an income perspective, one suggestion might be a disproportionate alimony carve-out for a short limited term, a longer limited term, or an indefinite term. It might even mean continuing the carve-out past a point of remarriage or the husband's retirement. Perhaps it may also mean performing a standard alimony determination based on the husband's current income situation but providing for a carving-out of future increases. Obviously, none of this is going to sit well with the husband, but the concept here is to consider the economic realities of the future and, in a similar sense, future retirement plan benefits. Should consideration be given to some carve-out of future pension increases or, perhaps, a future revisit to the QDRO situation, providing the wife with a supplemental QDRO of sorts some years down the road?

Of course, some people do not accept this concept of a marital investment in the human capital and that the divorce creates a loss of the sharing of the investment in each other that each made. If both walk away completely equal, which is not normally the case, then this likely would not be a problem. Certainly, none of this is easy, and the concept itself will rankle many. Besides, the practical issue of the economics, we have the difficulty in even considering carving out greater alimony than would normally be the case, disproportionate sharing of current assets, and a revisit in the future. All of these would typically be distasteful to the husband, and in many cases, keeping this type of connection would also be distasteful to the wife.

Independence of the Expert

This is not an issue that normally comes up, but it probably deserves a bit more consideration than we have seen, which is none. A fair question and area of challenge for an expert is the extent of that expert's independence regarding the specific assignment. The potential for a lack of independence or, at least, an impaired independence can arise in the expert's relationship with the client or the client's adversary, the attorney with whom the expert is working, and perhaps the attorney representing the other party.

Another area of concern is the accountant's relationship with the attorney. Having the attorney on either side of the case as an accounting or tax client is generally not an issue. This is especially so if that attorney represents a negligible amount of fees for the accountant or accounting firm. On the other hand, if the attorney bringing in the expert is responsible for a significant portion of that expert's fees (for example, the CPA performs a lot of litigation work, and that attorney or his or her firm, or both, gives this accounting expert a lot of work), then we might question whether that expert can be adequately independent or whether the results may wind up being skewed to favor that attorney's client in subtle ways. This might also be a concern when that relationship exists with the attorney on the other side of the financial expert, but there, the concern would be the flip side: the attorney engaging that accountant might have reservations about how fairly the expert will represent that attorney's client. This issue also exists when the attorneys agree on an accountant to be a joint expert or court appointed. Is the relationship between the accountant and one of the attorneys significant enough to bring into question that accountant's independence?

Joint Expert

To engage or not engage a joint expert, that is the question. From the attorneys' perspectives, is it better to have a joint expert or for each party to have its own expert? Of course, the answer is that it depends. If the attorneys are the type who can get along with each other, and the clients aren't horrendously combative, then a joint expert can be the right route. Most experts welcome the opportunity to work as a neutrally engaged joint expert, but at the same time, most have reservations about the process. As has been said many times by various financial experts, "When you work for one side, you kind of at least have one 'friend,' but when you work as a joint expert, you have no friends." When working for one side, although we are not the advocate for our client (that's your client's attorney's role), we have a client; we know that client's agenda; and even if we don't accept that client's agenda or cannot make it our own, at least for a while (perhaps until the second bill comes in or the client hears the first thing that he or she doesn't want to hear), we are working with someone who somewhat wants us. Of course, the attorney who engaged us is typically also a "friend."

On the other hand, when jointly engaged, neither side specifically identifies with us, each side has its own agenda, and we are viewed as a tool to accomplish that agenda. Nothing surprising here, but of course, we now have opposing forces tugging at us. In addition, even though virtually all the time it is the joint efforts of both counsel that got us involved, we know and respect that counsel are advocates for their clients' interests, and notwithstanding our involvement at their behest and agreement, they have their own angles, twists, and turns. Everything just said about us being joint experts is simply made more difficult and problematic when we are court appointed. In that case, we have not necessarily been agreed to by the parties but, rather, have been thrust on them by the court. That lack of voluntary buy-in only exacerbates the situation.

All that said and done, why would any expert in his or her right mind want to be a joint or court-appointed expert? Of course, the reality is that this is what we do; it is simply good business in many cases; and notwithstanding the tug of war between both parties, it gives us the opportunity to somewhat ignore the demands of both parties, hear (no matter how biased and distorted) both sides, and produce as fair a product as possible. This is not to say that being engaged by only one party fails to produce a fair product, but when engaged by only one side, we hear much more from that side, perhaps giving us biased input.

What about the clients' and attorneys' perspectives? Does a joint expert makes sense, or should we have our own? Again, the answer is that it depends. If the matter is unusually sensitive, if the attorney needs a financial expert with whom he or she can specifically consult and strategize, or if it is believed that a joint expert won't provide counsel and the client with the right balance of power, then each side should very likely engage its own expert. Some attorneys compromise; they see the merit of a joint expert but also engage their own expert in the background on behalf of their client to look over the shoulder of the joint expert, provide one-on-one strategizing, or address other necessary issues.

Fairly often, the decision to use a joint expert or have the judge appoint one is dictated by finances; simply, it is believed that each party cannot afford to have an expert. Let us briefly address the matter of fees for a joint expert. Having a single joint expert does not cost half as much as each side having its own expert. As a general statement, with many exceptions, a joint expert will probably cost between 60 percent and 70 percent of the combined cost of each side having its own expert. The basic reason is that a joint expert will do more work than half of the total of 2 experts. Being a joint expert generally entails more interaction with both parties and counsel than is typical for an expert engaged by only one side. Joint experts have to field multiple, lengthy calls from both sides, with each side trying to impress upon the expert his or her side of the story and address the latest current events.

Also, typically, when engaged by the business spouse, not much, if any, of an interview is conducted with the nonbusiness spouse; as a joint expert, both spouses get somewhat equal treatment. Of course, when engaged by the nonbusiness spouse, it is common practice to not only interview that spouse but also the business spouse. Because of the neutral role, when interpretive issues and judgment calls exist (for example, the business spouse says that his or her car is 85 percent business, his or her trips were all business related, and his or her typical work week is 60 hours), we need to hear the story from both sides. Does the other spouse agree? If not, we may need to go back and forth between both parties to fine-tune the issues and resolve the differences.

Thus, the joint expert will typically cost more than 50 percent of the sum of 2 experts. Before addressing where there may actually be a savings against that 50 percent, let's briefly put into context the kind of dollars we might be talking about. Depending on many aspects, the investigation and valuation of a business, along with all the other issues involved, can easily run between $20,000 and $50,000 for any one expert. This wide range is necessary because so many variables and different situations exist, and in many situations, the fees will reach into six digits. Of course, that range of $20,000–$50,000 is only up to the issuance of a report; it excludes trial. Through that point, each side having its own expert would likely mean fees for the experts of between $40,000 and $100,000 or possibly much more. If we accept the statement made earlier that a joint expert will cost between 60 percent and 70 percent of the sum of 2 experts, using 65 percent as the midpoint would suggest fees of between $26,000 and $65,000: a savings of between $14,000 and $35,000. Again, allowing for tremendous ranges and differences, it is easy to see that a joint expert can save a significant sum of money.

Notwithstanding the previous comments, it is possible that the use of a joint expert can actually cost less than half of the cost of two experts. Two interconnected aspects here can result in such a favorable economic development: the infamous battle of the experts and the potential for a trial. With two experts, we can expect two different conclusions. Hopefully, those conclusions will not be far apart, in which case the so-called battle of the experts does not happen. Further, each side having its own expert may force each expert to do a better job, and two experts bring a broader view to the matter, two sets of eyes, and possibly a better end product.

On the other hand, and we have all seen this, there can be two very different results. If we wind up with very divergent opinions from the experts, what will now inevitably happen is that the experts will criticize and analyze each other's reports, there may be meetings between the experts to try to narrow their differences, there may be depositions, and there may be the need for the experts to revisit some of their assumptions and analyses. While this is going on with the experts, we all know that there will also be a commensurate additional level of work by each of the attorneys, such as addressing their respective experts, coordinating issues, asking questions, and so on. There will be correspondence back and forth and very possibly a polarizing of positions (my expert is bigger than your expert). Then, with those differences and polarized positions, a lesser likelihood of settling exists, which then means going to trial. It is possible that with a joint expert, all of this wouldn't happen, and settling out of court on a much more civil basis would be more likely. This is where the joint expert can represent a very significant cost savings.

Of course, it is always possible that one side or the other, or both, will have a strong negative reaction to the joint expert's findings. The business owner may find the income determination and value conclusion far too high, or the nonbusiness spouse may be shocked by the low income and value numbers. Depending on their relative strengths, experiences, and personal opinions, counsel may not be in a position or able to soften the client distress and may wind up joining in on the expressions of dismay. To a degree, each side is kind of stuck with that joint expert's opinion. Of course, we can always now hire our own expert, but isn't that where we began and what we were trying to avoid?

Another area where the joint expert can indeed save money and bring down the otherwise expressed percentage of 60 percent to 70 percent is the possibility of an exit conference followed by a short letter for the file versus a full report. Every expert will give a somewhat different opinion, but the difference between coming to a conclusion in a business investigation and valuation without writing a report versus doing the same and writing a report is typically from a few to several thousands of dollars. When each side has its own expert, it is a virtual guarantee that each side will do a full report.

On the other hand, what works very well with a joint or neutral expert and helps the clients save money is to hold an exit conference after our work is completed, during which we explain our work and conclusions. Then, follow that up with a short letter (typically two or three pages) summarizing what was expressed at the exit conference, including the conclusions. This provides the appropriate backup and paperwork for the files and gives the clients something to reference. It is made clear that type of letter is absolutely not sufficient for trial. However, it is my experience that in well over 90 percent of such neutral situations, with the help and encouragement of counsel, the exit conference suffices and provides a more than adequate substitute for a full report, and the matter does not go to trial. This is an area that can represent a significant financial savings and one that a joint expert can often accomplish but two experts could not.

Leveling the Playing Field

For the sake of counsel and experts, far too little respect has been given to the issue of pendente lite counsel and expert fees for the spouse without direct access to the money—typically meaning the nonbusiness spouse, or, when no business is involved, the spouse who does not control the finances. We all know that in the majority of the cases, this means the wife. The realities here are that in one fashion or another, this limitation on access to money negatively affects that person's ability to wage an equal battle by limiting his or her choice of counsel or expert. Once counsel or an expert has been engaged, often, the inability to come up with additional funds until the case is settled may affect the quality and quantity of service provided, to the detriment of that litigant. A harsh reality is that clients who don't owe anything or clients who pay their bills on time or have the ability to pay their bills get better and timely attention. They also enable or, perhaps, encourage the professional, giving the professional the incentive to apply some extra thought, brain power, and creativity toward the goal of the best resolution for that client.

In many cases, financial resources can be used to see to it that professionals are paid within 30–45 days after submitting their bills. If a business involved, it is a pretty safe bet (exceptions exist) that counsel and the expert representing the business owner are getting paid a lot better and timelier than counsel and the expert representing the spouse. When no business exists, but one spouse is clearly the breadwinner, the results are the same, especially if funds are invested solely in the name of the breadwinner and serve as a pool from which to make payments.

Would it be unreasonable to require some form of equivalent level of payments to both sides? Putting aside that the work is often not equally balanced between counsel and experts on behalf of the husband and wife, assume that within modest parameters, it is a rational and justifiable to insist that if the husband can come up with $50,000 to pay counsel and experts, there needs to be a source, perhaps from that same husband, to come up with $50,000 to pay the wife's counsel and experts. If we assume that the husband could only access $50,000, and the wife could access nothing, then wouldn't it be reasonable to mandate that said $50,000 be split equally between the husband and wife?

Forcing this type of leveling may result in not only fairer representation and results but may actually speed up the process. A battle of equals, if such a thing exists, provides both sides with reasonable incentives to come to a conclusion and compromise. A battle of unequals very well gets dragged out based on the dictates of the party in power and, barring a capitulation by the weaker party, which hardly does justice to anyone, likely will go on longer. Ultimately, a case going on longer also means that it will cost more. Thus, to a degree, leveling the playing field will also help reign in fees.

To some degree, the known risks of counsel and experts of representing a client without financial resources have to, in one way or another, result in higher fees overall, especially when the receivable is going to escalate, which will possibly cause collection issues and friction. A plain and simple logic is at work here; if a professional knows that he or she is going to have to wait a long time to collect and is probably going to have to compromise the outstanding balance, one way or another, that is going to be built into the fee structure. Thus, the system that prevents the parties from having somewhat equal financial power causes higher rates and fees than might otherwise be the case.

Marital Momentum

This is an underappreciated and underused angle to consider in divorce litigation, although it has generally limited applications, and like so many other interesting ideas, it needs the right case and financial magnitude to justify pursuing. The concept is that on or around the time of the filing of the complaint for divorce, the business (or the earning power of one or both of the litigants) reached a critical mass—kind of a precipice—and from this point forward, the business' value can be expected to increase dramatically, perhaps far out of proportion to what might otherwise be considered normal. The marital partnership has devoted years of effort to building up something, whether that be a business or career, and the fruits of those years of labor are now (*now* being defined as around the time of the filing of the divorce complaint) about to be realized. Would this not warrant some additional consideration, value, payment, or some other financial compensation to the spouse who will no longer share in the rewards for which he or she worked, in effect an investment in deferred benefits that are now coming in to pay status?

Using a career, nonbusiness owner employee situation as an example, assume we are dealing with a corporate executive who has worked her way up through the ranks and is currently earning $200,000 per year. The marital lifestyle, build-up of savings, and everything else that goes along with that level of income, is consistent with her yearly salary, and in a divorce context, alimony and the equitable distribution aspects can be expected to fall into place in accordance with normal procedures. However, this is not normal; this corporate executive is on the verge of being recognized and has developed a skill set that will get her a great promotion, an increase in pay, and the next stepping stone to corporate executive stardom or position her to be able to jump ship for a major increase in pay, options, benefits, and so on. None of these potentialities has happened, and none could have contributed to the marital lifestyle or a build-up in assets.

Is it fair to turn off the spigot at the DOC, or should the stay-at-home spouse be allowed to share in what the two of them were working toward all those years? Can it be seriously posited that this executive's upcoming move, with all the financial rewards that it entails, just happened within the last few months or year, or is it more likely that this quantum increase in financial power was the result of years of effort? If so and if the concept of a marital partnership is relevant, wouldn't those years of effort mean that the marital estate has a vested interest in what is about to happen? Wouldn't it be appropriate and equitable for the spouse to be rewarded with escalating alimony as the years go by, some share of a dramatically increasing pension benefit, or another form of savings?

The issue is perhaps a bit more complex when it involves a business; however, the basic concept is the same. In theory, when valuing the business, the valuation expert takes into account the potential for the business at that point (at any point) to grow and become more valuable. Nevertheless, at least two issues arise. For one, most valuation experts would be extremely reticent to make assumptions of the magnitude of growth and increase in value that are under consideration here. Odds are that the valuation done as of the DOC, based on history and reasonable expectations of the future, did not take into account the extent of the increase that is at issue here. As a result, the expert may conclude with a dramatically lower value than a valuation would conclude were it done one or two years later.

The second issue with a business, even if the valuation issue was fairly addressed, is what the increase in income will mean to the standard of living, including a build-up of savings. Not only will the business itself increase in value, but the compensation received, pension benefit, personal savings, and all other accoutrements of a higher income will, in the traditional approach, inure only to the business spouse—none of it to the soon-to-be ex-spouse. Again, taking into account the premise expressed earlier in this chapter, is that fair?

One possible approach, at least in part to some of these issues, would be the determination of enhanced earnings and a calculation of the present value of those earnings. In effect, this is treating enhanced earnings as a form of an asset that can be valued. By way of illustration, assume that the executive spouse can anticipate an increased income stream of $200,000 per year above and beyond what has already been realized, that $200,000 being above and beyond what would reasonably be expected were it not for this martial momentum concept. Further, assume that enhanced level of income can be expected to continue for the remainder of that person's working life.

Thus, in some way, wouldn't it be fair to calculate what those enhanced earnings mean on a present value basis and then possibly tax effect those earnings and award the other spouse an equitable share of that future income? By way of an oversimplified example, this executive spouse is expected to work another 20 years, and this $200,000 bump-up in income is an extra $4 million. Do we present value that $4 million? On one hand, it seems like an obvious need; on the other hand, a present value may not necessary because it can be expected that the $200,000 of income being considered will be adjusted by at least the rate of inflation (probably more) as an offset to the present value discount.

Let's now go to the next step; we have determined that a $4 million asset exists, and the spouse is entitled to a fair share. For discussion purposes, assume that a fair share is 20 percent ($800,000), which is less than what might otherwise be an equitable distribution percentage. It is probably a certainty that the marital estate that currently exists doesn't have that extent of additional funds to carve-out to the nonbusiness spouse. It would require some form of a future payout. In this manner, perhaps the nonbusiness spouse gets a right (a lien?) to share in a future (contingent?) benefit.

Palimony

In many states, although a judge cannot order a lump-sum buy-out of alimony (it has to be paid over a period of time), when it comes to palimony, it is pretty much diametrically the opposite: a judge can only order a lump-sum buy-out and cannot order ongoing payments. In that sense, some would argue that palimony is superior to alimony. However, one aspect of the palimony issue is either overlooked or not recognized by a lot of judges and practitioners: the issue of the taxability or nontaxability of the palimony buy-out. The common thinking among the bench and bar is that we calculate the alimony buy-out by determining the appropriate support amount, present value that stream of income based on the life expectancy of the recipient, and reduce it for a tax factor. The result is the determination of a lump-sum buy-out to be paid in lieu of monthly support payments.

It is that last step in the process, tax effecting the payments, that presents the potential problem. The clear assumption is that these payments are intended to not be taxable to the recipient and not be deductible by the payor. In traditional alimony situations, payments are deductible and taxable, so this tax calculation is done to keep somewhat of an equal balance. The payor is getting his or her tax deduction via paying a number that has been reduced for the tax benefit, and the recipient is getting the money tax-free; therefore, it has been reduced from what it would otherwise be in a taxable mode. That is fine in concept, but the problem is that those assumptions may not be correct. If this exercise was performed in an alimony situation (husband and wife), then the result would be exactly what was intended. However, this is not alimony; it is palimony, which by definition does not involve a husband and wife. No matter what we say or do about the payments (whether you tax effect them), are they indeed taxable to the recipient and deductible by the payor?

Keep in mind that anything being discussed here regarding taxes is at the federal level, although for the most part, at least in this area, the tax laws of many states tend to be consistent with federal tax law. One general tax rule is that income (the receipt of money) is taxable, unless it is specifically provided otherwise. Thus, interest received on a corporate bond is taxable, but interest received on a municipal bond is not because it is specifically stated in the tax law that the interest is not taxable.

That brings us to the recipient of the palimony. He or she has been paid a lump sum that has been reduced for assumed taxes. That is an alimony thought process for something that is not alimony. Palimony is the receipt of funds (income) of one form or another. Under federal tax law, that is taxable, unless a provision to the contrary exists. We researched this area and can find no provision to the contrary (that is, we find nothing that would suggest palimony is other than a taxable receipt of funds by the recipient). As such, tax effecting is unfair to the recipient because what is received is taxable, even if the state family court has determined that palimony will be reduced by assumed taxes.

The result is that in theory, what is received might be taxed, resulting in nearly a double taxation on the same money. Assume for the moment a 30 percent tax bracket; a $100,000 determination if paid as such to the recipient and then taxed would yield a net $70,000 to the recipient. The way the process currently works is that $100,000 is reduced by a 30 percent tax bracket, and the recipient is then paid $70,000 under the assumption that it is net of tax. However, in all likelihood, the $70,000 is taxable at a tax cost of $21,000. Thus, what was intended as a net $70,000 payment may actually turn out to be a net $49,000 payment, with an effective $51,000 tax burden on a $100,000 present value palimony award.

Although the palimony issue is dealt with in family court, it is considered, at least by one school of thought, to be more akin to a contractual situation, with the recipient suing and, thus, collecting under contract rights. That approach does not change the likelihood that the payments are taxable. If we follow the logic of a contract matter, the recipient is receiving an income stream (albeit determined through a lump sum) as the result of some contractual rights. That is taxable. Although our research has shown us nothing that would support the tax-free treatment of the previously described palimony structure, neither has it uncovered anything specifically on point that would suggest the palimony issue has been determined in either direction. However, basic tax law is that all income is taxable, barring a specific finding to the contrary.

Let's turn now to the payor, and realize that a problem also exists here. First, the good news; the way the system works, the payor is getting a tax deduction and, thus, would be on equal footing as if the tax deduction was for alimony payments. However, that may actually be too beneficial to the payor. Tax effecting the palimony payments operates under the assumption that because the payments would be deductible by the payor, his or her real out-of-pocket expense is only the net posttax amount. Who says that the payments are deductible? Remember, this is not alimony; it is palimony. Again, dealing with tax law, for payments to be deductible, they need to be expenses incurred in business or the production of income, or they have to be allowed by specific operation of the tax law as a deduction. For instance, alimony falls into the latter category because the tax law specifically allows for the deduction of alimony. Office supplies as part of operating a business are deductible because they are an expense incurred in the process of producing income. Where, if anywhere, do palimony payments fall? They are clearly not an expense involved in the production of income, and they are not provided for anywhere in the tax code as a deductible item (unlike alimony). Therefore, it would appear that the payor would get no deduction for these payments, even if they were made like alimony and spread out over time.

Thus, we have the unusual but not unheard of situation in which payments are not deductible; yet, those same payments as received are taxable. Tax effecting the lump sum provides an unwarranted benefit to the payor and adds an extra burden to the payee. On the other hand, not tax effecting these payments, in comparison to how alimony would be treated, would seem to be unfair to the payor but reasonable and appropriate to the payee, except that we are unaware of any palimony recipient picking up those payments as taxable income or the IRS attacking those payments as taxable income. The latter is almost assuredly because these payments have remained below the IRS's radar screen, not because it has made a conscious decision to avoid this area. Any compromising still presents a problem because, in theory, the recipient is taxed on whatever he or she receives, regardless of any justification or rationale for a reduction of the lump-sum amount.

Separate Property

A different approach might work in the classic, limited, special-circumstance situation. Earlier, the classic separate property issue involving a closely-held business was addressed. One of the parties to the divorce either inherited or was gifted an interest in a closely-held business during the marriage. What is about to be put forth here does not work if this interest is premarital; further, it works best only if the gifting or inheritance occurred at least a few if not several years into the marriage.

At first blush, we all know the basics, and it would seem on one level to be irrefutable: the value of that interest in the business that was gifted or inherited (the value at the time of such gift or inheritance) is out of the pot. Subject to jurisdictional issues, only the appreciation attributable to active efforts during the marriage is within the marital estate. However, how about the argument that the gift was the result of sweat equity during the marriage (which would be more difficult to make if the gift was inherited)? The argument here would be to not take it so quickly as a given that the value of this gift or inheritance is out of the pot because, by definition, it is separate property. However, can we make an argument that for the few or several years (or whatever time frame) preceding the gift or inheritance, the spouse who received it earned it through sweat equity? It was not truly a gift or an inheritance; it was payment—in the classic sense of deferred compensation—for efforts made over the years, and those years were during the marriage: thus, joint marital efforts.

It would seem that to make this argument, we would perhaps have to be able to show that during the past certain number of years, this spouse was underpaid for the efforts that he or she made on behalf of the business. After all, if pay was reasonable and normal, that might eviscerate any such argument. On the other hand, for the moment, assume that the job that was filled was a $150,000 per year job, and because of implicit, explicit, or inferred promises, hopes, or expectations of eventually getting an interest in the business, the subject spouse accepted $100,000 per year of compensation. In the right circumstances, a solid argument might be able to be made that this $50,000 per year differential, for a certain number of years, was de facto marital earnings that was forgone for the benefit of getting a future interest in the business. We might then be able to argue that the value of the business at the time of the gift or inheritance is in the pot. Alternatively, we may be able to argue that the then stepped-up present value of the forgone compensation constituted a value to the marital estate.

THE LEOPARD AND ITS SPOTS—Pound for pound, beauty parlors are among the most egregious violators of tax law. For one such business that we investigated, we had the husband make available to us (it was his wife's business) some records that he was able to grab; the only problem was that these records were three, four, and five years old. Nevertheless, we used them to (in our eyes) conclusively prove significant unreported income (URI).

That wasn't good enough for the wife or her attorney, and we had to slug this out in court. I testified about the process I went through to determine URI, and the records that I relied upon. The wife's attorney repeatedly challenged me because the records that I used were a few years old. How could I possibly know that they apply to the current time frame, and how could I justify extrapolating the results from 3–5 years ago to the present? I patiently explained the process and logic several times, and the attorney kept coming back to challenge me on that same issue. Finally, exasperated, the judge interrupted the testimony; looked at the wife's attorney; and said to him, "What Mr. Barson is saying so politely is that once a crook, always a crook." It is so nice when they get it.

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Postdivorce Services

A CHANGE IN CIRCUMSTANCES—We were trying our best to get access to a lawyer, so that we could review his books and records because of his impending divorce. He was not cooperative, and we had difficulty getting him to return any calls. Finally, he did return our call, and he explained that he was preoccupied and didn't think that we really needed to investigate his law practice. We've heard that one before, and of course, we were skeptical. I carefully explained to him why it was necessary for us to review his records and value his practice. He kept trying to stop me from explaining, but I persisted and finally finished my explanation. He then, somewhat exasperatedly, explained that he was just convicted of multiple crimes and was about to be incarcerated for some years and lose his law license. So much for valuation theory.

Certainly in my case, and perhaps in yours too, in the vast majority of the situations when the divorce matter is finished, that is effectively the end of my business relationship with that client. However, perhaps in 10 percent or so of the situations, there is the potential (and sometimes you have to decide whether you are interested in that potential) to continue services. Some of our divorce clients will need tax advice planning postdivorce, and we might be the right ones to do that. There are also opportunities to refer these clients to other professionals – whether it be for estate planning, or investment advice. Chapter twelve deals briefly with various postdivorce areas in which we might be involved.

So, you finished your investigation, you performed the valuation, and you issued your report. Besides all that, the case settled, or you have gone through trial; finished your testimony; and maybe after waiting one year or so (depending on jurisdictions), the judge has reached a decision. You are finished; your services are done; this was a one-time, litigation-only client; and that is the end of it, right? Answer—maybe.

Accounting or Tax Client

Depending on individual style of operations and the specific client (tremendous variations here), that might indeed be the end of our work on behalf of our client, or it might simply be a point of transition to a new level or range of services. Typically, the first issue of relevance here is whether we worked for the business or nonbusiness spouse—assuming a business. If there was no business, then in that sense, it is almost like we had one or two tax clients. If we worked on behalf of the business client, it is likely that our services and involvement with that client are finished. After all, he or she probably has a regular accountant, and we are not going to be shunting that accountant aside.

On the other hand, perhaps we represented the spouse of the business owner, and now, the practical aspect is that he or she is not going to be staying with the long-time business accountant for reasons that would include no longer trusting that person, making a clean break, and so on. We are the natural choice because, in many cases, we are the only other accountant that person knows. Assuming family or some other connection has not gotten involved and depending on how the two of us interacted during this case, we may be the likely beneficiary of that person's future accounting (tax) needs.

One of the questions we, as well as our prospective tax client, need to address is, are the two of us a match? If as a result of the divorce, this prospective client now has the need for a basic Form 1040, with or without itemized deductions, but little other need for an accountant, then depending on how we practice accounting, that person most likely will not be a match for us or our firm. On the other hand, if this was a more upscale divorce, and this nonbusiness client now walks away with a couple million dollars, one or two pieces of real estate, and the like, then that client may be a good match for our tax practice, assuming we have one. The exception to accepting such a client is when we were jointly agreed to or court appointed. In those situations, there may be some restrictions, and it is certainly something that should be considered.

Once in a while, a client wrapping up a divorce may approach us with the prospect of bringing his or her business accounting to us. Tread carefully. We need to address the following two major issues:

- The sort of easy one is when you represented that business owner; thus, this simply becomes an extension of that relationship. However, you cannot and should not ignore the issue of the existing company accountant. This issue becomes more complicated when you were the neutral expert. Tread carefully here; you may seriously need to consider advising the other spouse, as well as that spouse's attorney, that you have been approached to take over the accounting of this business, and your intentions are to accept, subject to an opportunity for that other spouse, as well as his or her attorney, to advise you of any objections or concerns. What you cannot afford is for you to appear as having favored that business owner in the litigation process, and you are now getting your reward for that favoritism.

  A similar but less likely vein is when you represented the nonbusiness spouse, and the other spouse is now approaching you to take over the accounting of the business. On one hand, that is a pretty big compliment because you obviously made the right impression, handled yourself professionally, and so on. On the other hand, it does not take much imagination to realize the awkward position you will be putting yourself in if you now accept the business owner as a client. I was involved in a similar situation when I represented the wife, and the husband owned and ran the business. After the divorce was over, the husband approached me, advising that he believed I understood his business, I did a fair job, and he wanted me to take over the accounting. Also, his present accountant was aware that they would be amicably parting ways, which I confirmed. Because I was interested, I approached my now former client, as well as her attorney, with this information. To my former client's credit, she said that she thought the divorce went well; the level of animosity was minor; and considering they are now ex-spouses, she gets along rather well with her former husband. She also provided that information to her attorney, and between the two of them, no objection was raised; in fact, my former client was in favor of me taking over the accounting of the business. It seemed she also believed that the husband would be getting better advice, which would better secure her long-term payout.
- Equally as difficult and, sometimes, far more troublesome is when you are approached by the business owner to take over his or her business accounting and tax needs, and you need to take into account the issue of the current company accountant. This becomes a bigger issue when, as is common, you have had interaction with that accountant during the divorce matter. Assume for the moment that the accountant was cooperative, helpful, more than cordial, and a long-term accountant for that company. It only gets worse if you have also known that accountant for some years outside of this divorce matter. The safest and easiest answer is that each and every case stands on its own. In general, you simply do not go in that direction. You simply do not and, perhaps, cannot accept such a client. At the very least, in all likelihood, you will need to reach out to the company's current accountant and discuss the situation with him

or her. The good news is that you may hear that the client relationship was long in jeopardy, and if it is not you, then it's going to be someone else, so go ahead. On the other hand, you might get a very strong, visceral, negative reaction that even implicitly or explicitly extends itself along the lines of threatening to file a complaint with the state board of accountancy. This is a very sensitive and touchy area. Probably the best advice is to follow the so-called Golden Rule: put yourself in the shoes of that other accountant who is about to lose this business client, and ask yourself what you would want the divorce accountant to do.

Referral Opportunities

Sometimes, our future opportunity with this client is not that of handling the business or even a tax return. It may be that we have little to no future with this client, other than to be in a position to refer that client to someone else. Do not minimize such an opportunity. We all know how much we can benefit by being in a position to refer someone to another accountant because of work that we don't do, work with which we have a conflict, or work that we don't want to do. The same holds true for a business referral situation. It is not unusual to be in a position to recommend our client, who has walked away with a significant investment portfolio, to an investment advisor. We want to be in the position where the client relationship has been that good that he or she feels comfortable asking us to make a recommendation.

Besides that, knowing a few good and trustworthy investment advisors puts us in the very comfortable position of being able to refer business to them, which can only help our position in the long run. You know exactly what I am talking about and how you benefit in those classic win-win situations. Make sure that you know of, and have a comfort level with, at least two or three investment advisors, financial planners, insurance brokers, and the like. In general, these are all people who are important for us to know as part of our normal practice, and they are very important to know in terms of being able to refer divorce clients. Many people come out of divorce with adequate funds to make a good client for some of these sources, and at the same time, they have no past experience of having made the decision to choose one of these people. We can help them make that choice—in effect, making the choice for them—and everyone involved in the process benefits.

Budgeting

Some clients, typically the ones who have not had significant financial responsibilities in their marriages, come to us after the divorce is over and ask for assistance with certain basic, financial day-to-day needs. For instance, think of budgeting. Take a situation involving a divorce client who comes out of the divorce with $200,000 per year of alimony plus $40,000 per year in child support and has never had fiscal responsibility in the past. This may also be someone who does not fit our tax client profile and, thus, will not be a tax client for us in the future. Nevertheless, at least for a limited, near-term time frame, and perhaps longer than that, we have the opportunity to keep this divorce client as a regular client and help him or her move forward in his or her new life. The basic help that a person like this needs is budgeting. Other than perhaps future employment, which is often part time and at a low financial reward level, the financial parameters of this person's life going forward are fairly well defined. In the preceding example, $240,000 per year covers living needs, including the children. This same person has never dealt with controlling the monthly inflows and outflows; we are in a position to assist.

This type of assistance, in all likelihood helping with the budget, especially if it involves ongoing help and supervision and maintenance, is a service that may not be able to stand our normal rates. However, it may be an excellent job for a paraprofessional within our office, a junior or maybe a bookkeeper. Also, the concept of a paraprofessional can be adaptable and stretched. If we have a so-called administrative individual who is bright and capable, particularly one who is comfortable with software programs and data input, this may open up an avenue for billable work, sometimes at a higher rate than that person would otherwise command. Depending on the number of cases we handle and the outcomes, we may find a fair amount of work available for this individual.

Estate and Financial Planning

Another possible consideration for us or for us to refer is will preparation and estate planning. Virtually always, people coming out of divorce need new wills. Sometimes, this is the first time they have ever bothered with a will. Often, people coming out of divorce with any decent amount of assets also need some degree of estate planning. Encourage them to tend to these issues, regardless of whether we are going to be the direct provider of those services. I would imagine that most of my fellow CPAs reading this book do not do wills, although a number of us may do estate planning or have someone within our firm who has that expertise. Regardless of whether we do some or all of this in-house, it is an opportunity for service or referrals. It is possible to receive a greater benefit from referring, rather than keeping the work in-house.

Depending on our relationship with the client, we may even be asked to provide remarriage planning, assistance in a subsequent prenuptial agreement, or help in timing certain tax issues relevant to a remarriage. A relatively wide range of possible services are all subject to our abilities; our relationship with the client; and the client's abilities, needs, and fit with our practice. After a number of years, we may find that we have a decent-sized practice (even if it is only tax returns) from these former divorce clients.

To assist my readers in providing some of these services, I have included a sample personal budget form in this chapter. In part, it was developed from the standard financial disclosure requirement in the State of New Jersey. Note that specific considerations may vary among states, based on laws and regulations that govern.

PERSONAL BUDGET FORM

		PER MONTH	PER YEAR
Principal home	— Mortgage or Rent	$ ________	$ ________
	— Second mortgage	$ ________	$ ________
	— Home equity loan	$ ________	$ ________
	— Parking fee	$ ________	$ ________
	— Real estate taxes	$ ________	$ ________
	— Maintenance charges (condo or co-co)	$ ________	$ ________
	— Insurance	$ ________	$ ________
	— Electric and gas	$ ________	$ ________
	— Oil	$ ________	$ ________
	— Wood	$ ________	$ ________
	— Telephone	$ ________	$ ________
	— Cable TV or Dish	$ ________	$ ________
	— Repairs and maintenance	$ ________	$ ________
	— Water and sewer	$ ________	$ ________
	— Garbage removal	$ ________	$ ________
	— Snow removal	$ ________	$ ________
	— Lawn care	$ ________	$ ________
	— Exterminator	$ ________	$ ________
	— Service contracts on equipment	$ ________	$ ________
	— Appliance replacement	$ ________	$ ________
	— Furniture replacement	$ ________	$ ________
	— Pool service	$ ________	$ ________
	— Internet service	$ ________	$ ________
Second home	— Mortgage or rent	$ ________	$ ________
	— Second mortgage	$ ________	$ ________
	— Home equity loan	$ ________	$ ________
	— Parking fee	$ ________	$ ________
	— Real estate taxes	$ ________	$ ________
	— Maintenance charges (condo or co-op)	$ ________	$ ________
	— Insurance	$ ________	$ ________
	— Electric and gas	$ ________	$ ________
	— Oil	$ ________	$ ________
	— Wood	$ ________	$ ________
	— Telephone	$ ________	$ ________
	— Cable TV or Dish	$ ________	$ ________
	— Repairs and maintenance	$ ________	$ ________
	— Water and sewer	$ ________	$ ________
	— Garbage removal	$ ________	$ ________
	— Snow removal	$ ________	$ ________
	— Lawn care	$ ________	$ ________
	— Exterminator	$ ________	$ ________
	— Service contracts on equipment	$ ________	$ ________
	— Appliance replacement	$ ________	$ ________

		PER MONTH	PER YEAR
	— Furniture replacement	$ ________	$ ________
	— Pool service	$ ________	$ ________
	— Internet service	$ ________	$ ________
Savings	— Personal	$ ________	$ ________
	— College fund	$ ________	$ ________
	— 401(k) or 403(b) plan	$ ________	$ ________
	— IRA	$ ________	$ ________
Credit card pay-down	____________________	$ ________	$ ________
	____________________	$ ________	$ ________
	____________________	$ ________	$ ________
	____________________	$ ________	$ ________
Loans			
Student	____________________	$ ________	$ ________
Other	____________________	$ ________	$ ________
Other	____________________	$ ________	$ ________
Other	____________________	$ ________	$ ________
Taxes	— Federal income	$ ________	$ ________
	— Self-employment and Social Security	$ ________	$ ________
	— State income	$ ________	$ ________
Insurance	— Medical	$ ________	$ ________
	— Disability	$ ________	$ ________
	— Life	$ ________	$ ________
	— Long-term care	$ ________	$ ________
	— Personal umbrella	$ ________	$ ________
	— Valuables (floater)	$ ________	$ ________
Food at home		$ ________	$ ________
Household supplies		$ ________	$ ________
Toiletries and cosmetics		$ ________	$ ________
Personal auto	— Payments	$ ________	$ ________
	— Insurance	$ ________	$ ________
	— Maintenance	$ ________	$ ________
	— Gasoline	$ ________	$ ________
	— Replacement	$ ________	$ ________
	— Tolls and parking	$ ________	$ ________
Personal auto	— Payments	$ ________	$ ________
	— Insurance	$ ________	$ ________
	— Maintenance	$ ________	$ ________
	— Gasoline	$ ________	$ ________
	— Replacement	$ ________	$ ________
	— Tolls and parking	$ ________	$ ________
Commuting expense		$ ________	$ ________
Cabs		$ ________	$ ________
Clothing		$ ________	$ ________
Hair care		$ ________	$ ________
Domestic help or maid		$ ________	$ ________

			PER MONTH	PER YEAR
Medical (unreimbursed)	— General		$ ________	$ ________
	— Counseling		$ ________	$ ________
	— Dental and orthodontic		$ ________	$ ________
	— Eyeglasses and contacts		$ ________	$ ________
	— Prescription drugs		$ ________	$ ________
Nonprescription drugs and vitamins			$ ________	$ ________
Club dues and memberships		____________________	$ ________	$ ________
Club dues and memberships		____________________	$ ________	$ ________
Sports, hobbies,and collecting			$ ________	$ ________
Tapes and CDs			$ ________	$ ________
Children's expenses	— Music lessons		$ ________	$ ________
	— Dance or gym lessons		$ ________	$ ________
	— Parties		$ ________	$ ________
	— School lunches		$ ________	$ ________
	— Camps		$ ________	$ ________
	— Day care		$ ________	$ ________
	— Babysitting		$ ________	$ ________
Vacations			$ ________	$ ________
Schooling				
— Private School		____________________	$ ________	$ ________
— Private School		____________________	$ ________	$ ________
— College tuition and expenses		____________________	$ ________	$ ________
— College tuition and expenses		____________________	$ ________	$ ________
— Adult education		____________________	$ ________	$ ________
Dry cleaning and laundry			$ ________	$ ________
Restaurants			$ ________	$ ________
Entertainment			$ ________	$ ________
Alcohol			$ ________	$ ________
Tobacco			$ ________	$ ________
Newspapers			$ ________	$ ________
Magazines and books			$ ________	$ ________
Postage			$ ________	$ ________
Allowances				
	— Personal		$ ________	$ ________
	— Spouse		$ ________	$ ________
	— Children	____________________	$ ________	$ ________
		____________________	$ ________	$ ________
		____________________	$ ________	$ ________
		____________________	$ ________	$ ________
		____________________	$ ________	$ ________
Alimony			$ ________	$ ________
Child support			$ ________	$ ________
Parent support			$ ________	$ ________
Gifts—Own family			$ ________	$ ________
Gifts—Others and events			$ ________	$ ________

		PER MONTH	PER YEAR
Temple or church membership		$ ________	$ ________
Contributions		$ ________	$ ________
Legal and accounting		$ ________	$ ________
Computer expenses		$ ________	$ ________
Satellite radio		$ ________	$ ________
Lottery tickets		$ ________	$ ________
Pets			
	— Food	$ ________	$ ________
	— Medical care	$ ________	$ ________
	— Miscellaneous	$ ________	$ ________
Miscellaneous		$ ________	$ ________
	TOTALS	$ ________	$ ________

YOU SHOW ME YOURS, AND I'LL SHOW YOU MINE—Often, we can bring a case to a close by simply having the accountants sit down to compare and hash out their differences. Sometimes, those differences are matters of opinion, which are hard to resolve, but sometimes, they're the result of one or both of the accountants having wrong information, which is certainly much easier to accept and correct. In one such case, I sat down with the accountant for the other spouse, and we had a very pleasant discussion about the case and our respective conclusions. We then compared certain key numbers, including receivables and inventory. It became obvious that he and I were talking about different numbers. Our differences didn't make sense to either of us, so we simply exchanged copies of the company's financial statements that we each had in our files. That's when the fun began. He and I had financial statements for the same business, dates, and time frame that were prepared by the same accountant, but they had different numbers. We each reported back to our respective clients and counsel and were able to bring this matter to a quick close. To this day, I'm not sure what happened to the company accountant.

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Same-sex Marriages and Civil Unions: A Tale of Twisted Taxes

WHY THE TONGUE IS INDEED THE MOST VITAL ORGAN OF THE BODY—In a particularly contentious case involving the valuation of a personal-service business, the other expert and I were far apart. One of the critical factors causing our difference was our respective development of the capitalization rate and, in particular, some of the components that went into that development. On the stand during direct examination, when asked to opine on my approach, the other expert was emphatic that one of the components I used in the development of the capitalization rate lacked common sense. During cross-examination by the attorney with whom I was working, the other expert was pressed on that issue and, again, repeated that my approach lacked common sense. He was then asked if he had ever used that type of approach, and he emphasized without equivocation that he had never used that approach. He was asked that question at least two or three times, and he strongly emphasized the word never each time. The only problem was

> *that he had indeed used that approach only a couple years earlier, and the attorney with whom I was working had a copy of that report. As you might imagine, bringing that report to his attention while on the stand dramatically changed the tenor of the cross-examination.*

This short chapter is intended to provide some of my thoughts on a burgeoning area of confusion. There are now a number of states that allow same sex marriages and some, such as my home state of New Jersey, have essentially the equivalent, but call it *civil union*. As we all know, none of this is recognized at the federal level. Thus, we have an area of confusion, and potentially a very messy series of tax events that might arise because of the conflict between state and federal tax law. The aim of this chapter is to share with you some concerns that I have – but really no answers. I have no doubt but as this area continues to evolve, and as there becomes a bigger body of litigation involving same sex couples, we will start running into more and more of these conflicting tax concerns.

Same-Sex Marriages and Law

A number of states recognize and perform same-sex marriages (SSMs), and other states recognize same sex unions—the word *marriage* didn't quite make it into the law. Special tax treatment (or tax treatment equivalent to traditional marriage) for SSMs and civil unions (CUs) is only at the state level in the applicable states. The reference to *state* is extremely important because no such recognition exists at the federal level. Putting aside our feelings about SSMs and CUs, it creates some potentially unbelievably complex and convoluted tax issues.

Let us start with the basic premise that federal tax law and, as an outgrowth, probably every state provides significant tax benefits for married couples that are not available to unmarried people. This includes the filing of tax returns, transferring of assets, inheritance issues, and the like. At the federal level, these potentially very significant financial benefits are only available to a husband and wife. These benefits are now available to same-sex couples who are in an SSM or CU but only within their states and other states that recognize SSMs and CUs.

Our first reaction might be that it's not such a big deal or complex issue that a joint return can only be filed at the state level. That's correct, but the problems, confusion, and inconsistencies are of far greater substance. So, let's quickly get past the relatively minor joint-return conundrum and deal with some of the truly confusing and difficult issues.

Day-to-Day Living

When a husband and wife (a phrase to denote a traditional union) pool their resources, have a joint account, and the like, the tax rules are very clear and favorable. There is no tax impact, reporting issues, or concerns about a husband and wife commingling their assets and income unlimitedly and to whatever extent they wish. An SSM or CU couple will be under that same benign system at their state level but not at the federal level. Say one partner in a CU owns a house, and as part of the affection in getting together under a CU, that partner transfers the house from his or her sole name into joint name with the CU partner. Keeping in mind that the questions here are strictly at the federal level, does that transfer constitute a gift subject to gift tax reporting rules and, potentially, an erosion of the unified credit or worse? Perhaps it's not a gift but, rather, compensation or consideration for services, in which case it is taxable to the recipient and, most likely, not deductible to the person making the gift. What about something as simple as opening a joint checking or savings account, with one of the two partners being the traditional major breadwinner? Again, are we looking at repetitive gifts, compensation for services, or the like? By the way, conceptually, this isn't really any different than two unmarried people living together, sharing various expenses, and having a joint checking account. However, the concept of SSMs or CUs expands this concern, expands what might be the magnitude of what is typically involved, and might upset a number of people who have issues with alternative lifestyles.

In regard to the sale of a home, with $250,000 of tax-free gain per person, on one hand, nothing has changed, and of course, in various states, SSM and CU couples are the same as married couples. However, at the federal level, a married couple can avail themselves of $500,000 of tax-free gain when they sell their home, as long as they both lived in that home for at least 2 years of the last 5, and one of them owned the home. Addressing federal tax issues, an SSM couple can also each get $250,000 of exclusion, as long as each of them lived in the house for at least 2 of the last 5 years (the same as for traditional married couples), but because the federal government does not recognize SSMs, ownership also must be joint.

Divorce

Certainly, with same-sex partners now able to enjoy state-sanctioned marriage, it won't be long before we see SSM and CU divorces. When a husband and wife divorce and split up various assets, such as the house, a share in the business, a stock portfolio, and so on, the federal tax code (Internal Revenue Code [IRC] Section 1041) makes this a very simple and painless situation. Split up those assets any way you wish, nothing happens from a tax point of view, and it's not even a reportable event. That is the way it will now be for SSM and CU partners in their states at the state level. However, looming in the background is the federal government and its representative, the IRS. The federal government does not recognize SSMs, CUs, or anything remotely close, and it's highly unlikely that it will for the foreseeable future. So, what happens when the SSM or CU couple breaks up? Under state family law, the assets are divided, with one party getting the house and, possibly, some stocks that were in the other "spouse's" name, and the other "spouse" keeps the business, some of the stocks, and so on. Under federal tax law, none of this falls under IRC Section 1041 because there was no marriage at the federal level. What we may now have is the taxable and reportable event of a sale of an asset, maybe a gift, maybe compensation for services, and so on. What we do know is that we've got a mess; what we don't know is how it's going to be cleaned up.

Let's take this one step further to something that can truly be a nightmare: retirement plan benefits. Whether it's a qualified plan for which a qualified domestic relations order (QDRO) is used or an IRA, which requires little more than written advice to the trustee, these assets are easily transferred between spouses in any kind of split as the result of a divorce, with no immediate tax consequences. Again, at the state level, that's exactly what will happen when SSM or CU partners break up. At the federal level, we have the potential for an absolute quagmire. However, even at the state level, would the rules for the traditional married couple still apply? Although we can certainly allocate interests in retirement plans and IRAs between a divorcing SSM or CU couple and incur no state taxes, a QDRO is a document created under federal tax law, and an IRA is a concept created under federal tax law. Thus, it's questionable whether we can even use a QDRO for an SSM or CU split. The same holds true in regard to handling an IRA. Also, will an out-of-state company be obligated to respect an SSM or CU QDRO?

For the moment, assume that we can use a QDRO; we now get into the absolute morass of the federal versus state treatment. Because an SSM or CU couple is not recognized at the federal level, for federal taxes, we cannot allocate the retirement plan benefit or IRA account of one of the parties in an SSM or CU for the benefit of the other because doing so creates a distribution. At least on one level, the person receiving the funds has no problem, as long as he or she doesn't roll those funds into an IRA or another retirement plan account. From a federal perspective, such funds will not be recognized as being a qualified distribution, so they are not eligible to be rolled over. At the federal level, a person can receive these funds with absolutely no tax consequences, unless an argument can be made that they're for services rendered. An interconnected problem is that if the recipient follows the federal rules and avoids tax by not rolling the funds into an IRA, at the state level, they are taxable. If the recipient follows state tax rules and rolls the funds over to avoid state tax, then at the federal level, they are monstrously taxable. At the federal level, this is considered an excess (improper) contribution to a plan or IRA. Now, a penalty exists at the federal level that will continue year after year until the money is withdrawn. When the money is withdrawn, income exists at the state level.

That's only part of the problem. Look at it now from the vantage point of the distributor—the person from whose plan or IRA the money is being taken. At the state level, the distributor has a nonevent, regardless of whether the distribution is by QDRO or an IRA transfer. However, at the federal level, the distributor is doing something that is not allowed: taking money out of a qualified plan or an IRA (assume that the distributor is under age 59½). As a result, the distribution is income to the distributor (that is the case regardless of age), and if the distributor is under age 59½, he or she is also subject to a 10 percent premature distribution penalty.

This only gets more complicated when we factor in the possibilities at the distributee's (recipient's) end. It is not out of the realm of logic and possibilities that the IRS will argue that such a distribution is a gift or, maybe, payment for services. If a gift, the distributor now has to file a gift tax return (assuming substantial sums are involved), which doesn't change the issue that the distributor has taxable income and possibly a penalty at the federal level.

The more aggressive IRS approach might be to argue that such distributions are for services rendered. If that is the case, then we have the wonderfully unique tax situation of the distribution being taxable to the distributor because pension money is being withdrawn, as well as a 10 percent penalty if the distributor is under age 59½. In addition, the distribution is taxable in the hands of the distributee because it is earned income for services rendered, and it is subject to the self-employment tax, which depending on many other factors is anywhere from 15.3 percent to the current cut-off, plus an additional 2.9 percent. By the way, in such a situation, not only would the distribution be taxable to the distributee, but there would be no tax deduction for the payment by the distributor because there was no business purpose for the payment. The ultimate result of this farce is a combined tax and penalty approaching 100 percent versus what should have been a tax-free maneuver. Although it's probably not accurate to say that the possibilities are endless, use of the words *mind-boggling* and *fantasyland* and some expletives would be appropriate.

Estate-related Issues

We have covered getting together and breaking up, so let's now deal with death and the transfer of assets upon death. In the conventional marriage, the transfer of assets between husband and wife is unlimited in life and death. Thus, a husband can leave to a wife, or vice versa, millions of dollars with absolutely no estate or inheritance tax at either the federal or state level. That is now the case for an SSM or CU couple at the state level only. At the federal level, they are considered unrelated parties, unless they happen to be siblings or cousins, which does not help anyway. If a partner in an SSM or CU dies and leaves everything to the other partner in his or her will (as is often the case in a traditional marriage), at the federal level, it is the same as if he or she left that estate and money to an unrelated third party. In that case, the normal estate exclusion rules prevail. For the vast majority of people, that doesn't present a problem because most people don't leave millions of dollars in their estate. However, many of us regularly deal with higher-end divorces in which a multimillion dollar estate is routine. In such a situation, there can be a very substantial federal estate tax. Of course, that is no different than it was before states recognized SSMs and CUs. In that sense, nothing is really new; it is just another inconsistency between federal and state tax law.

State to State Issues

Substantially all of the problems referenced in this chapter focused on the disparity between state and federal tax rules. Before bringing this chapter to a close, we also need to recognize the potential for significant confusion at the state level when one or both of the parties involved in an SSM or CU moves out of their state. For instance, let us deal with the matter of alimony. An SSM or CU couple divorce, and one is ordered to pay the other alimony. Strictly from a state tax point of view, as long as they both remain in their state (or any like-minded state), we understand the tax issues. Assume that the recipient of the alimony moves to a neighboring state that currently has no SSM or CU provisions and does not explicitly recognize either relationship from other states. In regard to that recipient, is the money that he or she receives still alimony in the new state? If not, what, if anything, does the new state consider it? Currently, there is simply no answer. What if the payor moves to the new state? The payments received by the recipient in the original state are still considered taxable alimony to him or her. What about the payments being made by the payor? Does the new state allow those payments to be deducted as alimony? Again, there is currently no answer. What if they both move to different states? Again, there are no answers for this, and even when we do start getting answers, it is likely going to be one state at a time. These types of issues continue and, in some situations, become far more complex when we deal with crossing state borders for equitable distribution payments; receiving or rolling over IRA or retirement plan benefits; and estate issues (for example, an SSM or CU couple stay together, but one partner moves to a new state and then dies). What would be the effect of the new state's estate and inheritance rules on assets left to a partner in another state's SSM or CU?

The word *morass* was used earlier, and it's certainly apt because of the areas of rampant confusion and total mystery about this topic. It is too new to have any serious testing, but it is clear that from a tax point of view, the SSM and CU situation will be on the forefront and cutting edge of IRS legerdemain and, undoubtedly, a politically infused football, likely with religious groups weighing in.

What is certain in all of these situations is that it is critical that our clients receive well-planned and well-explained tax planning, so that even if many unknowns exist (they do), at least they are informed and aware of the complexities they are facing.

WHERE IS THE BILL OF RIGHTS WHEN YOU NEED IT—Sometimes, the most innocuous of items and insignificant of typos can create, or set the stage for someone to create, a confrontation that boggles the mind. In one of our routine cases, we communicated with the business's accountant in the normal course of getting records of the business. On our billings, we referenced that communication and indicated that we had met with the company accountant, Mr. Fidelo (the name has been changed to protect the uninvolved). The problem was that we made a simple typo on the billing by referring to the accountant as Mr. Fidel. Yes, we left off the o. As a result of either an emotional unbalance or simply using almost any excuse in the world to create an issue when there was none, the business owner sent a scathing letter to the judge complaining that we had slandered his Italian heritage by intentionally misspelling his accountant's name.

14

Data Forensics

By Paul G. Lewis

DIGITAL CLOAKS AND DAGGERS —A high-powered CEO and business owner suspected that his wife of 15 years had been cheating on him. Although he had no evidence that would suggest she was being unfaithful, he travelled often and just had a gut instinct. His business partners convinced him to investigate because if the marriage was to fail, his wife would control a significant interest in the business. At stake was a significant business, and the husband's equity was considered a marital asset. When the husband asked his wife if she had been having an affair, she acted surprised and almost flattered and assured him that nothing was wrong. However, data forensics eventually told the true story.

When his wife departed on a week-long spa vacation with her girlfriends, she accidentally left her cell phone on the kitchen counter, so the husband retained a firm to analyze the data on the cell phone. The firm was able to quickly produce startling text messages, e-mails, and photos that proved his wife was engaged in not one but many sexual affairs. In addition, this upper-middle-class house wife was found to be heavily involved in illegal drugs, with many drug deals *for illegal pills being arranged through texting. Photos on the phone revealed that the wife often attended sex parties, had both male and female partners, and was living a second life that she completely hid from her husband. Although her hedonistic lifestyle was very disturbing to her husband, additional information recovered from her cell phone was even more devastating.*

Digital evidence suggested that the wife had attempted to murder the husband on at least one occasion. Several text messages with a girlfriend described how the wife had offered her husband a glass of scotch tainted with poison. The husband drank the scotch while reclining in a chaise lounge chair by their pool. A photograph that was taken that evening showed the husband in an unconscious state in the chaise lounge chair with the glass in his hand. The photo was e-mailed to the wife's girlfriend with the message, "I think I got him this time." Hours later, another photo of the husband in the same position, this time soaking wet due to rain, was sent by e-mail with the message, "I am scared. I think I really killed him!"

The failed murder attempt was only the beginning. Recovered text messages demonstrated that the wife had contracted with her drug dealer to murder her husband. The murder was scheduled to take place while the wife was away on her spa vacation. Luckily, the crime was thwarted, and the wife was indicted. Had the wife not accidentally left her cell phone behind, the husband would likely have been killed.

In the past couple decades, the use of computers and computing devices has grown at an exponential rate, and such devices are now ubiquitous in all aspects of business and personal life. We use computers and hand-held devices for the vast majority of personal communications and rely on them to maintain our busy schedules, keep track of our contacts, conduct our banking transactions, and store virtually all of our information. Simply take notice of the world around you, and you will witness almost constant, real-time communication. Stroll down the street in any busy city, and you will see a plethora of individuals multitasking with their iPhone or BlackBerry in hand. Everyone, it seems, is communicating about everything—reviewing, sending, and receiving information at light speed. Take notice the next time you board an airplane or enter the subway. Watch carefully in restaurants, sporting events, and even on the beach. Everyone is communicating by firing off a quick e-mail, checking a portfolio, sending a text message, posting a picture on the Internet, and so on, all at breakneck speed 24 hours per day, 7 days per week. However, what most people don't realize is that the bits and bytes of data that are so quickly exchanged from virtually any location leave behind trace evidence that is easily extracted through the use of data forensics. This extracted data, which is plentiful and available from so many sources, helps an investigator build a time line of events and recreate the scene of a crime. Data forensics is both a science and an art, and it allows an investigator to take a deep look into the habits and activities of his or her subject, often without the subject even knowing.

In a divorce dispute, the use of data forensics may provide a significant view into the secret world of a spouse. An examination of computer data can sometimes expose hidden relationships, lifestyles, or bank accounts. Recently, the use of social networking sites has become extremely popular, and such usage now allows one to easily reconnect with a high school sweetheart or former lover. Dubbed the "Facebook Trap," such connections stir up excitement and bring to life dormant feelings that may evolve into a potentially dangerous temptation that can drive a wedge through even the strongest of marriages. Innocent e-mail messages can lead to frequent texting and, eventually, a physical meeting. Data forensics is able to recover website history, e-mail messages, text messages, photos, calendar events, credit card purchases, and other information that can be threaded together to accurately recreate the timeline of an infidelity. If one of the parties in a divorce dispute is a shareholder in a closely-held business, the use of data forensics can sometimes reveal financial facts that may have been previously unknown by the other party. Analyzing the computers used to conduct business will likely uncover a wealth of financial history, corporate records, the location of business assets, and other business data. These items become fair game in a divorce. A business's reported figures can be fiercely challenged through the use of data forensics, at times uncovering unreported assets and increasing the value of the business.

This chapter will discuss how data forensics is used to extract information to better understand the facts surrounding a matter that may potentially be presented as evidence in a courtroom. It will explore how the data is captured, what it consists of, and what it can reveal. From a layman's perspective, we will learn how data is stored and manipulated and delve into real-life case scenarios in which the application of data forensics assisted in providing an absolute conclusion.

The History of Data Forensics

Data forensics first became a tool used by the FBI in the mid-1980s after the introduction and immediate success of the personal computer and the continued proliferation of mainframe and minicomputers in corporations. The FBI's Magnetic Media Program allowed the U.S. government to perform a digital autopsy, so to speak, of latent data stored on magnetic storage devices. The program proved to be successful and was later expanded into what is still known today as the Computer Analysis and Response Team (CART). CART has processed information stored on countless computers, cell phones, file servers, e-mail systems, and just about every device that stores or manipulates data.

Some debate exists about the proper phraseology of the science. Although some prefer to use the phrase *computer forensics*, that is inaccurate because computer forensics suggests that the forensics process is applied to a computer. The term *forensics* is commonly defined as the use of science or technology to investigate and establish facts in criminal or civil courts of law. Although it is true that the process often involves examining data that was produced by, or stored on, a computer system, it almost never involves the dissection of a computer system or an analysis of its components, such as the cover, fan, processor, and so on. Instead, it is the data left behind by computational transactions that is the fruit of the investigation. This data may exist in an active state or at rest, and it may include data files, deleted files, logs, records, or even fragments of information. The source of the data may be a computer, cell phone, thumb drive, DVD, or even data collected from the Internet. It is the data itself that is of significance, not necessarily the computing device from which the data was extracted. Because it is the data that is analyzed, the phrase *data forensics* is preferred to describe the science. Some individuals prefer to use the phrase *digital forensics*, but that also is not an accurate phrase because the term *digital* simply signifies the binary state of an object and does not accurately depict the science. Therefore, *data forensics* is the best phrase to accurately describe the science discussed in this chapter.

Data Forensics: What Is it?

Data forensics is the extraction, preservation, and analysis of information created, stored, or contained within a computing device or system. By examining the data, a data forensics analyst or investigator is able to reveal an abundance of information with respect to what the user of the computer or device was doing at various points in time. This holds true whether the person was using a personal computer, Mac, smart phone, cell phone, or any other device that stores or maintains data. Even today's photocopy machines allow a forensic examiner to extract information about when a specific copy was made and, in most cases, even recover a copy of the original document.

The forensic process is primarily focused on the recovery and analysis of latent evidence. As with any crime scene, latent evidence is left behind by a perpetrator and may be in the form of finger prints, shell casings, tire tracks, or another physical element that can be used by an investigator to determine what happened. The same principle holds true for computer evidence. Like finger prints at a crime scene, log files and recovered data tell a story and bring to life the events that took place on the computer.

Data forensics is still considered a fairly new discipline and has not yet been completely standardized. In the private sector, independent companies operate in a very loosely structured framework, and work product is commonly inconsistent with varying levels of depth, depending on the habits of the forensic examiner and tools used for the analysis. In private industry, such an endeavor is usually called *data analysis*, reserving the term *data investigation* for services performed by law enforcement or a branch of the federal government.

During a forensic analysis, two general types of information may be reviewed: persistent data and volatile data. First, *persistent data* is data that is found at rest and typically stored on hard drives or other storage medium. Persistent data is not dependent on power, meaning that the data exists and remains the same whether the computer is turned on or off. Examples of persistent data include document files, spreadsheets, e-mail, logs, deleted files space, and any other data that may be stored on a hard drive. Persistent data is commonly used by most forensic examiners.

The second type of data is volatile data. *Volatile data* is information stored in random access memory or in transit between devices. Volatile memory is not preserved when a computer system is powered down; therefore, it is more difficult to capture. Although volatile memory will not usually play a critical role in an investigation, it should be noted that it may be an extremely important component for certain types of investigations. However, volatile memory must be captured from the active computer while it is still powered up, and it is not always possible to capture this data. For example, if a corporation wishes to conduct an investigation of a former employee, and the computer has been granted to another user, all volatile memory is probably lost because the computer was likely shut down to be moved to another location.

Data Forensics: Why Is it an Important Tool?

Data forensics is a powerful tool on many levels. By analyzing data, it is possible to discover the habits and actions of a person and is often employed in a divorce dispute to verify suspicions early in the process. A forensic review of a home computer can easily determine the presence of pornography or if the user has visited dating websites. It can also produce chat room logs and other activities unbecoming to a healthy relationship. A thorough analysis of Web logs left behind on a computer can sometimes identify hidden assets, such as online bank accounts that have been concealed by one of the parties. In one example, the home computer of a cheating husband was analyzed, and the wife was astonished to learn that the husband had various bank accounts with large sums of money in each. The analysis also exposed a hidden and password-protected spreadsheet listing a complete inventory of hidden assets.

Consider, for example, a matter in which data forensics uncovered a fraud involving hidden real estate assets worth $11 million. Two men had worked their entire lives to build a substantial corporate real estate company in Florida. They were both equal partners, and for decades, they had been very good friends. Their wives had also become good friends, and all 4 travelled the world together and vacationed in exotic destinations for almost 40 years. One of the partners suddenly passed away from a heart attack, and the grieving widow was required to surrender her inherited equity under the terms of a buy-sell agreement between the partners. The process required that an independent firm conduct a comprehensive review to determine the proper business valuation. The end result was startling.

In a proactive move, the company forensically preserved the computer used by the dead partner. A cursory data forensics analysis of that computer revealed a second corporate identity with a very similar name to the primary business. Further analysis discovered several bank accounts, and online banking artifacts were found in Internet cache files left behind on the hard drive. This strongly suggested that the ghost company maintained several bank accounts. A forensic investigation was launched.

The scheme was a simple one. The ghost company intercepted payments and deposited the funds into bank accounts known only to one of the partners. Over the course of 40 years, he had embezzled over $11 million and used the money to buy residential properties across the United States. A lawsuit was filed by the company against the widow in an attempt to recoup the embezzled funds.

During the course of the litigation, the home computers used by both partners were forensically analyzed. In a surprise twist, the data forensic analysis produced data indicating that the deceased partner had maintained a long-term love affair with the living partner's wife. So, not only did he cheat his partner out of $11 million, he also cheated his partner out of his marriage. The living partner has since filed for divorce, further complicating how the business and stolen assets will ultimately be divided. Although not all matters have such a dramatic ending, it is clear that data forensics can play an incredibly strong role in such an investigation.

Data Growth

Data grows at an impressive rate. While the rate of data growth continues to surge, the cost of storage continues to fall. As our need to transact more business and events online continues to grow at an exponential rate, the storage devices required to archive the data are approaching zero cost. Today, it is already possible to archive huge volumes of e-mail messages, along with attachments, on Google's Gmail platform. Oftentimes, users of the Gmail system use it as a mass storage device, archiving many years worth of e-mail messages into a single location while maintaining the ability to rapidly search and query the data. However, such a tool may prove to be rather dangerous to one who uses the system for unethical purposes because a complete accounting of all events is left behind and easily recovered for review.

As computing power continues to double every 18 months or so, storage costs are approaching free. This paradigm shift creates the ability to archive all information on an indefinite basis. The problem that develops, which we are now seeing, is how to manage such huge volumes of information. For example, the popular online website YouTube allows anyone with an account to publish videos to their site for no charge. Because many portable devices and smart phones have built-in video cameras, it is fairly easy to record a short video, up-load it to YouTube, and show it to the world. By some estimates, 8 hours of video content is published to YouTube every minute, making it impossible to actually view the information.

The Three Phases of Data Forensics

The three phases of data forensics are acquisition, analysis, and reporting. Although many matters settle before they reach trial or may never have been destined for court in the first place, it is very important for the forensic examiner to adhere to strict best practices when handling evidence and that every step of the process be performed through court-accepted procedures to ensure that the data will be admissible should the matter be advanced to trial.

In a divorce dispute, it is also critical to determine the rightful owner of a computer or cell phone prior to analyzing any of the data. The spouse who launches the investigation must have legal ownership to the device that is to be analyzed. For example, a notebook computer owned by the husband's company is most likely not allowed to be analyzed by the wife. A computer used by the family and located in a jointly-owned house is most likely considered a joint marital asset, and it is likely that either spouse would have the legal right to view data on the computer. However, it should be warned that the laws in this area are evolving, and local laws must be observed. The issue becomes clouded when a jointly-owned computer is partitioned separately for each user. If the wife has different login credentials than the husband, they may not have a legal right to access each other's data.

Although it is possible to enlist the services of a family friend who has IT knowledge, it is usually better to bring in an independent third-party expert with knowledge of systems to help determine the initial scope. This is because the family friend may be named a party in the investigation or might be considered a security risk.

Acquisition

The first phase in any data forensics investigation is the acquisition of data. Although data acquisition is somewhat standardized, it is extremely important that this phase be executed with exact precision. Any error or failure that occurs during this phase may make the results of the entire investigation inadmissible and, therefore, jeopardize the litigation. For this reason, the acquisition phase is of paramount importance; oftentimes, it is intensely scrutinized at the time of trial.

At the onset of any investigation, the equipment that likely contains responsive information must first be identified. This step may occur with the assistance of an internal IT department, but because of the risks previously discussed, it is best to enlist the services of a qualified third party to manage this process. A general overview of the computing environment is usually warranted to better understand the flow of data and where response data is likely to reside. By having this discussion before any analysis is conducted, the process is usually much better defined, resulting in a shorter time frame for the total investigation and saving money by avoiding having to return to capture additional data. The general rule of thumb is that if a

20 percent chance exists that a device will contain responsive data, it is better to acquire the data from that device at the beginning of the process than to leave it behind.

When considering where responsive data may reside, we must consider all devices that could potentially contain such data. It is fairly common to first list the computer used by the party of interest. If the issue is a civil matter involving, for example, theft of intellectual property, the corporation may want to consider acquiring and preserving data from the employee's work computer and other company-issued computers, such as a notebook; any company-issued cell phone or smartphone; the corporate e-mail database; and any shared folders on the company network that may contain confidential files that may have been targeted for theft. In addition, it is recommended that any external data sources, such as USB drives, CDs, DVDs, and so on, that may also include responsive information be preserved.

Other data sources should be earmarked for future examination. An example of this is the home computer used by the suspect. It is most likely not possible to access this data, unless the suspect is notified and voluntarily grants permission to have his or her home computer analyzed. If the initial results of the data analysis yield information that strongly suggests the home computer is somehow involved, a court may grant an order requiring the suspect to make the computer available for analysis.

If it is determined that the home computer or some other system not legally accessible at the onset of the investigation may contain responsive data, it is generally a good idea to issue a preservation statement to the suspect. A preservation statement simply states that the data on the computer may become instrumental in the investigation or litigation and that the owner is placed on notice to preserve any and all data that resides thereon. This will help protect against the computer being mysteriously lost or becoming damaged and discarded by alerting the suspect that any damage or destruction of data will be considered spoliation of evidence and subject to court discipline. Data privacy laws vary from state to state and country to country, so it is recommended that before any data is actually acquired, an attorney is consulted to ensure that the company has legal access to the data.

The forensic process of acquiring data from a hard drive does not in any way change any of the data on the hard drive. When performed properly, the process leaves no trace evidence on the drive and does not modify any of the data. Upon arrival to the scene, the subject computer and surrounding area is first photographed. When photographing the computer, a picture is taken of the computer in the condition it is found, including a picture of the screen that will indicate if the screen is on or off and display any information on the screen. Next, the computer is slightly moved to expose the rear wire connections, and the exact placement of each wire is then photographed. This will assist in placing each connector into the proper interface once the acquisition process is complete. Once the connections have been photographed, they are labeled accordingly, and another photograph is taken. At this time, a chain-of-custody document should be created to transfer custody from the corporation to the examiner. A partial example of a chain-of-custody document is as follows:

T&M Protection Resources

CHAIN OF CUSTODY

SECTION 1 – PROJECT IDENTIFICATION

Client/Matter Code	Server, Custodian, or Other ID (N/A if unknown)	Color Code
-- --		Place Sticker Here

SECTION 2 – MEANS OF ACQUIRING CUSTODY

☐ **Delivered by Client / Representative – *ENTRY IN SECTION 5 REQUIRED***
☐ **Transported by our Staff – *ENTRY IN SECTION 5 REQUIRED***
☐ **Received by 3rd Party Courier**

Evidence Control #

Evidence Control Custodian

Courier Name: Tracking Number:

Received by (Print Name): Signature: X

☐ **Onsite Imaging and Release – Signature temporarily releases device for imaging**

Access for imaging authorized by (print name): Company: Signature: X Date:

☐ **Unavailable or unwilling to provide signature – *EXPLAIN IN SECTION 7***

SECTION 3 – DEVICE INFORMATION

HOST DEVICE ☐ Server ☐ PC ☐ Laptop ☐ Personal Device:__________ ☐ Other:__________ ☐ N/A (Received with no host or is standalone)

Evidence ID #	Make:	Size: ☐ GB ☐ TB ☐ KB ☐ MB ☐ Other:______
	Model:	☐ N/A
Photos: ☐ Yes ☐ No (Explain in Section 6)	Serial #:	
	Other identifying information:	

INTERNAL / STANDALONE DEVICE ☐ Hard Drive ☐ Disk Media ☐ Flash Media ☐ Tape Media ☐ Logical ☐ Other:__________ ☐ N/A

☐ Additonal Media Exists (*See Chain of Custody – Additional Media* form)

Evidence Item #	Make:	Model:
Photos: ☐ Yes ☐ No (Explain in Section 6)	Serial #:	Other identifying information:
Size: ☐ GB ☐ TB ☐ KB ☐ MB	Interface Type:	Jumper Setting: ☐ Master ☐ Slave ☐ CS ☐ N/A ☐ Other __________

SECTION 4 – IMAGING & LOCATION INFORMATION

Location of Imaging

Company Name:	Address:		Suite / Office:
Country:	City:	State:	Zip:

Imaging Information

Start date (MM/DD/YYYY):	Start time (0000):	Initiated by (print name):	Signature: X
Completion date:	Completion time:	Completed by:	Signature: X
		Verified: ☐ Yes ☐ No (Explain in Section 6)	

Imaging Utility	Write Protection	Copies	BIOS Information (Explain in Section 6 if unavailable)
☐ FTK Imager	☐ Tableau (TD1 / T35e / T8)	Copy 1 ID:	BIOS date & time (MM/DD/YYYY / 0000):
☐ EnCase (Windows / DOS / Linux)	☐ USB Registry Keys	Compression: ☐ Yes ☐ No	
☐ Other:	☐ Other:	Level: GOOD BEST 0-9 ______	
		Copy 2 ID:	Actual local date & time (MM/DD/YYYY / 0000):
Version: __________	☐ N/A (Explain in Section 6)	Copy 3 ID:	Source: ☐ Cell Phone ☐ Other:__________

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Once custody is transferred, the computer may be moved in order to allow the examiner to photograph and record the make, model, serial number, and any other identifying information. The computer is then labeled with an appropriate evidence label to allow it to be positively identified in the future. The evidence label will likely include a unique identifier or code that would cross-reference to the matter and device. Additional photographs are taken once the label is in place.

To Pull the Plug or Not Pull the Plug

The next step is largely debated. The choice is made to capture the volatile data or simply lose the volatile data in an attempt to preserve the exact state of the persistent data. If the volatile data is captured, a chance exists that data will be written to the hard drive during the process, thereby changing the original evidence and causing potential problems with the admission of persistent data collected after the modification. On the other hand, simply pulling the plug will crash the system and lose all the volatile data. In most scenarios, the pros outweigh the cons in favor of pulling the plug, but this is usually a game-time decision left to the examiner.

Once power is removed from the computer, it is dismantled, and the hard drive is located. The inside of the computer is photographed, and the drive is labeled and photographed again. The drive is then removed from the computer and unplugged. It is advised to take as many pictures as possible during this stage of the acquisition. It is better to have too many photographs from different angles than to discover after the fact that a key photograph is missing. After the drive is removed, it is connected to a write-block device that physically protects the drive from having any data written to it. The write-block device is next connected to a data acquisition device, which may simply be another computer or a device specifically designed to forensically capture data. A forensic duplication is then performed, which reads every single bit of information from the source drive and copies the exact data to a target drive. The data exported to the target drive may be the raw files or in a database format that creates an image file of the source data. An *image file* is a proprietary file format that contains an identical image of the hard drive contents. An image file is sometimes referred to as an E01 file, which is a common format used in both private industry and the public sector.

Verifying the Image

Once the image file is created, it is verified to the original and determined whether it is an exact duplicate. The process to compare the images is very simplistic, but the science behind the process is quite complex. The formula, sometimes referred to as an MD5 hash or SHA hash, involves an intense computational analysis of the contents of the drive to produce a digital DNA signature. This hash value is a unique character set and will identify if the copy that was made exactly resembles the original. A manual review of the hash value of the source and target drives will reveal whether the values match. If they do, most courts will generally accept the copy as being an exact duplicate of the source (original data).

The process is then duplicated, so that a second copy is made, which is then verified to be identical to the original. The purpose of making a second copy of the drive is to allow one copy to be archived and the second to be analyzed. The first copy is labeled "Archive Copy," and the second is labeled "Working Copy."

Once the original drive has been properly acquired, it is reassembled into the original computer, and the computer may be placed back in service. If the computer is not immediately needed, it should be securely stored.

Data Forensic Analysis

Data forensic analysis is more of an art than a science. Although a stringent process should be followed, each investigation will have a unique set of data and case parameters, and as clues are uncovered, the investigation will meander down its own path. Depending on what is suspected, the investigator is given some liberty on how to approach the investigation. Most investigations will start with a relative time frame and specific keywords and may include a focus on deleted files, e-mail, or some other type of information. It is of utmost importance to document every step of the analysis, so that a given result can be recreated.

Time Frame Relevance

Most computer files record basic information that includes the dates that the file was created, last modified, and last accessed. These dates can sometimes help streamline an investigation by eliminating all files that were accessed outside of a specific date range. Care should be taken when applying a date range filter to a file set because although the assigned dates are useful, they are not 100 percent accurate. For example, a range of files may have been accessed by a backup system that will reset the date of last access. It is important to remember that other routines and standard operations may change the file parameters, causing the dates to be something other than what was initially expected. The same holds true for the creation date of the file. If a file is created on a work computer in April and copied to a home computer in July, the home copy may have a creation date of July. This is because the process of copying a file actually creates a new file. Although both files are identical, the copy on the work computer will have a creation date of April, and the copy on the home computer will have a creation date of July.

Keyword Searches

A common procedure for forensic analysis depends on searching a data set for keywords. Some forensic tools will actually build an index of every word in every document and allow for the rapid searching of keywords. A keyword can consist of a proper name, an e-mail address, a Social Security number, or any other type of information. One application may store the data differently than another application, but powerful forensic tools are able to decipher how data is stored in a vast number of applications and display accurate results. The use of keywords may immediately identify e-mail messages or documents hidden deep below many layers of folders. Keyword searches will also identify potentially responsive documents that have been deleted or exist only as a fragment on the hard drive.

Reporting

The results of an investigation may be delivered in various formats, but a decision needs to be made if the report will be in a written format. Typically, it is desirable to verbally report any potential response findings to counsel. A formal written report will include a detailed accounting of the acquisition and analysis phases, including photographs. The forensic report is prepared in such a manner that it states only the facts of a matter. It does not necessarily form an opinion or attempt to interpret the results. Typically, the forensic examiner will author the report and sign a statement attesting that it is factual and accurate. The report may be used at the time of trial and potentially marked as evidence, so it is of great importance that the forensic examiner is able to explain the findings in layman's terms that the judge and jury can understand.

Court Testimony

If a matter proceeds to trial and computer evidence will be admitted, it is likely that the forensic examiner who produced the data will be required to provide oral testimony. The examiner will be presented to the court as an expert witness and accepted or rejected by the judge. If accepted, the expert witness will recount the steps taken to produce each piece of data that is presented in the report. Oftentimes, opposing counsel will present an opposing expert in an attempt to discredit either the expert witness or work product that was produced.

Data Forensics Versus e-Discovery

In recent years, there has been much discussion of e-discovery. Today, virtually every lawsuit is required to consider electronically stored information at the beginning of the litigation. As a result, an industry was born overnight. Many players entered the market, including litigation consulting firms, technology firms, storage companies, and traditional discovery service providers. The average cost of a litigation matter rose quickly because immense volumes of data were now being labeled as discoverable. Settlement discussions were entered into not only based on the merits of the matter but also because of the inherent costs of e-discovery. E-discovery would quickly become one of the costliest components of the litigation process.

The benefits of data forensics have been somewhat eclipsed and lost in the wake of the larger and more profitable e-discovery process. Many guiding authorities use the terms somewhat interchangeably, which has further confused corporations and individuals. A need exists for both services, but each provides a specific type of output, and in many cases, both services are not necessary. In fact, it can be argued that data forensics, when properly utilized, can greatly reduce or even eliminate the need for e-discovery in some litigation matters.

E-discovery is generally used to produce large volumes of nonprivileged information. It is typically focused on e-mail communications and active files, and many times, it is just a dump of data that can be easily copied from a computer or network using traditional and standard tools. Some e-discovery companies have created automated tools that preserve and convert the data into a searchable array, eliminating duplicate files or redundant e-mail strings.

The general business of e-discovery is to rapidly produce discoverable data items in a timely fashion. E-discovery typically is not used to help support a position and generally produces data simply because the court mandates the data be produced. The producing party attempts to produce as little information as necessary in order to be compliant, and the requesting party usually requests as much information as it can reasonably get away with. Many times, the end result is an overproduction of data at a large expense. Although the data will be scoured for responsive information and may be further reduced by keyword searches or time frame relevance, for the most part, it comprises information that is easily extracted from active systems. The e-discovery process is similar to cultivating a large hay field, collecting a great number of hay bales, and delivering them to the adversary.

On the other hand, data forensics is a different process altogether. Data forensics may be used to quickly understand the facts surrounding a matter, and many times, it is employed before litigation. The process focuses on deleted files, website histories, or user logs—all items that are usually not included in the e-discovery process. Data forensics takes a surgical approach to identifying small but highly responsive pieces of data. In essence, it tries to identify a smoking gun that is so important to a matter that it alone can be used to sway a jury or force a settlement. This process is similar to searching a single hay bale for a single needle.

Theft of Intellectual Property

Information that resides on a computer can be copied or duplicated with ease. It is because of this trait that computer data is easily stolen, which is a process known as theft of intellectual property. Theft of confidential trade secrets can damage a company in many ways. Data can be removed from even the most secure network infrastructure in multiple ways. In an attempt to thwart off the theft of confidential data, many corporations impose safeguards that often reduce employee efficiency. There remains a fine balance between reducing network access to prevent data theft and locking down the system to the point that it frustrates employees and negatively affects productivity. It is commonly known that most data theft is caused by internal employees, not an outside intruder. Although outside attacks happen and are sometimes sensational, the real threat lies within the walls of a company.

A frequently used method of stealing intellectual property is through the use of e-mail. With relative ease, a corporate employee can attach a confidential file to an e-mail and send it outside the company. Once the file is outside the control of the company, it can be copied, printed, and sent to others without permission or even the knowledge of the company. For this reason, many companies restrict the size of e-mail attachments. However, the problem is much more complicated than that.

Most users maintain two or more e-mail addresses—usually a work address and one or more personal addresses. Popular e-mail systems such as Yahoo! Mail and Google Gmail allow fairly large attachments and can be accessed from any Internet connection that does not block access to those specific sites. So, from a company computer, it is possible to access a personal Gmail account and attach large files to a blank message. The message can then be sent to the same address or another third-party mail system. In fact, it is not even necessary to send the message in order to steal the attachments. The user could simply save the message as a draft and then log in from a home computer later that night and retrieve the message from the draft folder.

Many corporations block access to popular e-mail sites, but literally thousands exist; it is difficult, if not impossible, to block access to all of them. However, some corporations believe that restricting access is the right thing to do, but others believe that the employee has a right to access personal e-mail messages.

Certain industries require all business communication to be archived as part of a regulatory requirement. This is a task in and of itself because business communication often takes place outside the systems the company can control. However, a regulated corporation should make every possible effort to secure and archive communications. A recent study of a trading company found that although all trade-related communications are archived, users are sometimes permitted (and even encouraged) to access their personal e-mail from the office for nonbusiness-related communications. By allowing open access to third-party mail systems, a company introduces the risk of theft of intellectual property through e-mail transmission through those systems.

If a company makes the business decision to block third-party e-mail systems, a risk may still exist with corporate e-mail. Most companies allow for remote access to e-mail either through a BlackBerry or web access. Any type of remote access to e-mail could introduce a potential vulnerability by allowing a user to create a draft message, attaching confidential files, and saving the draft. The message can then be accessed remotely and the contents copied to a data source outside the control and knowledge of the corporation.

Data forensics is a useful tool in determining if information has been transmitted outside the company. A forensic analysis of a personal computer can easily identify if a third-party mail system has been accessed and can usually produce some message content. If a third-party e-mail system is used, it is likely accessed through the computer's browser—typically Internet Explorer.

Due to the inherent nature of the way a browser operates, much of the information displayed on the screen is cached to the hard drive. This allows the computer to continue downloading information from the Internet while the user is reading the current screen. In recent years, browsers such as Firefox and Chrome allow the user to have some control with regard to what is cached to the hard drive. By setting the browser to run in stealth mode, the user can prevent data from being cached to the hard drive altogether. If stealth mode is enabled, a forensic examination may not produce any cached e-mail, but it will most likely be able to determine that the browser was set to run in stealth mode and confirm whether the browser was used by the user.

Another widespread method of stealing intellectual property is through the use of USB drives, also known as thumb drives. Although these devices are very small, they are able to store a huge volume of information. A typical thumb drive is able to store the equivalent of approximately 90 CD-ROMs. Not too long ago, the same amount of data required approximately 45,000 floppy disks. When a USB drive is attached to a computer, it appears as a local drive. Reams of data can quite easily be dragged from a network drive to the local USB drive and walk right out the company's front door in an employee's shirt pocket. To combat against this threat, many companies have opted to disable the USB ports on company-owned computers. Although this may seem like a logical decision, doing so impedes an employee's ability to copy files for acceptable and appropriate use outside the office, which has a negative effect on productivity.

If a user copies files to a USB drive, several important pieces of information will be left behind and can be recovered through the use of data forensics. A typical analysis will likely be able to determine when a USB drive was installed into the computer. When a device such as a USB drive is installed, the system will automatically identify it and load the appropriate supporting drivers. This action leaves behind concrete evidence that such a device was installed, along with the date and time it was inserted into the computer. Additionally, if files are dragged from the computer to the USB drive, the system may create shortcut files identifying every file that was copied by name. If the user then deleted the files from the hard drive, further evidence would be left behind showing that action. Lastly, it is very likely that the forensic analysis would be able to recover the deleted files, thus illustrating the exact timeline of activity: insertion of USB drive, files copied to the USB drive, files deleted from the computer, and recovery of the deleted files.

Online storage companies present another simple option for one to steal intellectual property. A plethora of services are readily available, including Apple's iDisk that allows one to copy files to a virtual drive on the Internet for later retrieval from a computer connected to the Internet anywhere in the world. This type of service is used for benign purposes to post large amounts of data for immediate access by someone elsewhere on the globe. Once a file is posted, it is no longer controlled by the company. Data forensics may be able to identify what online storage site was used and may even be able to determine what files were posted.

Concealing the Identity of a File

A computer system is able to use any alphanumeric character to name a file. Human nature causes us to usually grant a name that describes the content. For example, a file named executivebonuses.xls is most likely a spreadsheet containing the values and recipients of all bonuses. Some companies will modify the name of a file in order to identify it as being confidential. So, instead of executivebonuses.xls, the file may be called executivebonusesCONFIDENTIAL.xls. The network may then be configured to prevent a file that contains the word *confidential* from being e-mailed, copied, and so on, or it may allow such action but create a log when someone accesses the file. However, if the filename is changed, these systems may fail. If a user wanted to copy executivebonusesCONFIDENTIAL.xls, the file could simply be renamed to bobsbudget.xls and then sent out of the company unnoticed.

Similarly, a user can create a folder named vacationpictures and store confidential information within the folder. A cursory review of the computer would probably not give cause for alarm, but a forensic analysis would very quickly and easily be able to identify confidential files stored in a place where they should not be stored.

An even cleverer trick is to change the file extension. The file extension is a three-character value that tells the computer the file type. An extension of ".doc" typically indicates that the file is a word processing document, and ".xls" a spreadsheet. If executivebonusesCONFIDENTIAL.xls was changed to sunflower.jpg, the operating system would identify the file as a JPG graphic file and automatically change the icon from Excel to Windows Photo Viewer or another graphic-based application. The file can be attached to an e-mail message as described earlier and sent out of the company without raising any flags. When the file is later retrieved, it can be renamed back to its original name and opened in Excel. Data forensics allows for a process that identifies a file type by the contents, not the filename or extension. A forensic analysis can quickly identify all spreadsheets that exist on a hard drive, not just the ones with an extension of ".xls." A quick comparison of the two will identify if any file extensions have been changed to conceal the type and contents of the file.

Malware: Viruses and Spyware

Malware is short for malicious software and is defined as a software application that performs unwanted tasks. Computer viruses and spyware are examples of malware. A computer virus can harm a computer by deleting files and folders and causing the computer to fail. Spyware can collect data from the computer without the user's knowledge and send the data to another location. Common spyware applications collect website information and even credit card and bank account numbers. Spyware is also spread through e-mail and by visiting websites. Many times, the user is lured into accessing a website or clicking on a link in an e-mail by being promised something in return.

According to Kaspersky Lab, a leading antivirus company headquartered in Moscow, over 34 million known computer viruses exist, and new viruses are being created daily. A virus may be transmitted through e-mail or obtained from visiting an infected website. Once accessed, the virus installs itself on the computer and may be capable of infecting other computers on the network or concealing and sending itself in an e-mail message to contacts in the address book. Once released, a cleverly designed computer virus is able to propagate around the world in a matter of hours.

Computer programmers who write malware applications are devious, and care should be exercised when opening e-mail or surfing unknown websites. Some malware applications are actually triggered by displaying a pop-up window stating, "Malware Detected! Click HERE to scan your computer for free!" By clicking the link, the user is actually allowing the malware to manifest itself and infect the computer.

Other E-mail Threats

Other threatening information can be sent via e-mail, which can have a horrendous effect on one's integrity and reputation. A disgruntled high school student once sent an e-mail to an instructor that contained hundreds of illegal images of children engaged in sexual acts. The instructor clicked on the message and read an innocuous note from the student that appeared to ask for help with a homework assignment. Embedded in the message were the images, which the sender shrunk to one pixel each—too small to display on the screen but full pictures nonetheless. The pictures were automatically transferred to the instructor's hard drive. The student sent a whistle-blower e-mail to the local authorities, and the instructor's computer was analyzed and found to contain child pornography. Data forensics ultimately revealed the time line of events and traced the images back to the e-mail message, but by then, it was too late. The instructor's reputation had already been destroyed by the local press.

Other examples of e-mail threats include messages that are sent with the text color changed to white. The recipient cannot read the white text on the screen, but if the message is printed on a black and white printer it becomes clearly legible. A lawyer of a large East Coast law firm used this trick to send a seemingly binding note of agreement to opposing counsel, but it contained many conditions not visible on the screen. Opposing counsel replied agreeing to all the terms, not knowing that the white text was part of the message. Once printed, the agreement read very differently, but data forensics was used to expose the deception.

Internet Protocol Addresses

When information is sent over the Internet, it requires a valid Internet Protocol (IP) address. An IP address is unique to every device connected to the Internet and comprises four sets of numbers from 0–255. A sample IP address is 192.168.1.201. IP addresses may be assigned statically, meaning they always remain the same, or dynamically, meaning they are temporarily assigned for a brief period of time. Typically, an IP address is assigned through a third party, such as an Internet service provider.

When data is sent over the Internet, it almost always includes the source and destination IP addresses. The user does not typically see these numbers or even know that they exist because they are embedded in the packet of data. However, through the use of data forensics, the IP addresses can be determined. In a recent example, a former employee illegally accessed the company network from home in order to destroy files and wreak havoc because he was disgruntled over being terminated. A relatively simple analysis divulged the source IP address that was quickly traced back to the former employee's home. Armed with such absolute records, the company convinced the court to place the former employee under a restraining order and demand remuneration for the damages. Tracing an IP address is relatively simple, but many times, a static address will point to an Internet service provider and not the individual who was using the provider. In such cases, it may be necessary to issue a subpoena to the provider, ordering it disclose the identity of the user.

Social Networking Sites

Social networking websites such as Facebook and LinkedIn can provide insightful information. However, although it may be tempting to log into a social network using a spouse's log-in ID and password, doing so may be illegal. Even if the password is known, another user is not allowed to use it without the owner's permission. It is possible to view some or all of the posted information if the two accounts are connected, such as the husband and wife becoming friends on Facebook. Recent legislation has made it illegal to create a false or misleading profile in order to join another person's network. For example, a husband cannot create a fabricated profile claiming to be one of the wife's girlfriends in order to have a friend request accepted. In some cases, the court may require the production of social network website data. Oftentimes, these requests are met with resistance from the Web hosting company, and the production must be made by the profile owner. It is important to understand the seriousness of altering or deleting information after it is requested and before it is produced. Such activity may be considered spoliation of evidence and carry stiff sanctions imposed by the court.

Cell Phones and Smartphones

Cell phones and smartphones are capable of storing vast amounts of information, and in many cases, they allow deleted data to be forensically recovered. In addition to contact lists and recent call activity, it is usually possible to recover text messages and other communications. Smartphones have evolved to become extremely capable devices with astonishing computing capabilities.

A basic cell phone typically does much more than simply make and receive phone calls. Almost every phone manufactured provides the user with multiple ways to communicate. Sending short text messages from a cell phone has rapidly become the preferred method of communication for many people. Depending on the specific cell phone and carrier, a quick text message may be forensically recovered long after it was sent. Text messages have played a vital role in many sensational legal matters. The general rule of thumb is that anything sent via text message may be admitted as evidence in a future trial. Like e-mail, a text message may live on forever.

Recent advances in smartphones have created a whole new set of challenges across all industries. Because smartphones are sophisticated computers, they are capable of performing many functions that usually were reserved for a notebook or desktop computer. Data forensics of a smartphone can produce a plethora of data, including huge archives of e-mail, text messages, photos, videos, Internet activity, online banking information, application data, and many other items. A smartphone is a highly technical computer that allows communication in many different ways and interaction with numerous applications. It connects us to our home, bank, travel agent, place of work, and each other. It allows us to purchase virtually anything and have it shipped to us overnight. We can watch movies on it, program the DVR in our living room while out to dinner or on vacation, and create movies to be immediately uploaded for the world to see instantly. All of these actions may be recovered through the use of data forensics.

Global Positioning System

Most modern-day cell phones have global positioning system (GPS) capability. A GPS-enabled device, such as an iPhone, typically knows in real time exactly where it is located. This is obviously useful to the user because many applications rely on knowing the user's location. For example, a search for restaurants may result in only the restaurants in the nearby proximity being displayed. However, GPS plays a much more significant role. A GPS-enabled cell phone can track in real time the physical location of the device through a website. This is helpful when a parent wants to know where his or her child is going. The parent simply goes to the website to see the physical location of the phone, along with any movement. This is usually performed without the child's knowledge.

This same tactic applies to a spouse watching where his or her partner is going every step of the way. Some systems allow the microphone to be remotely activated, which will allow the spouse to see the physical location on a map and actually hear the conversation. This can be done without changing anything on the phone or installing spyware.

Another common use of cell phones is to take pictures or record video. Today's GPS-enabled cell phones embed a geotag to each picture or video, allowing a viewer to determine the latitude and longitude of where the picture or video was taken. Users should be forewarned that if a picture is posted to the Internet, it retains this information, so anyone who views the picture has the ability to see where it was taken.

Spyware Specific to Cell Phones

In recent times, a rash of spyware has been developed specifically for cell phones. Once installed, the spyware allows a remote user to have access to many of the phone's functions and will sometimes transmit sensitive information, such as text messages or e-mails, to a third party. The spyware may also allow phone conversations to be monitored and even remotely control other applications on the phone, such as online banking applications. Although the threat is real, cell phone spyware infections are still difficult to detect, and not much is yet known about the rogue code. However, it is known that a phone does not even need to be touched to get an infection. It is possible for one to infect a phone through Bluetooth, meaning the target phone only needs to be in the same room as the infector.

Conclusion

With technology so pervasive in our everyday life, it is difficult to remember how we all managed to somehow get by without it. Computers and cell phones are truly little marvels. However, as a society, we have to remember just how dangerous all of this technology can be. Our routine interaction with technology allows us to work harder and faster, exchange data and ideas on a global level with the click of a mouse, and remove many boundaries, but the technical tools create a digital landfill of data waste. Cyber bin divers are able to collect this data and expose the information days, weeks, months, or even years later.

Data forensics can determine the facts surrounding an event and provide insights to time lines and trends. Business owners should recognize that a second set of books or confidential communications with a potential buyer can be uncovered with relative ease. When determining the income from, or value of, a business, data forensics may be used to separate fact from fiction and introduce many new factors. In the event of litigation, data forensics becomes an extremely valuable tool and should be relied on heavily in deciding the legal strategy in almost all cases. In any legal dispute, a computer or cell phone may contain the smoking gun that ultimately decides the outcome. People lie; on the other hand, computer data doesn't lie.

CYBER BAIT AND SWITCH —In one case, the CFO of a private company received an e-mail that appeared to be from the popular job recruitment site monster.com. The e-mail advertised a CFO position with a high compensation at a public company. The CFO of the private company clicked on the link and was taken to a fabricated page that closely resembled monster.com. At the same time, it loaded a piece of spyware on the local hard drive. Once the computer was infected, it was programmed to collect bank account numbers and passwords.

The CFO routinely transferred corporate funds via his computer by logging into a secure banking website and entering the account number followed by the password. The spyware on his computer recorded the keystrokes when it detected an account number and sent the data to a user in another country. Soon, the company noticed that sums of money had been transferred from its operating account to a foreign account. The transfers were small enough to go unnoticed but cumulatively amounted to over $250,000 in less than 30 days. The CFO suspected that his computer may have been infected by the monster.com e-mail but failed to bring it to management's attention because he didn't want anyone to know that he was looking at other job opportunities on the Internet. Data forensics ultimately proved that the CFO had, in fact, clicked on what he thought was a job posting that ultimately caused $250,000 to be sent overseas and become irrecoverable. The CFO resigned in disgrace.

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Members on the Same Team—Forensic Accountants, Attorneys, and Clients

By Richard H. Singer, Jr., Esq. and Richard F. Iglar, Esq.

The Role of the Forensic Accountant

Along with the attorney, the forensic accountant will often play an extremely critical role in a divorce matter. The attorney and client have to place great faith and reliance in a quality work product that will be utilized in a negotiation or trial. On some occasions, an accountant may be court appointed or designated a joint expert for both parties. More often, however, the forensic accountant is retained by one of the parties as his or her expert. Forensic accountants are generally asked to evaluate two discrete areas: the value of closely-held businesses and professional practices and an analysis of income and expenses for a lifestyle report.

Forensic accountants may be asked to offer analysis on any of a variety of economic issues in a divorce case that require an investigation, an interpretation of data, and a conclusion in the form of an expert opinion. A lawyer may ask a forensic accountant to offer expert testimony on virtually any economic issue that the lawyer must address and resolve. By way of example, a forensic accountant may be asked to trace assets to prove the premarital portion of an account or establish the commingling of marital and nonmarital assets. Forensic accountants have been utilized for such unusual issues as the amount of money the opposing party spent on a secret residence, a girlfriend, and purchases made through home shopping television programming. The forensic accountant may be asked to investigate and analyze any specific issue that draws upon his or her expertise and is of importance to the issues in the case.

On the most elemental level, the forensic accountant is simply providing factual information or rendering expert opinions for use by the attorneys and court. However, the forensic accountant often plays a far greater role in a divorce case. The forensic accountant retained by one side or the other is usually a member of the team, working in conjunction with the attorney and client to marshal the facts and information that will serve as evidence in support of the client's position. Because the forensic accountant has knowledge and a skill set that neither the attorney nor client are likely to have, the forensic accountant may be in a unique position to suggest avenues of approach that are helpful to the attorney and client in reaching the client's goals.

The role of the forensic accountant does not end with the production of the report. It is of critical importance that the forensic accountant, as a member of the team, be able to effectively participate in settlement negotiations and be persuasive in support of his or her opinion. If the case is tried, the forensic accountant must possess the necessary skills to testify effectively in a clear, concise, and conjunct manner to communicate to lay persons how the work was performed and the opinions arrived at. Obviously, defending one's position in cross-examination is also of paramount importance. Not every forensic accountant possesses the skills necessary to take the witness stand and perform in court. If we are to hold ourselves out as forensic accountants in family law matters, we must not only have the technical expertise and requisite educational background and credentials, but we must also be prepared to participate beyond the scope of simply producing a report.

What the Attorney Wants

What does the attorney require of the forensic accountant acting as his or her client's expert? The forensic accountant must perform quality work. He or she must be thorough and diligent and able to competently apply the theories of valuation or principles of accounting to the facts. Ultimately, the forensic accountant must produce a good work product: a sound expert report that will establish the value or prove a conclusion to be presented at trial. However, the attorney wants more than competent work. The attorney wants an expert who will make a positive contribution toward achieving the client's goals. Typically, the attorney chooses the forensic accountant or, at least, has great weight in the decision and will naturally want to select a forensic accountant who will be helpful.

The forensic accountant, just as the attorney, is in a service business. The attorney will want someone who will make his or her task easier and benefit the client. Why would the attorney want to involve someone who is going to make his or her job unnecessarily harder or not produce a quality professional report? A successful forensic accountant who wants repeat business from the attorneys with whom he or she has worked should remember that future assignments often depend upon the regard with which he or she is held by the attorneys recommending a forensic accountant. Attorneys judge forensic accountants based on their professional credentials, the quality of the work product produced, and their skill in assisting in negotiation or testifying in litigation. We only get one chance to make a good first impression; we have no do-overs, and being engaged is not a try-out. The client's economic welfare is at stake, and often, significant sums of money are involved. Forensic accounting, particularly the subject of business valuation, should not be undertaken without considerable thought and evaluation about whether you have the necessary skill set to accomplish the assignment.

More specifically, what are the skills that the forensic accountant must bring to the table? He or she must be able to interact with the client and must have interviewing skills and the ability to gather useful information from the client and other sources. The forensic accountant must be able to think creatively about how factual information will be factored into a conclusion. He or she must be able to present his or her opinion and generate a comprehensive report with supporting schedules. Hopefully, that report will include text, rather than just calculations and numbers on a page. Some experts might prefer to do without text, but it is especially useful to the nonaccountant lawyers and judges who may be more comfortable with narrative explanations. Also, that report must be generated in a timely manner. An attorney cannot be put in the tenuous position of not having the required report by the due date set forth in the case management order. After producing the expert report, the forensic accountant must be able to explain his or her opinion in a confident and persuasive manner. This will be needed during settlement negotiations, at a deposition, or when it becomes necessary to present the expert opinion during trial. The forensic accountant must apply all of these skills to assist the attorney in his or her arguments and be an asset to the client's case. As previously stated, substantial sums of money are often in dispute and dependent on the technical and communicative skills of the forensic accountant.

Being Retained

After the forensic accountant is asked to become involved in a case, a formal written retainer agreement is necessary. Who is retaining the forensic accountant: the attorney or client? The attorney usually chooses the forensic accountant and will direct his or her work, but the client pays the forensic accountant. Often, the client signs the retainer agreement because he or she will be paying for the services.

Although this is the general practice, in some cases, the attorney or client might consider the possible strategic advantage of a retainer in which the attorney hires the expert. Case law provides that the attorney-client privilege will be extended to an agent of an attorney who receives communications that will be used for the purpose of obtaining legal advice from a lawyer. Therefore, if a particular concern exists about the need to limit the forensic accountant's work product from the other side, consideration should be given to the possibility of having the attorney retain the forensic accountant.

The Investigation

Generally, the first event involving the forensic accountant will be a meeting with the attorney and client to discuss the issues to be analyzed and review all the known information or sources of information. The attorney, forensic accountant, and client should discuss which people may have information relevant to the forensic accountant's analysis, and they should also discuss how the forensic accountant will obtain that information. In a business valuation, for example, the forensic accountant may need to interview the business owner, employees, customers, or other parties with knowledge that would be useful in the analysis.

Often, the forensic accountant will first issue a document demand to the opposing party that sets forth all the documents that he or she determines need to be reviewed as part of the evaluation process. The forensic accountant may issue subsequent document demands indicating additional documents that he or she determines will be needed as the investigation and analysis continues. When the books and records of a business are required, the document demand may be the first step to obtain the necessary information. If the records are inadequate or do not reveal all the information needed for the analysis, the document demand alone will not suffice, and it may be necessary to interview key individuals and third parties.

It is also appropriate for the attorney to pursue formal discovery from individuals with information that the forensic accountant will need to analyze. Issuing a subpoena to obtain relevant documents is an example of information gathering in which the attorney assists the accountant. In some cases, it may be necessary to subpoena a person with relevant knowledge for a deposition. The attorney, forensic accountant, and client should discuss what information is needed and the best method of obtaining it, taking into consideration strategy, efficiency, and cost.

The Forensic Accountant's Interaction With the Opposing Party

The role of the forensic accountant is dramatically different depending on who we are representing. If we represent the business owner or professional, our job is generally much less complex and difficult. If we are representing the nonbusiness owner, it is highly likely that we will be confronted with a much more difficult task. When the forensic accountant performs a business valuation of a business owned by the client's spouse, the forensic accountant should first interview the client to obtain as much background information as possible about the spouse. Typically, the forensic accountant will also seek to interview the business owner and third parties, such as employees or even customers. Considerable thought should be given to how the interview is conducted. In some instances, the accountant simply meets with the business owner, with the opposing business evaluation expert present. This approach is less formal than a deposition and may be efficient and cost effective. In other instances, it may be necessary for counsel for each side to be present at the interview or a formal deposition.

When an expert relies upon a representation of a business owner during such an interview, the problem about what was said may arise. If the interview was conducted by the forensic accountant without either the other accountant or attorney present, there may later be an outright denial of what was said. Relying on statements that could later be refuted must be avoided because they can undermine the integrity of the entire report. One method of avoiding such a factual dispute is to not interview the business owner but instead conduct a deposition where a record is created. This provides greater control on the flow of information and reliability about the exact nature of the information provided and relied upon. It is clearly the safest method of proceeding.

It is highly desirable and preferred that a review of the business records be conducted at the place of business An on-site visit to the business premises can often permit the forensic accountant to gain valuable insight about the operation of the business. Sometimes, these visits can inadvertently reveal information that would not otherwise be obtained if the forensic accountant was not on the business premises.

If we are representing the professional or business owner, our ability to gather information is exponentially enhanced. We can expect that we will have far greater access to information than if we were on the opposing side. Our ability to understand the nuances of any particular business or industry will also be greatly improved, and our report should generally be more authoritative and comprehensive because of this opportunity.

It is often possible for the forensic accountant representing the business owner or professional to influence the report of the forensic accountant of the other side by virtue of an enhanced understanding of the asset being valued. This is an opportunity not to be overlooked, but it must be deftly handled. The skills of the forensic accountant beyond technical expertise can be employed in this area.

Analyzing the Information and Data

After the forensic accountant has obtained all the necessary raw material, he or she must analyze that information and data gathered and form opinions or conclusions that are to be set forth in the expert report. A draft report for preliminary analysis should be circulated to the attorney and client. Once this draft has been properly vetted and discussed, a final report can be prepared.

When the preliminary report is issued, particularly on the subject of the valuation of professional practices and closely-held corporations, several variables need to be thoroughly discussed. Among these variables are reasonable compensation and capitalization (cap) rates. These variables can dramatically shift the valuation conclusion. The forensic accountant must be able to thoroughly explain and defend all the variables in the report to the client and attorney before the final report is issued. Any weakness in this area can be fatal. The forensic accountant should expect to be challenged on all these variables and subjected to intensive questioning by the other side in an effort to undermine the integrity of the report.

The Neutral Forensic Accountant

The neutral forensic accountant, whether jointly retained or court appointed, often plays a greater role than simply assessing the data and offering conclusions. Although officially he or she is simply engaged to perform an analysis, it is possible for the neutral forensic accountant to play an enhanced role. Valuation is not a science because a valuation analysis can fall within certain parameters. A skillful neutral forensic accountant can be useful in establishing a range of values for the consideration of the parties. With no apparent vested interest, the forensic accountant can assist in the resolution of valuation issues by not having to adhere to a fixed position that would not be conducive to flexibility and compromise. Again, the extent to which the neutral forensic accountant takes on this role is completely dependent upon the wishes of the parties. The forensic accountant may be a resource who helps bridge gaps, but the parties may choose to seek only the factual data or conclusions from the forensic accountant and argue to the judge why those facts or conclusions support their theory of the case.

It is important that the neutral accountant not overplay his or her hand. It is not uncommon for a court-appointed expert in these matters to feel that he or she is vested with some additional authority or responsibility to broker a settlement. That is not an accurate assessment of the expert's role. For example, experience in dealing with these issues in the 39 years that New Jersey has been an equitable distribution state has shown that some accountants have exceeded the boundaries of their authority in the hopes that their participation in the settlement of divorce matters will encourage judges to reappoint them in the future.

Court-appointed accountants and their role in assisting in the resolution of matters have had mixed results. Simply put, some accountants have exceeded their authority and tried to force settlements through marathon negotiation sessions in their offices. Although initially this seemed to be a successful model for accountants to adopt, ultimately, it was counterproductive. Attorneys and clients became wary of accountants who felt that it was their mandate to produce settlements. Accountants found themselves in the quasipractice of law, offering opinions about how nonaccounting issues could be resolved. Although it is desirable to assist in resolving issues, forensic accountants are cautioned to recognize the limits of their authority and expertise. It is better to produce high-quality, professional reports that are reliable and would encourage courts to reappoint you.

Timing of the Production of a Report

Often, the parties are required to produce their expert reports by a date ordered by the court and set forth in a formal case management order. Whether by court order or mutual agreement, a simultaneous exchange is the best methodology. This simultaneous exchange may occur at a meeting between counsels or experts. It could also occur by some other mechanism such as mutual overnight deliveries or faxes or e-mails by a certain time, but such exchanges require some element of trust in the other professional doing what was agreed. It may be that the detailed arrangements take on absurd cloak and dagger proportions, but the integrity of a mutual exchange is desirable.

If one party's expert, let's call him or her the early submitter, produced his or her report first, the other expert may have an advantage. The party who has not yet submitted a report—the late submitter—might have been considering a range of values for some variable, perhaps a cap rate or reasonable compensation or perhaps the overall value. Having seen the opposing party's expert opinion, the late submitter may now be able to use the early submitter's determination as either a floor or ceiling in selecting a range or an exact value for a particular variable. The late submitter may be able to present facts or propositions that refute or discredit some aspect of the early submitter's report.

Usually, both experts will want to avoid giving the other side a sneak preview of their report and will insist upon a mutual exchange. It is not unreasonable to consider allowing one expert to produce a report, with the other side then reviewing that report and commenting on it. This approach can achieve considerable efficiency and cost savings, and it avoids both experts reviewing the same raw data and compiling it in preparation for the report. However, this approach cannot be employed without full knowledge of the quality of work and integrity of the forensic accountant compiling the preliminary report.

Once a preliminary report has been completed, the forensic accountant on the other side should review and critique that report. It is entirely possible at this point that a meeting of the accountants can take place during which the variables in dispute are discussed and a resolution on value is achieved.

Another situation can arise that needs to be considered. In this circumstance, one side is compelled to produce their report preliminarily. In many cases, both parties have a critical interest in valuing a business or other asset, and they intend to invest their full resources and efforts in coming to an answer. However, on some occasions, one party has more of an interest in presenting an expert opinion. Perhaps one party has the legal burden of proof, and the other party knows that if no reports exist, they would win a particular issue. The opposing party may be of the opinion that it may not need its own report or does not want to produce a report unless the other party can meet its burden. In such a situation, there may be an advantage to having the attorney ask that the case management order require the other party to produce a report by a certain date, with a rebuttal report to be produced in a specified period of time thereafter. The forensic accountant should urge the attorney to take this strategic opportunity if it is available.

Depositions

The forensic accountant should assume that he or she will be deposed by the opposing counsel with regard to his or her expert opinion. Like any other witness, the forensic accountant has an obligation to answer the questions truthfully; however, unlike lay deponents, he or she will be asked about much more than objective, concrete facts. He or she will be asked about his or her professional opinion.

The deposition is the first opportunity for the forensic accountant to employ the critical skills of verbally communicating and explaining his or her opinion. The critical importance of this aspect of the services being rendered cannot be stressed enough. A good report without the ability to communicate to lay persons is simply not going to get the job done. A deposition is an information-gathering tool for lawyers. It could also be very important to the forensic accountant in gaining an idea of what testimony would be like at a trial.

The forensic accountant will need to defend the report (that is, explain the report in response to specific questions). A natural inclination exists to want to show the other side, "I am right," or "I am smart and understand this topic." However, that is usually the wrong approach. Like any other witness, the best policy is usually to simply answer the question and not offer any other information that will only provide more material on which to be questioned by opposing counsel. The forensic accountant should remember that a deposition is not about proving his or her case. The forensic accountant's client does not win the case when the expert provides good deposition testimony. When the deposition is concluded, the opportunity for the parties and their attorneys to evaluate their respective positions has been enhanced and may lead to further discussions and settlement.

The forensic accountant being deposed is on "defense." The deposition is an opportunity for the opposing party to gather information about the forensic accountant's opinion and try to find weaknesses in the forensic accountant's report. It is usually not in the interest of the forensic accountant being deposed to volunteer information or respond to a question outside the boundaries of what is being asked. If the questioning attorney misses the point or fails to grasp some aspect of the expert's opinion, that is the questioner's problem. If the forensic accountant addressed a topic in his or her report, he or she will be able to testify at trial about it, regardless of whether it was a topic at the deposition.

Trial

The trial is the forum where the forensic accountant must be fully prepared to participate in a skillful and an effective manner. One can be a great forensic accountant but lack this particular skill set. Holding oneself out as a forensic accountant without the ability and comfort level to participate in a trial must be avoided. Everything done by the attorney and forensic accountant should be focused toward the goal of presenting a winning case at trial. If the parties cannot settle their case, the trial determines the outcome. The attorney, forensic accountant and client must keep the following old adage in mind: "Cases prepared for trial settle; cases prepared for settlement go to trial." When one side is aware that their opponent is ready to present a compelling and effective case, they need to evaluate their risks and options in proceeding and consider the possibility of coming to an acceptable resolution through settlement instead of losing. If we are aware that the forensic accountant on the other side of a matter has weaknesses in either his or her report or ability to communicate at a trial, that presents the opportunity to go through with the trial and take advantage of the fact that the other side cannot do what they set out to do. We could also drive a hard bargain and achieve an advantageous settlement from a party that knows they cannot go the distance.

To be prepared for trial, the forensic accountant should be confident that he or she has gathered and interpreted the relevant data and can explain his or her conclusions. It is often the case that we will find ourselves testifying in front of judges who are unsophisticated in financial matters. When that is the case, the testimony being offered by the forensic accountant should take on the nature of an educational opportunity, which involves more than simply repeating under oath the information in our report. The attorney and accountant should work together to have the forensic accountant educate the court with basic accounting principles and the underlying rationale for such things as reasonable compensation and building a cap rate.

The entire need for the educational approach can be best illustrated with a brief anecdote. In a trial, one of the attorneys in our office asked an accountant about a company's earnings before interest, taxes, depreciation, and amortization (EBITDA). The judge interjected and asked, "How do you spell that?" It was quickly apparent that the judge never heard of EBITDA. In fact, the judge was not aware of a C corporation or subchapter S corporation. We then went back to some fundamental educational questions that allowed the judge to grasp basic concepts and ask questions of his own to the forensic accountant. Ultimately, this resulted in somewhat of a bonding experience between the judge and accountant, which needless to say was helpful to our client.

When testifying, it is particularly useful to look at the judge and relate to the judge as if he or she was at a seminar where we are lecturing and explaining. Obviously, we must rely on our attorney to give us guidance about the sophistication level of any individual judge, so that we can direct testimony to his or her needs. During cross-examination, the expert's testimony will be more like the deposition. The expert will answer the questions and not offer additional material for further questioning. He or she should have the opportunity on redirect to explain and elaborate his or her expert opinion to the extent that an explanation is required after cross-examination.

Forensic Accountant Expert Fee

It is not uncommon for the fees of the forensic accountant to be equal to or exceed those of the attorney in complex matters. This is often due to the fact that the volume of work being done by the forensic accountant is much more time intensive than the attorney's work. Divorces are expensive. An old joke asks what a divorce is worth. The answer is every penny.

Notwithstanding the wisdom of that joke, during the divorce process, many clients have tremendous anxiety about the mounting costs of their divorce. The costs of a divorce are not ordinary expenses incurred by a business but, rather, a personal bill that must be paid from the parties' income or life savings. During the divorce process, the clients may view every dollar spent on the divorce as a wasted dollar or a dollar spent to send their lawyers' children to college rather than their own. Both the lawyer and accountant need to be cognizant of, and sensitive to, these legitimate fears and anxieties.

At the time the forensic accountant is retained, he or she should impart a clear understanding to the client and lawyer of the costs involved in performing the requested work. The forensic accountant should be able to estimate the costs associated with reviewing and analyzing the appropriate documents and preparing an expert report. Although the client may not understand the work involved in the required analysis, the forensic accountant does, and he or she also understands that variables, unexpected obstacles, or delays may arise. It is important that the forensic accountant provide the client with a realistic and reasonable estimate of the costs involved, based on experience and familiarity with billing in similar, prior assignments.

At the inception of the case, the forensic accountant will become familiar with the family income and assets. He or she is in a position to evaluate the totality of estimated costs in proceeding with the requested assignment and to consider the parties' ability to pay. It would be a disservice to blindly embark upon a project that will generate a bill that the client cannot pay or is out of proportion to the economic benefit of the client. Forensic accountants are in business. No one wants to find themselves in accounts receivable land. Serious consideration needs to be given to the scope of the required work, its cost, and the ability to get paid. There is virtually no reason to take on an assignment when the ability to be paid for our services is in significant doubt.

Based on his or her knowledge and experience, the forensic accountant may be in a position to suggest an appropriate, practical, and cost-effective manner to obtain the information that the attorney and client seek. In the case of a business valuation, professional standards require the business evaluator to take certain steps to be in compliance with the promulgated standards. Although the criteria of such standards may represent the best methodology, it may be possible to perform a less expensive analysis by which the forensic accountant can still come to a calculation about value. A calculation of value report may be reliable, admissible evidence that will serve the client's needs at a lesser cost. Similarly, it may be possible for the forensic accountant to first provide an oral report or an oral report with certain supporting schedules. If this information can be utilized as a gauge in settlement negotiations, the client may be able to avoid the expense of a full report.

Staffing

The staffing of a case clearly has a direct effect on the cost. The forensic accountant may appropriately decide to staff a case by having more junior accountants perform various tasks as steps in the forensic analysis. Clearly, it would make sense to have the most junior accountant perform data entry or compare and verify the years against documents. The problems usually arise when the midlevel or other senior accountants are billing for their efforts to become familiar with the client's situation and learn the information that has already been presented to the forensic accountant who was selected as the expert. The client may not understand the nature or legitimacy of other accountants, whom the client does not know, charging him or her.

These problems are multiplied when the forensic accountant staffs the case with an army of people. When the client is billed by five different individuals for the work entrusted to his or her expert, the client may feel that he or she is the victim of a feeding frenzy. The result will be an unhappy client with an astronomical bill that cannot or will not be paid. The client may also attribute blame to his or her attorney who created this "mess." The forensic accountant is in a service business, providing a service to the client and attorney. The attorney will be loath to utilize the services of that forensic accountant in the future if he or she believes that the forensic accountant carried out the assignment in an impractical matter, generating angry feelings on the part of the client toward both the forensic accountant and attorney. It is imperative that the forensic accountant appropriately estimate costs, provide the client with a reasonable expectation of costs, and perform the necessary work in a cost-effective manner, so that the client's goals can be logically and reasonably advanced.

Overstepping Bounds

Respecting the role of the attorney, the forensic accountant should realize that although he or she is playing an integral role in the divorce case, the attorney is ultimately responsible for handling the case. The report of the forensic accountant may address the main issues in the case. The information presented by the forensic accountant may constitute a large part or even all of the substance of the case. However, the attorney is charged with representing the client before the court. It is the attorney who will confirm the final terms of settlement in a fully executed settlement agreement or, alternatively, present the entire case to a judge at trial.

The attorney may call upon the forensic accountant to explain or even advocate the forensic accountant's opinion during settlement discussions. This may occur because the forensic accountant is better suited to explain his or her opinion, as well as the accounting or valuation principles involved. The forensic accountant may present a persuasive analysis but is infringing on the role of the attorney if he or she attempts to negotiate. The attorney may ask the forensic accountant for alternate approaches on an issue or a range of appropriate values, but it is the attorney who will communicate a proposal to the other side in an attempt to reach mutually acceptable terms. In performing his or her role and providing a service to both the client and attorney, the forensic accountant should ensure that he or she is providing what is requested, offering helpful ideas or suggestions, and not usurping the decision-making authority of the attorney.

In a business valuation case, one expert opined that the business was worth $16 million, but the opposing expert opined that the business was worth $8 million. After reviewing both reports, our accountant was asked to explain how 2 well-respected accountants could be $8 million apart in the valuation of the subject business. Our forensic accountant suggested that a member of his firm would meet with a member of the opposing accountant's firm to discuss the elements of each report that were subjective, rather than strictly fact based. Our side agreed to the meeting between the accountants with the intention that we would have a better understanding about the differences; therefore, we would be better able to formulate our trial positions. When the meeting was concluded, our expert reported that both accountants had agreed that the appropriate value of the business was exactly in the middle of the 2 figures: $12 million. The accountants exceeded their role by negotiating a value in a Solomon-like fashion. Our expert was supposed to meet with the other accountant to evaluate the areas of disagreement; he was not supposed to negotiate an agreement on a value. Our expert clearly exceeded his authority and undermined decisions that should have been in the hands of the attorney.

Conclusion

Forensic accounting in divorce matters is a growing industry. A unique opportunity exists here to develop a business that can afford an accountant a very comfortable income and lifestyle until retirement. However, the forensic accountant should have the requisite credentials, such as CPA, ABV, and CFF. In addition, he or she must be able to effectively communicate, as has been stressed in this chapter. Judges and attorneys are consistently looking for top-notch experts, and we have no second chance to make a good first impression. If we do our jobs well, judges and lawyers will seek us out, and we can develop a very lucrative specialty. The forensic accountant is an integral part of the team made up of the attorney, client and forensic accountant. Lawyers are extremely reliant on their forensic accountants and are always looking for a symbiotic relationship that works to their mutual advantage.

Appendix: Managing a Practice

WELCOME TO LA-LA LAND—It's important that we talk to our clients, hear what they have to say, and take that into account in the investigative work that we do relevant to these divorces. Sometimes, we have clients whose minds are just a bit off the well-worn path. Of course, we might get information from a client that might sound odd but turns out to be well founded; other times, you just kind of know that there's something wrong somewhere. In a case in which we were the neutral experts, and the wife had a fairly significant and complex business operation, we were faced with a nonbusiness husband who had some rather peculiar ideas about many things, including life in general and his wife's business. We were assured by the husband that a hidden staircase was behind one of the walls in the business (he was very specific about which wall), and at the bottom of the staircase was a treasure chest filled with gold, silver, and jewels. The only things missing were an eye patch and a wooden peg leg. By the way, we did test the alleged false wall hiding the alleged staircase that led to an alleged treasure chest. We didn't have to take it to the end result because there was nothing behind the wall other than some sheetrock and another office.

Undoubtedly presumptive on my part, but after having been involved in providing litigation and divorce services for something like 30 years, and managing a department and then my own practice focusing/specializing in that area, I had the idea that I might be able to share some thoughts with my readers as to how to manage a divorce litigation oriented practice. Please keep in mind that I don't always take my own advice. Thus, this appendix, which goes on for quite a bit, provides some suggestions and practical ideas in matters such as collecting your fee; dealing with attorneys; dealing with your clients (including when and how to fire a client); avoiding accidentally practicing law; and working with your tax or accounting clients (or even a partner in your own firm) who might be going through a divorce. There are various other points raised here—all with the idea of trying to assist in better running a practice that is exclusively or heavily focused on litigation matters, particularly divorce litigation.

Let's face it; it is different performing forensic accounting, business valuation, and related services versus managing the practice that enables you to spend the time doing these types of services. A multitude of issues, concerns, and areas require attention, and I have tried to cover as many of them as possible. A general predicate for this appendix is that it is not going to deal with the technical aspects of what we do because it is assumed that you are familiar with our work; besides, the rest of this book addressed those issues. What I am going to deal with here is not accounting services per se but, rather, handling the business of being a forensic accountant.

Accounts Receivable and Collections

Unless you are one of those oddities among our peer group who does not have problems with receivables and collections (actually, only collections are a problem), that area has always presented more than its share of headaches, and the recent recession (piled on by a volatile stock market and horrendous contraction in the real estate market) has made this area a more pressing and immediate concern. Because I find it difficult to go to the bank and deposit my receivables (they prefer to see my collections), from a management of an accounting practice perspective, this has typically been, and has only become more so, one of the most critical elements of running a successful practice.

The litigation arena, particularly divorce, is in the proverbial world of its own. Suggestions to improve this area include the following:

- *Client selection.* A tried and true procedure, but be careful who you accept as a client. That's easier said than done; it may work fairly routinely in the commercial world, but in the litigation and divorce field, it is not quite so simple because of the following reasons:
  - Typically, the client is referred through an attorney or, sometimes, a judge. Depending on relationships and a whole slew of issues, you may have a certain degree (low, medium, or high is your call) of a pseudo-obligation to work with that client. After all, by refusing, are you telling your referral source that although the client may be good enough for him or her, that client is not good enough for you?

- — Due diligence on a business is generally not that difficult; however, due diligence on an individual is nowhere near as simple. Even getting a credit report won't tell you very much, except in the worst of situations.
- — Divorce can bring out the worst in people. It will make good people bad, and it will make bad people intolerable. Thus, even somebody who under normal circumstances would be a good client, pay bills, and the like can become a bad client under the pressures of a divorce case with fees sometimes escalating out of hand. This aspect is very unpredictable.
- — The marital net worth may be substantial, but that does not make it ours yet nor does it mean that your client is going to get his or her share. Even when that happens, there may not be enough for you. Maybe, in the client's eyes, you just didn't do the right job, so the marital net worth doesn't do you any good because you are not going to be seeing it. Also, net worth is not synonymous with liquidity. The client with millions of dollars of real estate does not necessarily have a positive cash flow that is going to get you paid, and waiting for a piece of real estate to sell is no fun.
- — The very act of divorce and the costs that go along with it, combined with a normal business or economic downturn, can make someone who started out as a financially stable and sound client turn into someone who now has concerns about what retirement is going to look like, and your bill is in the way.

- *Get a bigger retainer up front.* This one is terrific, and it works many times, but it sounds better than it really is because of practical limits. If your normal retainer is $5,000, maybe bump it up to $6,000 or $7,500, and if you're really daring maybe $10,000. The problem is that we might be pricing ourselves out of the market. A prospective client may turn out to be a nonclient. It is a competitive environment out there, and even though an increased retainer might be justified, it often comes down to how much you want that business. It also may revolve around the referral source of that business. I can relate to you a fairly recent situation in which I was asked to represent a doctor in a divorce action. The difference between me getting the job and not getting the job (hourly rates for the other expert were very similar to mine, so that was not the issue) was lowering my retainer from $7,500, which was quite reasonable in this situation, to $5,000, which is what my competition (who the client had already interviewed) was asking. By doing that, I got the job, notwithstanding a straight discussion with the prospective client to make sure that he was aware that all we were talking about was a time shift: pay me that $2,500 now, or pay me in 1–2 months. Fortunately, this one had a good result.
- *Stopping work.* This one brings in mixed results. On one hand, it stops the bleeding. On the other hand, it doesn't bring in any liquidity (unless the pressure of stopping the work succeeds in doing that), it further alienates the client, it might alienate the attorney with whom you're working, and it might get you nowhere. Nevertheless, this is a very reasonable and appropriate response to a client who can afford to pay but is not paying.

A word of caution and concern about that last issue of stopping work. Be careful about using that as leverage very close to trial or when the report is due, the deadline is near, and you have little flexibility. If your engagement letter is like mine, you have the absolute right to not finish your work, to not issue the report without payment being completely current, to stop service at any time if payment is not current, and to insist on a payment toward trial in advance of the trial. All that is well and good, but if it is a matter of us really needing to get paid for a report that we already issued, and we're facing a court-imposed deadline that is in a few days or one or two weeks, be careful how far you push this leverage. If the client can't or won't come up with the money or balks at the pressure, be candid and careful about your exposure. By not issuing that report, notwithstanding being in complete compliance with your engagement letter, are you now opening yourself up to a suit by the client, with the client's best argument being that you did not insist on payment earlier, you continued the work, and you have irreparably damaged the client by not issuing a report before the deadline? Far be it from me to tell you not to issue the report. I'm on your side; just be practical and cautious about what this means.

Attorneys

By far, without question, from all of my experience and what I know from all of my peers in this business, especially for divorce practice and virtually any other form of forensic accounting, the key source for this business is the attorney. Some of my readers will have variations on this—maybe you generate a lot of work from judges or insurance adjusters. But, in the divorce field I can say with total comfort, the source of business is attorneys. In many ways, the attorney is almost your client, despite your ethical and other responsibilities to the actual client. From a professional point of view, your client is the one for whom you are performing some level of service, who is ultimately paying your bill, and who is going to benefit from your services.

However, from a business person's point of view, you have to look at the attorney as kind of a proxy for your client. Although the following is not a completely accurate analogy, it gets the message across. Equate the person for whom you are performing this service (the real client) to a quarterly review job, and the company for which you are performing this review job is the attorney who referred you that quarterly review. Each quarterly review stands on its own; you are never going to have that quarter back. What we are hoping is that the attorney will ask us to perform a quarterly review the next quarter and the quarter after that. Hopefully, we will also be asked to perform the annual review or annual audit, and that request is going to come from the company that asked us to perform work for that quarter.

This is a fairly reasonable comparison to how it works with attorneys. We want that attorney to refer us another client. With a little luck, perhaps we'll get a quarterly or yearly job. The concept is that your actual client is a one-time client; from an operational point of view, the source of that client is your real client. That means that you need to treat the attorney as you would treat any potential or current client. Whatever your marketing approach, such as attending attorney conventions or meetings of trade groups, writing articles, having lunches, and so on, it is important to recognize that you are marketing the attorneys, not the actual client.

Calendar Control

As accountants, various tax and other filing deadlines have been ingrained in our minds. Working in a litigation environment, various court-imposed deadlines become part of the normal, daily routine. It is vital for the sake of your practice that for each of the cases you are controlling, you know the various deadlines. When do you have to request or demand discovery? When is your report due? When is trial scheduled? At least in the matrimonial field, deadlines tend to be meaningless because they change almost every week. Nevertheless, at some point, some level of respect needs to be given to them.

Client Selectivity

One of the most difficult aspects of dealing with the client is the process before that person is even a client. What steps do you take to pick and choose your clients? How selective are you? What is your basis for deciding that a particular prospective client is not acceptable to you? For most of us in the litigation arena, the reality is that when an attorney refers some business to us, we will instinctively accept; it is going to take some extreme problem for us to decline that business. Perhaps that is not a bad approach, but certainly, we need to keep in mind the importance of picking and choosing. One feeling might be that if the client is good enough for the attorney, he or she is good enough for us, and that may even be the attorney's philosophy. After all, suggesting to an attorney that you are not accepting a client because that client is not a good choice might be a slap in the face to the attorney who already has that person as a client and was thoughtful enough to refer him or her to you. Those situations are difficult judgment calls that each and every one of you has to decide on its own merits. However, what we should look for and consider in terms of making the decision not to accept a client are the following:

- The litigant has already gone through one or more forensic accountants or attorneys, or both. What makes you the special one? If this litigant has already fired other attorneys and experts, it is certainly a warning sign. That is particularly the case if you know that this litigant fired a fellow CPA who you know to be very good, but this potential client is bad-mouthing that expert. Nevertheless, you might argue that it is okay to accept this client (and the possible hassles that will come with the client), as long as you receive a sufficiently large retainer.
- The litigant is either too aggressive or not aggressive enough, which are two extreme sides of a coin. These are not easy to determine and, sometimes, may not bother you. However, if you are interviewing a client, and his or her attitude is that he or she walks on water, everyone else does not know what they are doing, things are going to go his or her way or not at all, and so on, it is a pretty sure bet that this is the type of client who will never be satisfied. Worse, if this person is someone who is clearly

abusive to the other party, it may simply be a moral or an ethical issue that you cannot tolerate that type of client.

On the other extreme, is the mouse of a client. This client will simply not stand up for himself or herself, is insecure to an extreme, is sure that the other side is smarter and going to win, and is sure that he or she will never get justice. This type of client is easier to satisfy because if you have any success at all, you are going to look like a hero. Nevertheless, if you have someone who is that insecure and down on himself or herself, you may have qualms about working with such a client and concerns about a lack of assistance in areas where a client needs to assist us. You may also have concerns that somewhere down the road, a client like this, once out of the oppression of the marriage and back on his or her feet, may establish another relationship and gain some greater measure of self-respect. If so, this type of client may come back and sue everybody because no one gave that client the right support. Again, I am not suggesting that you do not accept these clients; I am just trying to present some warning signs to give you food for thought.

- Cost is no object; it is the principle of the thing. Unless this potential client has really deep pockets, it is pretty dangerous when the attitude is that we have to do everything, no matter how much time it takes and how much it costs. The person who is on a mission does not focus on the realities of the case. You will never be able to make this client happy because this client will not accept compromise, and only this client can be right.
- We can delve into a lot of really great issues and topics that require serious brain power and attention, but unfortunately, many of them come attached to a financial reality that cannot support the work necessary to address the interesting issues. Even a run-of-the-mill case without any special issues requires a certain level of financial wherewithal. This is often difficult to address before you have been engaged, but it is something to seriously consider. For instance, perhaps the situation involves a substantial multimillion dollar business that is losing money and has little liquidity. At the same time, the couple has exhausted their financial resources over the last few years to keep this business alive. Thus, you have the potentially very interesting case of a business with significant issues for investigation and valuation and a marital estate that has little to no liquidity and, maybe, little to no net worth. This is a great $50,000 job for which you might get paid $3,000.

To the extent possible, try to determine the finances of the matter before being engaged. What is the practical likelihood of you getting paid? Will the fees be far more than the marital estate can handle? If such a problem exists, that doesn't necessarily mean that you should reject the case. Perhaps you can have a discussion with the attorney who referred the case to you and suggest that everyone agree on a shortcut approach to try to come to a speedier resolution of the matter. This might save everyone's limited financial resources, enable the professionals to get a reasonable fee, and provide a great service to the clients. However, they would have to understand and agree to the severe truncating of what might otherwise be a very expensive process.

- In general, working for a relative would typically bring into question your independence. It may not preclude you from accepting the client, but on the other hand, do you really want to have Thanksgiving dinner with this relative who is in the middle of litigation you are intimately involved in? In a sense, it is more difficult when the litigation involves your neighbor. As a general comment, the neighbor does not create a conflict. On the other hand, do you really want to be representing a neighbor going through a divorce or any litigation matter? Taking the stereotypical situation, you represent the husband in a divorce, and he has left the marital home; now, your neighbor is his wife who, in theory, you are working against. Talk about the potential for awkward situations.

Conflict Check

One of the critical elements of client selection is to also perform a conflict check. These take many different forms, depending on your particular firm. The larger firms will typically have a formalized process along the lines of perhaps e-mailing the particulars to all members of the firm and requiring feedback within 24 hours. A small firm might have a much simpler process, and a solo practitioner might simply respond that he or she has never heard of the litigants, has no conflicts, and so on. The point is that you need some system for verifying that no conflicts exist before you accept the case. In a divorce, this usually means nothing more than making sure that neither the husband nor wife is or was a client of yours. The same holds true when any business is involved. In the commercial litigation world, it tends to get far more complicated, especially when multiple litigants are involved.

Contain Yourself

Do not be too optimistic or pessimistic, and do not make promises. Typically, that is the province of the attorney anyway. As an example, assume that early on in your involvement in the matter, you are given tax returns, and it is really obvious from the tax returns (maybe from certain percentages or dollar amounts) that serious games are going on, and you know it is a slam dunk that you are going to be adding back at least $100,000 of perquisites to income. All that may be the case, but do not jump the gun and tell your client all the good things that you are going to do before you have had a chance to thoroughly investigate this situation. Even if you qualify your statement by telling your client that it looks like the adjustments could be $50,000–$100,000, that's a very dangerous comment. Your client just heard $100,000. Worse, what happens when you find out that the adjustments only total $20,000? Hold off on your feedback, and do not raise hopes and expectations.

Do Not Practice Law

This one is not as easy as it sounds. Yes, we all know that we are "only" CPAs; we are not lawyers, and we have no intention of practicing law. However, a divorce client and, sometimes, other litigation clients will often ask us a legal question, not an accounting or financial question. After all, we are accountants, and we are supposed to know just about everything about anything. For instance, it is hardly unusual for a divorce client to ask if he or she will get alimony, and if so, how much. This is a normal and reasonable question; nevertheless, it is a legal question, not an accounting question. The answer to provide is that he or she is asking a legal question, we are not attorneys, and he or she should raise this question with counsel. Giving an answer, even if qualified by saying that you are not an attorney, and the client needs to check with counsel, is still you giving an answer that your client is now going to use in some fashion. Avoid it by all means.

Engagement Letter

Always, always, always, get an engagement letter. Remember that the engagement letter's purpose is to protect you, not the client. The engagement letter should be both as brief and as detailed as possible at the same time. Brief in terms of your obligations; detailed in terms of your client's obligations. You want that engagement letter to briefly state the work that you are going to perform but in such a fashion that it obligates you as little as possible. The point is that no matter how well you practice and how thorough your job, if you list many services that you are going to perform, at some point or another, it is inevitable that you will not do certain things because they are not possible or relevant or helpful to the subject matter. It does not matter how justified the reason—if you do not do certain things that are stated in the engagement letter, and you have a dissatisfied client, you have a problem. Thus, keep the specifics of your obligation as broad as possible. We have included a sample engagement letter on the following pages for reference.

On the other hand, you want an engagement letter, which is a contract, to be as strong as possible in terms of your relationship with the client and your rights to collect your fee. I can tell you from experience that I have had more than one situation in which after I have billed in excess of the retainer, the client says to me that he or she thought the retainer was the totality of what I was going to charge. Simply pointing to the paragraph in the engagement letter where I indicate that the retainer is not the complete fee and that I am going to be billing is certainly enough to prove the client wrong. It may not stop you from having to deal with a difficult client, but it eliminates one possible problem. Also, as another example, assume that you are engaged to determine the income generated by a business, but the client advises us in advance that he or she does not want to spend the money on a valuation. The engagement letter should and must make that clear by stating that the engagement is to determine the income generated by the business and then explicitly stating that the engagement does not include a business valuation. Of course, it could be just the opposite; maybe the client needs a valuation and does not want to spend the money to let you do the right forensic job. The language issues and your need for up-front protection are the same.

SAMPLE ENGAGEMENT LETTER

Re: Investigation and Valuation of ___________________________;

Dear ___________________________:

You have requested that (accounting firm) investigate _________________, and render an opinion as to the income of _________________, the personal net worth of _________________, and the fair market value and fair value of _________________ as of _________________. For the purposes of our opinion, fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts; fair value is defined by court decisions as essentially the same as fair market value but generally without the application of marketability or minority interest discounts.

Before preparing our opinion we wish to outline our understanding of the terms of our engagement and the approach we will follow in performing the above services.

You will note that several parts of this engagement letter are presented in bold print. That is specifically to draw your attention to various areas of this engagement letter which we believe require extra attention because they deal with matters such as your financial responsibility to us, other responsibilities you may have to us, and the scope and limitations of what we will be doing.

We understand that you require this opinion for the purposes of the equitable distribution, alimony and support issues relating to your pending divorce action.

It is understood that (accounting firm) is not being engaged to perform an audit as defined by the American Institute of Certified Public Accountants, but rather the necessary tests of financial records that will be performed for the purpose of issuing a report as to income and/or value, and not a statement regarding the fairness of presentation of the financial statements of a business.

We have been requested in this engagement to perform a valuation analysis in conformity with the "Statement of Standards for Valuation Services No. 1" (SSVS) of the American Institute of CPAs and to present our finding as a conclusion (calculation) of value as defined in SSVS.

Certain values, derived from reports of others, and which are so designated, may be included in our report. We take no responsibility for those items. Nor do we take responsibility to update the report or disclose any events or circumstances occurring after the date of the report.

In the event sufficient records and/or documentation cannot be supplied to (accounting firm), no such report will be issued.

It is understood and agreed that the nature of what is involved (a financial investigation that culminates in a set of conclusions) is such that there tends to be little, if anything, to show in the sense of a report, interim or draft, until the work is concluded and we are in a position to issue a report or present our findings. In addition, it is recognized that the premature issuance of a preliminary report or an in-progress report could be damaging to the strength and credibility of our final work product. **As such, it is therefore agreed and understood that there will not be a preliminary or interim report, prior to the completion of work**.

This report will be subject to, at least, the following contingent and limiting conditions:

1. Information, estimates, and opinions contained in this report are obtained from sources considered reliable; however, we have not independently verified such information and no liability for such sources is assumed by (accounting firm).
2. All facts and data set forth in the report are true and accurate to the best of our knowledge and belief. We have not knowingly withheld or omitted anything from our report affecting our conclusions.

3. Possession of this report, or a copy thereof, does not carry with it the right of publication of all or part of it, nor may it be used for any purpose, other than for the specific purpose of this engagement, without the previous written consent of (accounting firm), and in any event only with proper attribution.
4. None of the contents of this report shall be conveyed to any third party or to the public through any means without our express written consent, other than for the specific purpose of this engagement.
5. No investigation of titles to property or any claim on ownership of the property by any individuals or company has been undertaken. Unless otherwise stated in our report, title is assumed to be clear and free of encumbrances and as provided to us.
6. No opinion is intended to be expressed for matters that require legal or other specialized expertise, investigation or knowledge beyond that customarily employed by accountants.
7. The various estimates presented in this report apply to this appraisal only and may not be used out of the context presented therein. Any other use of this report may lead the user to an incorrect conclusion for which (accounting firm) assumes no responsibility.
8. The appraisal of value to be reached in this report is necessarily an estimate. An actual transaction in the shares may be concluded at a higher or lower value, depending on the circumstances surrounding the company, the appraised business interest and/or the motivations and knowledge of both buyers and sellers at that time. (Accounting firm) makes no guarantees as to what values individual buyers and sellers may reach in an actual transaction.
9. It should be noted that the valuation (unless specifically stated otherwise) assumes the business will be competently managed and maintained by financially sound owners, over the expected period of ownership. This appraisal engagement does not entail an evaluation of management's effectiveness, nor are we responsible for future marketing efforts and other management or ownership actions upon which actual results will depend.
10. It is assumed that there are no regulations of any government entity to control or restrict the use of the underlying assets, unless specifically referred to in the report and that the underlying assets will not operate in violation of any applicable government regulations, codes, ordinances or statutes.
11. Reports may contain prospective financial information, estimates or opinions that represent our view about reasonable expectations at a particular point in time, but such information, estimates or opinions are not offered as predictions or as assurances that a particular level of income or profit will be achieved, or that specific events will occur.
12. We assume that there are no hidden or unexpected conditions of the business that would adversely affect the value, other than as indicated in this report.
13. Hazardous substances, if present, can introduce an actual or potential liability that will adversely affect the marketability and value of a business. Such liability may be in the form of immediate recognition of existing hazardous conditions, or future liability that could stem from the release of currently non-hazardous contaminants. In the development of the opinion of value, no consideration was given to such liability or its impact on value. We have not taken into account environmental considerations and potential liability.

It is possible that additional contingent and limiting conditions will be required, and the client agrees that all conditions disclosed by us will be accepted as incorporated into the report.

The validity of our report is predicated on the extent to which full, honest and complete disclosure is made by all parties. In completing this engagement we will necessarily rely on information and material supplied by you. Therefore, in order for us to render a report, we require that you confirm in writing (by your signature to this letter) that you have no information or knowledge of any facts or material which would reasonable be expected to affect our conclusions except as you have disclosed to us.

To the extent possible, reasonable and appropriate, it is agreed and understood that you will

provide us, in a timely fashion, with whatever relevant and pertinent records you may have. Part and parcel of our working to your best advantage, and as efficiently as possible, is having your cooperation and access to financial records in your possession or control. It is further understood that the failure to produce the records that you have, or the failure to produce them as soon as and as timely as possible, will likely cause our work to be more expensive and protracted**.**

It is agreed that you will pay us a retainer of ________________, which will be held to be applied against the final billing, and that our fee will be based upon services rendered at the rate of $xxx per hour for the services of XXX; $xxx to $xxx per hour for the services of our accounting staff; and $xxx to $xxx per hour for services of our paraprofessional and administrative personnel, together with actual costs (telephone calls are chargeable time). Hourly rates are charged portal to portal from our office. You are responsible for all costs of litigation, including but not limited to telephone calls, photocopies, postage, travel expenses and research. (accounting firm) has your authority to advance the costs of same. These costs will not be itemized separately on your bill. Instead, you will be charged a flat fee (service charge) of 3% of all fees for service – such fees stated at their full amount before any discounts or allowances – on each bill to cover your share of these costs. It is expected that we will perform research through computer or other databases, and that we may be required to purchase research materials relating to this engagement. These and other such substantial costs (such as travel) will be billed to you at our cost.

The retainer is explicitly recognized as only an upfront payment on account toward the complete assignment, and will not be credited against billings until the final billing. It is understood the retainer is almost never the full extent of the work involved, and that there is a very strong likelihood our fees will exceed the retainer, and may significantly exceed the retainer. It is further agreed that the continuation of our services is contingent upon prompt payment of our billings. Invoices for services, which will be presented approximately monthly, are due within twenty (20) days from the invoice date.

It is agreed and understood that, because of representations made to us as to the possibility or even likelihood of additional income as contrasted to that which is reported, and/or the existence of substantial and extensive perquisites (expenses claimed by a business that are more properly personal in nature), we will need to perform substantial forensic financial analysis so as to be able to determine, to the extent that it can be determined, the magnitude of same. It is understood that this element of our engagement will add significant time, and therefore cost, to the assignment.

For services rendered after December 31, XXXX, the above stated fees will increase as follows: for XXX to $xxx per hour; for staff to between $xxx and $xxx per hour; and for paraprofessional and administrative personnel to between $xxx and $xxx. Each year thereafter, these fees will increase approximately 5%.

Since it is considered unethical for us to perform these services on a contingency basis, it is important that our fees be paid promptly. The appearance of independence is of considerable importance for our firm to maintain our credibility. Therefore, we reserve the right to stop providing services at any time there is a balance due our firm beyond 30 days. In the event we continue to provide services, we do not waive our right to stop at a later date.

If you have a question concerning your bill, it shall be your obligation to inquire and we will be happy to explain the charges to you. It shall be your affirmative obligation under this agreement to review our bills as they are rendered and raise questions concerning such bills in a timely fashion. Failure to raise such questions in a timely fashion (regardless of whether our firm waives the right under this agreement to terminate its engagement if prompt payment is not made), shall be deemed to constitute acceptance of the charges presented on the rendered bill as fair and reasonable pursuant to this agreement and we shall rely upon this in performing continuing services. If no one raises (in writing) such questions concerning the bill within twenty (20) days of receipt of same, it shall constitute the acceptance of the obligation to pay the bill in its entirety.

Interest, at the rate of 18% (eighteen percent) per annum (1 ½ % per month), will accrue on any balance (after utilization of the retainer) not paid within 30 (thirty) days of the invoice date. Our failure to include interest on any bill does not constitute a waiver of said interest. In the event a balance is owed to us at the cessation or settlement of this action, it is agreed that said balance, including interest, shall be paid within 30 (thirty) days of such cessation or settlement, out of the proceeds from the distribution of assets or as otherwise reasonable.

In connection with our engagement, we may find the need for you to employ the services of other experts. We may even offer the names of suggested experts. However, upon your approval and engagement of such other experts, it will be your responsibility to pay them directly. We shall bear no liability for the cost or the use of such other experts.

(accounting firm) reserves the right to terminate services if you change your attorney. In the event we terminate services because of your change of attorney, we will cooperate, at no additional charge, in the transition to a replacement accounting firm.

All prior outstanding fees must be paid in full prior to our preparation for testifying at deposition or trial which may arise out of this matter. If there is a remaining balance due to us for fees upon the conclusion of this case, a judicial determination of this case, or by settlement between the parties, you agree to provide for the prompt payment of our outstanding fees in any final judgment, order or document in a manner consistent with this agreement.

If upon the final determination of this matter, it is required that certain of your assets need to be liquidated in order to pay our fees, then you agree to grant us a secured position in these assets, for us to so direct counsel if applicable, and to pay us out of attorney escrow immediately upon the disposition and/or sale of such designated assets.

In the event of non-payment of our billings, and in further relevance to the preceding two paragraphs, you herein specifically grant (accounting firm) the following:

- A retaining lien on all documents in our control and possession produced in this case until our fees are fully paid,
- The right for our fees to be paid to us via a lien or equivalent attached to and paid directly from any settlement proceeds or other funds received as a result of this case.
- The preceding items are not intended to be the limit or extent of our recourse. Any fees not covered by the above items remain as your obligation to us.
- (accounting firm) shall be entitled to require your attorney to file on our behalf whatever notices, liens or otherwise are necessary to effectuate the appropriate lien and attachment against said proceeds for our benefit. You will pay all attorney fees and costs necessary to put these procedures in place so as to protect (accounting firm's) position when the cause is the failure to promptly and timely pay our bills on an ongoing basis.

If it becomes necessary for us to initiate collection or legal action in order to collect our fees, it is understood and agreed that you will be responsible for and pay all reasonable costs of collection, including attorney fees. Reasonable collection fees will be considered to be 33⅓ percent of the outstanding balance, inclusive of interest. Venue for suit and collection shall be XXX.

(accounting firm) reserves the right to withdraw from this engagement at any time for reasonable cause. It is not our intention to withdraw. In the event there is an outstanding balance, we further reserve the right not to issue a report and/or not to make a court appearance in this matter. In order for us to issue a report, or to appear in court, we reserve the right to require advance payment for same. All work papers created by (accounting firm) will remain in our possession. In the event of a withdrawal, we would only be liable to return those materials and documents supplied by the client and the unused portion of the retainer.

The undersigned gives (accounting firm) the right to discuss this matter with the client's attorney, accountant, other individuals so designated by the client and any professional colleagues from whom information is sought.

It is understood and agreed that this is a contract/agreement between you on one hand and (accounting firm) on the other. Your responsibilities hereunder cannot be waived or assigned to any others without the written agreement of (accounting firm). In particular, an arrangement between you and another party (i.e. your spouse) as to the paying of our fee or allocating the responsibility, without our written agreement to accept such an arrangement, is merely an arrangement between you and another party, but in no way relieves you of the total responsibility to (accounting firm).

This contract shall act as a stipulation for withdrawal at any time if (accounting firm) is not paid its fee and costs as agreed to by this contract. This is a legal and binding contract between you and (accounting firm). Before signing, we urge you to read this carefully and be sure that you understand all the terms and conditions herein. If there's anything you do not understand, please ask us. At your option, you may wish this to be reviewed by your attorney.

As the result of our services, we expect to come into possession of confidential financial and other information. It is our policy not to disclose or share information with anyone outside of this matter unless specifically authorized to do so by our client. Governmental, judicial or legal directives would, of course, override such policy.

This engagement letter, at our option, will be considered null and void if a signed copy and retainer are not received by us by ________________.

The undersigned has carefully read this agreement, and understands it. I was not under any undue influence that might cause me to sign this other than voluntarily. I am aware that it is my right to have my attorney review this agreement and provide me with input if I so wish. I further understand that I have the right to question any aspects of this engagement letter which are unclear to me or with which I am not comfortable, and that I am entitled to a response to any such query. Thus, I am satisfied that any possible issues have been addressed to my satisfaction, and that I am signing this document free of any pressure to do so.

Kindly sign and return the enclosed copy of this letter along with our retainer.

Very truly yours,

____

(accounting firm)

XXX, CPA/ABV

I,____, hereby agree to the above terms.

____   _________________________

Signature   Date

Firing a Client

Just as concerns and issues need to be addressed before accepting a client, we need to address certain issues when we are considering firing a client. In the world of routine or regular commercial clients, firing one is generally a fairly straightforward procedure: an exchange of letters stating the termination of service, settling up your bill, and returning any original records. In litigation in general and divorce in particular, the following particular areas of concern exist:

- *Where in the case are you at the time*? It is fairly easy and of generally no particular concern if you are fairly early on in the case, no trial date is set yet, the trial date is several months away, and so on. However, if trial is fairly soon (for example, one month away), you need a really good reason to fire that client. You can expect that firing the client one month before trial is going to receive a very unfriendly reception from your client and, possibly, your client's counsel. After all, the argument could be made that you are abandoning your client too close to trial for that client to properly present his or her position, which could lead to an argument of damages and a possible suit.
- *The referral source*. In the commercial world, generally, the person who referred the client is not a big concern, although that type of relationship is obviously important to maintain. In the litigation environment, you will typically not only be abandoning that client but also the attorney who brought you into the case. That requires extra thought and consideration and maybe even discussion with the attorney in advance of putting down the hammer. Certainly, you do not want to endanger that referral relationship.
- *How much is owed to you*? It is difficult enough in the commercial world to collect an outstanding balance when the relationship is severed; it is considerably more difficult in a divorce matter. That client no longer needs us and, perhaps, dislikes us a lot. It is also a reasonable chance that the cause for the firing was because you were having trouble collecting your bills. The firing decision is that much more difficult when a substantial bill is outstanding, and you know that despite whatever engagement letter you have, you will need to sue in order to collect your fee.

Issuing the Bill

Based on discussions I have had with various fellow practitioners, it's my strong belief that most of our peers bill litigation and divorce clients on a monthly basis. It's a natural flow and break point, it's how we typically keep our work in progress runs, and so on. Of course, nothing is particularly sacrosanct or magical about that; it's just the convenience factor. Our billing method is also typically stated in our engagement letters. However, in some situations, such as the following, serious consideration needs to be given to using some method other than the simple lock-step monthly billing:

- *Bill regularly*. This is standard advice for almost any business and under almost any circumstance. As a general rule, the sooner you bill, the sooner you get paid. Even if that is not true, it does not hurt to bill early. Clients tend not to like surprises that are negative or cost them money. The job you are working on might be a $50,000 job, but billing $50,000 after 8 months of work is inviting a lot of headache and trouble. Instead, you should be billing several thousand dollars per month each and every month that you are generating work. I recall one case in which I was involved when the expert on the other side had a bill in the high five digits and did not send out a single bill in the space of 2 years. At the end of the case, he sent out his bill, and there was shock across the board from the client as well as counsel. The amounts would have been the same if he had billed on a monthly or even bimonthly basis, but the client and counsel would have been eased into the situation.

- *A lot of work is telescoped into a short period of time.* The client comes to you, needs a lot of work done in a very quick time frame, and you have to assign a big portion of your staff to get this job done. First and foremost, you need a retainer that is appropriate for this level of commitment. Then, you probably should be working out a weekly billing arrangement with short-term payment.
- *The case is finished.* Assuming that we find this out rather close to when the event actually happens, try to send out the final bill as soon as possible. If we are into the normal monthly billing cycle, and the case finishes on the 25th of the month, typically, all we really need to do is see to it that we get the bill out soon after the end of the month (for example, on the 5th), rather than worrying about a special midmonth cut-off. However, maybe the case finished on the 4th of the month. In that case, you are going to want to get all your time posted immediately and get the bill out as quickly as possible.
- *Have your bill as part of the settlement or divorce agreement.* This one generally swings widely in terms of your abilities. It might depend on your jurisdiction's habits or your relationship with the attorney, judge, or client. Ideally and typically, this requires the attorney to be solidly in your camp and assist in the collection process as the final divorce agreement is being developed and respective obligations of the parties are being included. It would be wonderful and certainly supportive to your ability to collect (in case there was a problem down the road) if the payment of your bill is stated clearly in that agreement as an obligation of one or both parties. Keep in mind that would not override a contract you have with one of the parties if the other party failed to live up to his or her obligation to you. This is a legal issue, but most likely, you would still have the right under your contract to go after your client; then, it would be your client's responsibility to seek reimbursement from the other spouse.
- *Pool of funds.* Sometimes, a judge will create a pool of funds from which lawyers and experts can get paid during the litigation process, but this requires adequate funds to be available. Oftentimes, home equity lines are used as part of the liquidity in the pool of funds.
- *Collection and suing.* This is a very touchy area among CPAs. Do you put this bill into collection; do you go as far as to sue in order to collect? In my experience, most of my peers will answer in the affirmative. They will try everything reasonable and even more than reasonable to get the client to settle. They will offer a compromise (that

it is a touchy area, and the magnitude varies widely); the ability to stretch out the payments over some reasonable period of time; or whatever helps make the payment of the bill as amicable and complete as possible. However, when the ultimate result is that you have a client who will not pay, or you are dealing with an unreasonable client who thinks that the world owes him or her, then you have a choice to either walk away from that bill or sue the client.

If we have done the job right, have been fair, and are pretty sure no skeletons in our work might come back and haunt us, then the classic threat by a client to countersue for malpractice is disregarded, and we move forward with a collection suit. Frankly, it is the only language that some clients understand. Obviously, you may need to coordinate this with your malpractice carrier, and that is a case-by-case and firm-by-firm situation. The point here is that we cannot be intimidated or scared of suing because of the potential of some ingrate client not facing up to the reality of a collection suit and trying to distort the situation by making a spurious claim of malpractice.

Keep Your Team Informed

Team is defined here as our client, as well as the attorney. Although exceptions always exist, the basic rule is that all of your correspondence needs to be sent to both counsel and our client. If you are communicating with the attorney about the need for certain records or some preliminary thinking, share that with your client because it lets your client know that you are always working on the case. If you are sending a letter to the other expert to coordinate an issue, timing, discovery, or the like, copy the attorney with whom you are working, as well as your client. Let them know what is going on, and as a self-serving item, let them know that you are doing work.

Library and Research Material

Whenever you have a specialty, it is highly likely that your library and research needs will also revolve around that specialty. Investigative accounting and business valuation are no different in that sense. Other than relating to divorce taxation (if you accept that as part of your role) and, perhaps, the occasional need to question whether appropriate accounting procedures were followed in a financial statement that you are investigating, the normal accounting library is never touched. Rather, you need to have reference material that includes books on business valuation (a few are excellent resources) and forensic and investigative accounting. In addition, your research needs will typically include subscribing to certain proprietary databases for items such as transactional activities useful in applying the market approach, economic research, reasonable compensation, and the like. In addition, on a case-specific basis, you may find the need to acquire or access information relating to specific industries, fields, or professions. The Internet is often very helpful, either as an end to itself for research or as a source for learning more about research and data sources. Potentially hundreds of sources exist for you to consider.

Marketing

Getting business requires some degree of marketing, unless you happen to be the only game in town or so well-known that you are in your own world. If so, feel free to ignore this section. Many books have been written about marketing, including those focusing specifically on professional services, and I recommend that you read one or two of them.

First and foremost, the majority of your divorce business comes from divorce attorneys (also known as family law practitioners), so we obviously need to market ourselves to that audience. Fortunately, it is easy to identify that audience because that information is common knowledge and in the public domain. Also, the bar associations of the majority of states have a family law section, and just about every state has a chapter of the American Academy of Matrimonial Lawyers. Typically, the latter are all members of the former, but not all the former are members of the latter. You will want to mix and mingle with these people as much as is reasonable and appropriate and as much as your style of operations permits. Depending on your area, either or both of these organizations may have regular meetings or programs in which you can participate. Typically, any such participation would be in the form of being a guest speaker or making a presentation of some form or another. Try to get yourself into that position by eliciting help from a friend on the inside, such as a family law practitioner with whom you have worked or with whom you are friendly.

Writing articles is another vehicle, not unlike what is recommended in almost any sphere of professional services. Find out what bar association newsletters are active in your city, county, or the like and see if they are interested in articles being contributed by accountants. Most of the time, you will get a favorable reception. A general caution about speeches and articles: be very conscious of what you say and write. Assume that at some point in time, it is possibly going to be brought back to you or thrown up at you at trial or deposition. After all, if you advocate a certain approach or concept in a speech or article and then take a contrary or inconsistent approach in one of your reports, you are fair game for an attack on your credibility.

In terms of giving speeches and even writing articles, do not overlook fellow CPAs as a potential source to market. If you have the opportunity, take advantage of speaking before fellow CPAs about your niche. Most CPAs do not do this, and some really should not do this. Thus, we can develop relationships with our fellow CPAs in a more routine fashion in the give and take of the normal course of servicing or as the result of giving a speech.

Fellow CPAs can be a good source of business when they find themselves in an area of work that is unfamiliar to them. Even if they do perform work in that area, they may have a conflict and will think of you because of a presentation you gave or relationship you have developed. As part of this process, they need to be reassured that you will strictly respect their client relationship.

Mediating a Client's Divorce

I have to share with you one of my most successful and, at the same time, least successful cases in which I helped mediate the financial aspects (which tended to expand outside financial matters) of the divorce of one of my business clients. Perhaps a brief illustration of this situation will be useful to you in helping you make your own judgment calls if and when you are faced with this type of situation. I had a good corporate client that was truly managed by both husband and wife. I'm not sure how much that mattered, but those were the specifics of the subject matter. After a number of years of marriage, things were falling apart, and they filed for divorce. Fortunately, we all recognized that if the divorce went along some of the usual divisive combative lines, in all likelihood, the couple would destroy their very nice business. I proposed to them that they allow me to work with both of them as a neutral expert in order to work out the financial issues and coordinate with their attorneys. I believed that it was important (and conveyed this importance to the couple) to keep their attorneys in the loop, and working with the attorneys was critical to making this process work.

Over a period of several months, I successfully mediated their divorce, saving their business and probably saving them hundreds of thousands of dollars in fees. This was one of my most successful divorce engagements. Unfortunately, once the divorce was put into effect, with the result being that each of them took a significant portion of the existing business (preserving the business in two separate hands), the now ex-wife decided that she wanted to make a break with everyone from her past, including yours truly. To make matters worse, the now ex-husband decided that saving a couple hundred bucks per year on fees was paramount, and he fired me and went elsewhere for accounting services. That is not an exaggeration; the difference in fees was literally just a few hundred dollars a year. Thus, in that sense, this was one of my most unsuccessful divorce cases.

I think that if I had the opportunity to do it over again, I probably still would because it was really the right thing to do at that time, and it served them both very well. Unfortunately, it did not work out all that well for me. I would suggest that if you have the temperament, the ability to gain the trust of both sides, and can be level and fair, you can assume that your clients might be more reasonable, more rational, and fairer than mine. At least you can hope so.

One of Your Clients

Every once in a while, you are going to be asked to step in on the divorce of a regular business client of yours, such as an accounting, an auditing, or a tax client. Regardless of which one but especially if an accounting or auditing client, proceed with extreme caution. One easy way to address this is to have a policy that simply says you will not take on those clients in a divorce action because the potential issues and conflicts are substantial. If your business client asks you to determine the income (and perhaps also the value) of the business in a divorce action, you should almost always (if not always) decline that invitation. It is one thing to assist in a consulting fashion behind the scenes by looking over the shoulder of the forensic accountant who has been engaged to review and comment on the other expert's report, but it is another thing to be the expert witness who has to arrive at certain financial conclusions and a value determination.

One immediate concern is, how clean are the client's books? Most of your clients put at least some questionable items through on the books, such as a combination business and personal trip, 100 percent of a car, and so on. Normally, you might not have any issues with such treatment. However, in the context of a divorce, when another expert CPA is going to go through that client's records and come up with conclusions, likely put those conclusions into a written report, and then testify about the conclusions, you are going to be put in a position of perhaps needing to prepare a rebuttal report (or your own report) and also testifying. It is simply not a good position to be in. You do not want to be testifying about the sanctity of the financial statements and tax returns you have prepared when the other expert has made a really good case of how your client has run personal expenses through the books. Alternatively, you do not want to be in a position of acknowledging (or perhaps even reporting on your own) these types of transgressions when you are the one who has prepared the returns and financial statements over the years. Stay out of it.

Besides all that, you also face the very real issue of a perceived lack of independence. Although the cornerstone of any preparation of a financial statement (but not a tax return) is independence, the concept and meaning of independence is different in a divorce trial than it is for a CPA presenting a financial statement for lending purposes. Even though you will almost never be challenged about your independence when you prepare a financial statement for your typical client, if you take that same client and go into court in a divorce case with a report on that client's income and value, you will almost never be perceived as independent. In the context of that divorce action, your ongoing relationship with that client and your ongoing fee resulting from that relationship will almost assuredly flag you as not being independent. That presents a significant disadvantage to you and your credibility versus the other expert.

The issue is not so black and white when that client is a tax client whose tax return you have prepared for a number of years. However, typically, when you have a married couple, joint tax returns are prepared, and if you are the one who has prepared the joint returns, then both spouses are your client. To go into court representing one of them in a divorce action may violate independence and certainly opens you up to challenge by the other spouse's attorney. It will likely be an uncomfortable position not worth taking. The situation is a bit better, but not perfect, if you filed separate returns. It is even better if you have filed returns for only one of the spouses, and the other spouse has filed a separate return using another accountant. Even then, you are perceived as having an ongoing relationship, which might significantly and negatively affect any perception of your independence and, thus, your credibility.

Probably even worse than being challenged about your independence and not carrying the day with your credibility with the court (if you don't do this type of work in the regular course of events, maybe you don't care all that much) is the potential for irreparable damage to your relationship with that very client whom you are trying to help. It is more than likely that your client will not fare well if things are being hidden. That is not going to look good, and as previously referenced, your credibility will probably be impaired. Thus, your client has a better than even chance of coming out of this unhappy. One way or another, unless you happen to have a prince of a client, you are going to be held responsible for some of that displeasure. In your client's mind, maybe if your report was better, you had testified more strongly, you had answered questions better, and so on, he or she would have had a better result. If your client has a good result, it is unlikely that you are going to get any credit for it. Thus, you have only downside in front of you. Why endanger a business client worth perhaps thousands of dollars per year for the ephemeral short-lived benefit of an increase in fees on a temporary basis for this extra work? It is simply not worth it.

In addition to all these caveats about not accepting the work, look at that prospect that you are going to refuse as an opportunity to score points with another CPA by creating a referral situation. At the same time, you benefit yourself by doing the right thing for your client. If your practice, your community, is anything like where I practice, I am sure that you have a friendly relationship with a number of CPAs whose work quality you respect. On occasion, you all run into conflicts that don't allow you to accept a situation, or you are faced with the need for a specialty that you do not have. That is a perfect opportunity to refer that type of situation to a friendly CPA who will do a good job, help you preserve that client relationship, and not attempt to steal that client from you. It is a win-win for everyone, and if the divorce does not go well, even though you were the referral source, the blame is going to go to that CPA, not you. Don't worry, that CPA, assuming he or she is someone who does this type of work regularly, is used to bearing those hard feelings. Also, you are now owed a favor, and maybe there will be reciprocity from that CPA when he or she faces a similar conflict situation or, perhaps, has a matter in which your specialty is in demand.

Partner Versus Staff Time

This is not management practice advice about how to balance your time but, rather, how to address the practical issue that will arise on occasion, usually only during trial (possibly if arguing with a client over a fee), and for which no right answer exists. How much time or what percentage of time should be partner time versus everyone else? After all, the partner is the one responsible for the case, typically the one to whom the client or attorney came, the one who got appointed, and so on. As a practical matter, everyone in practice who has one or more staff people pushes down to the staff whatever is reasonable for their level and the particularities of that case.

Regardless of whether you are the type who has his or her hands deep in all of these cases or the type who believes in being hands-off and letting the staff run with the case (you act more as a mentor), during cross-examination, you will be wrong. After all, if a case represents 100 hours of total accounting time, and the staff represented 95 hours of that time, and you as the partner represented 5 hours, you can be certain that during cross-examination, you will be challenged about why you had so little time involved. Doesn't that mean that the necessary level of expertise was not exercised and present; therefore, in some way, the work is deficient? Further, how could you be testifying on something in which you barely had any involvement? You all know the defense: you had the right people working on the case at the right level of experience, the case was done more efficiently this way, it followed your firm's procedures, and you are familiar with the file.

Using the same case example, staff represented only 70 hours, and you represented 30 hours. The cross-examination might go along the lines of you were perhaps overcharging (though the other side may not be all that concerned unless they are going to be responsible for paying) because you were too involved in the case at your high level. Perhaps a level of disbelief might be expressed that you spent so much time on this case, with the inference being that you padded the bill. By spending that much time on the case, if you did not acquit yourself well during cross-examination, you then might be asked how could you have possibly spent so much time on the case and yet not know as much as you should. Of course, some cases are more difficult and complex and require higher-level involvement. Sometimes, the client insists on that involvement. Whichever way it goes and whatever your answer, in cross-examination, you are going to be considered wrong by the other attorney no matter how right you are.

Premium Hourly Rates

If you simply divide your service world into two categories—regular accounting clients (businesses, individuals for tax returns, and so on) and litigation clients (divorce work)—and assume a so-called normal accounting rate for the former, then you are strongly urged to charge premium rates to the latter for the following reasons:

- This is a specialty area, and a specialty is entitled to premium rates.
- Without question, working in a litigation environment, particularly a divorce environment, will bring you more aggravation than is typical in your accounting life. You are entitled to get paid for that aggravation.
- Not necessarily in all cases but far too often in divorce, particularly when representing the nonmonied spouse, there may be long time periods between payments, and you might even get nothing between the retainer and settlement of the case, which could be months or even years down the road. Waiting to collect your fee is an implicit and explicit entitlement to a higher hourly rate.
- Tied into the preceding but a separate issue is that because of many factors, including how much the fees build up, the settlement is not all that your client wanted, the economy is not right, and so on, you tend to have more and larger write-offs in this field than is typical in the commercial accounting world. Thus, you simply need higher rates to make up for the higher write-offs. Of course, the logical issue is that if the fees were lower, there would not be as many write-offs. That is absolutely right in theory but absolutely wrong in practice. At the end of the day, when you have a $20,000 outstanding bill (which would have been $40,000 if you had billed at your premium rates), it does not make a difference. Your client, even a good client, is going to be looking for and expecting some kind of a haircut. After all, that's a big number (regardless of the number), you have charged a lot, and you make a lot, so you can afford to reduce your bill and take a haircut.

- Your engagement letters should always provide for interest on overdue bills. Generally, *overdue* is defined as after 30 days; whatever your style, go ahead and do it, but the point is that you should charge interest. Even if you ultimately agree to waive the interest, you want that interest charge to be there as your right. In some cases, it may be little more than a leverage tool. In other cases, especially if you have to sue to collect, having that right for interest is big. It can represent thousands of dollars of additional revenue, or it might give the judge the opportunity, when ruling in your favor in a collection suit, to award you 100 percent of your fees and maybe no interest. However, if you did not have the right to charge interest, you might have gotten less than the full amount of your fees.
- Along the same lines as charging interest, your engagement letter should also provide for the cost of collection, which is typically ⅓ of the outstanding amount. It is suggested that the wording be ⅓ of the totality of the outstanding amount, including services and interest. Similar to interest, this works as a leverage tool to encourage payment. Also, if you do take the case to collection without language in your engagement letter that allows you to charge and collect for the cost of collection, you probably have no chance of getting that money. Remember, the purpose of the engagement letter is to protect you.

Report Retention

As simply good practice, you will find it helpful to maintain a control list of the cases in which you have been engaged, as well as a copy of not only every one of your reports but as many of your fellow CPA reports as you can get your hands on. A suggested format for the former is included herein for your consideration. Maintaining such a list will often help you in such matters as refreshing your memory about which types of cases you have worked on and certain selected nuances of those cases. In regard to that idea of selected nuances, you can obviously expand the format I have presented herein with a multitude of additional columns to take into account a wide array of different concerns you may have or areas you may want to track. Only you will be able to decide how important that is to you. However, the key element is that you have some way of looking back (perhaps years) at information that may be helpful at some future time.

For instance, perhaps you get a call from a potential client who needs a valuation of an automobile dealership or a cardiology practice. You can expect that prospective client to ask if you have ever valued an automobile dealership or a cardiology practice or medical practices in general. Maybe you are the type who has perfect recall; if not, then it is helpful to be able to look at a list and facilitate your powers of recall by recognizing that you have valued a certain number of automobile dealerships: some for divorce and others for shareholder suits or a buy-out arrangement. Further, two of them were Bugatti dealerships, three were Rambler dealerships, and so on. Perhaps you haven't valued any cardiology practices, but you have valued 20 medical practices, including surgical specialties and the like. The ability to reference this type of experience can make the difference between you getting that assignment and not getting it. It also gives you the opportunity, especially if any of those other valuations were preformed relatively recently (the last couple years), to review your reports to familiarize yourself with some of the issues and industry-specific information in order to improve your initial interaction and discussions with that prospective client.

You will also want to make a habit of securing as many reports of your peers as possible. The easy part is when another expert is involved in the case because you will get a copy of that expert's report. The first thing you should do is make a copy of that report, so that you have a clean copy in a file where you maintain copies of those reports. Then, you can mark up the copy if you so wish. My point is that you make sure that your only copy is not one that you have marked up. You will find the retention of reports of others very helpful from various vantage points:

- You will likely find things in other reports that will educate you and make you better at what you do. Other experts and CPAs have different approaches, views, and sources, which will help you do a better job now and in the future.
- It will help you do a better job for that specific case. This can be extremely important because maybe you missed something, or maybe the other expert has what you have to candidly (at least to yourself) acknowledge is a better view, a better angle, or information that is more supportable than how you developed your report. You want to know that now, before the case goes to trial, so that you are better prepared.
- Sooner or later, you are going to run into the other expert on another case, and maybe that other expert applies an approach or takes a position that is different than, or even contradictory to, the approach that he or she took in the earlier case. A word of caution here: this could also apply to you. By way of example, perhaps in developing reasonable compensation in the first case, the other expert used the median from a particular survey, and then in the latter case, using the same survey, that expert used the 25th or 75th percentile. There may be a very valid reason for this difference (different type of business, work ethic, strength and experiences, and so on), but the important thing is that an inconsistency exists, which may prove helpful in rebuttal and, ultimately, the trial. However, be careful of the tables being turned here; if you are the one who has been inconsistent, you have a very good chance of your opposition knowing this and hitting you with it at trial.
- In regard to the possibility of using past reports of the opposing expert in order to do some damage (keep in mind that this works in both directions), I believe that two examples from situations in which I was personally involved would be very helpful in illustrating the range of what this entails and how it might come about:
  - In valuing a law practice, one of the biggest issues we were fighting over was reasonable compensation. The case could not be settled, and we were off to court, where both the other expert and I had to testify about our report analysis and, in particular, address our differences in reasonable compensation. For illustration purposes, it does not matter what type of attorney was involved, so let's simply say it was a patent attorney. The other expert was representing the wife of the attorney, and if you allow for cynicism, he came in with a very low reasonable compensation number, which was not terribly surprising.

What that expert apparently was not prepared for was that I had in my files a copy of that expert's report in another matter involving a patent attorney in the same general community that was done only a couple years earlier. In that case, that expert represented the attorney and had concluded with a very high reasonable compensation. There were no other factors that would have made a difference, such as considerably different working hours. The whole difference appeared to be, and in fact was, slanting the reasonable compensation to suit the client that he was representing. This was brought up by me during my testimony and also applied during cross-examination of the other expert. Fortunately, the result was predictable: that expert lost face with the court, and my reasonable compensation figure was accepted.

— In a matter involving a solo surgical practice, I represented the spouse, and in my capitalization rate build-up, I applied the industry-specific rate provided in the Morningstar/Ibbotson data. The logic was that even though there were no publically-traded medical practices, the economic factors affecting clinics and the medical field in general were the same economic factors affecting the surgical practice that we were valuing; therefore, the industry-specific premium and discount provided in the Morningstar/Ibbotson data were appropriate. The other expert did not use the industry-specific data. That by itself would not have made this such a big issue, except he went out of his way to comment in his rebuttal to my report, as well as in direct testimony on the stand, that the use of the industry-specific data for this medical practice (using his exact words) "lacked common sense." During cross-examination, the attorney with whom I was working hammered that expert on this issue, and that expert repeated that it lacked common sense; further, when pressed, he indicated that it was something that he would never do and has never done. The problem with that statement was that he had in fact done exactly that on a report just a few years earlier, and I had a copy of that report. You can easily imagine the embarrassment of this being brought out on the stand and the damage that it did to that aspect of his valuation.

Thus, it should be obvious not only how important it is to maintain files with copies of whatever reports you can get your hands on but also how important it is to apply methodologies and approaches as consistently and fairly as possible. When you do not do that, there is a startling good chance that it is going to come back at the worst time, and make a big difference in your credibility in the instant case and possibly beyond that.

Return Your Calls

Professionals in general and, unfortunately, lawyers in particular have a reputation (often well deserved) of not returning calls or, at best, taking an inordinate amount of time to return calls. It is perhaps one of the most galling aspects of what has become professional service. I urge your policy to be that all calls get returned the same day if at all possible.

Matrimonial & Investigative Jobs
(Update — __________________)

M – Medical
N – Net Worth
C – Construction/Real Estate
L – Law
S – Standard Living
F – Funds Flow
V – Vehicles
E – Eatery/Restaurant/Food
FLP – Family Limited Partnership

NR = No Report by Us
U = Unreported Income
A = Appointment (Judge)
T = Trial (report public record)

				Non-Matrimonial					
				Partner/ Shareholder Dispute	General Valuation, M&A	Commercial Litigation	Other A/C Report		Business/Job Description

Staffing

Just like any job, you need to give attention to staffing jobs. However, unlike a large audit or review job in which you might throw a couple juniors in the field and have them spend time doing various basic routine items, the litigation arena has less room for juniors (other than for basic data input, which is often best done at your office) because of the level of insight and experience that is needed to best handle the investigative accounting process. Thus, for litigation jobs, the need for experience tends to weigh more heavily than for the routine accounting client. When you are a member of a firm, you share staff, and the majority of the firm does not do litigation work, you will have to learn how to deal with the internal office politics to make sure your jobs are staffed properly.

One final comment relevant to staffing a job is about justified discrimination. Before my readers complain to the American Civil Liberties Union or Equal Employment Opportunity Commission, my reference here is to a somewhat benign situation but one that recognizes sensitivities. You are dealing with people going through a divorce, and every once in a while, you may have a client (assume the wife) who, because of the very bad circumstances (assume abuse) that caused the divorce and the need to sometimes coordinate regularly and face-to-face with you and your staff, may be extremely sensitive to gender issues and might be best served by using a female accountant. I frankly do not see this as discrimination in the "wrong" sense because this is a particular area that calls for sensitivity, and every once in a while, it is the right thing to do. I'll share with you an interesting twist on that. I had a situation a few years ago when we represented the husband, and the wife owned the business. The husband felt that we had to use a female staff person on the job because, in his opinion, his soon-to-be-ex-wife was gorgeous (she was indeed), and a male staff person would have his head turned and not be able to do the right investigation of the wife's business. We accommodated him and provided a female employee to handle a job. It did not work quite the way he expected. His wife was gay.

Tax Season

Whether you call it tax season or audit and tax season, which is more accurate for most accounting firms, when you work in the litigation field, seasons do not exist. The point is that litigation is a year-round issue, and if you are so heavily oriented toward audit and tax season that you cannot devote the appropriate resources to litigation at any time that it is asked, you are simply in the wrong field. In the litigation arena, it is vitally important that you do not allow the audit and tax season to interfere with your ability to take on and service assignments.

Time Runs

Many different styles of billing exist, from the one-line "for services rendered" to submission of detailed time records. In this day and age of software programs and technology, the majority of accounting firms (the exception being some very small ones) use a software-based time and billing system. Even if a firm or two still uses the old-fashioned manual system, every firm is expected to maintain time records. Assuming that 99 percent of the firms have the computerized programs, getting details and printouts is really a very simple process. Some clients really do not care about the details, as long as they believe that the bill is reasonable; others, even if they do not challenge the amount of the bill, want line-by-line and blow-by-blow descriptions of everything that was done. Most of you should not have a problem providing a copy of the detailed time runs if and when a client requests them.

Perhaps not as much in divorce practice as commercial litigation, but nevertheless a potential issue, is the quandary of how much detail is enough versus too much. It is pretty easy to agree that a line that says "services rendered" or "financial investigation and valuation" simply does not provide the kind of detail that clients would typically expect, regardless of whether it was computer generated. Also, virtually any system provides room and opportunity to give detail in a "Memo" column. That detail can be rather far ranging and run several lines or more. Generally, it is good practice to provide adequate detail, so that when a client reviews the time, he or she can appreciate what was done and believe that the bill is reasonable because of the certain volume and detail of work that needed to be done. This also helps you in preparing the bill.

The potential quandary, usually only in commercial litigation, is when a concern exists that the detail, if very complete (some might say too complete), may provide a road map for cross-examination or challenging certain things that you did or did not do. This concern does not have a simple, one-size-fits-all answer. However, if you are running a good practice and are comfortable with the work you have done, more detail rather than less would be the right direction to go because, most of the time, the need for detail benefits both you and your client.

Your Partner Going Through a Divorce

I have addressed client selection and conflicts, but an interesting and, sometimes, unique situation is when the person going through the divorce is your business partner, and because of your expertise in the field, you are asked to lend a hand. Having one of your partners as a client in his or her divorce is along the same lines as representing a business client in his or her divorce; it is strongly recommended that you do not do this. Obviously, you are not independent, and worse, you are dealing with investigating and valuing your own business, which you cannot do. However, I will acknowledge that I was in exactly that situation a number of years ago, and by accepting the limited role that I insisted on not exceeding, the situation worked reasonably well. It did require the right balance of interaction between my partner and myself and a mutual understanding of the severe limitations in the role that I would play; however, the specific matter worked because of that mutual interaction and understanding of limitations.

The purpose of my involvement could essentially be distilled into two factors. First and foremost, my partner wanted to save money and not hire his own expert; thus, he used my "free" labor. Second, neither my partner nor the rest of my group was eager to open our books to another accountant. Imagine that. Nobody wants to open up their books to outsiders. Regardless, it worked because my role was understood and agreed to be limited to acting as an intermediary between my partner and the accountant hired by my partner's wife to investigate and value my firm. He was obviously capable of dealing with the financial issues and responding to them, but it was also a personal and an emotional issue, and it was certainly best handled by somebody who had no emotional or personal ties.

In our specific situation, it also worked well because the wife's expert was reasonable. He knew what to do and how to proceed and cut through the unimportant matters. However, notwithstanding this very civilized approach, there was more than one tense moment and an occasional issue between me and my partner. Thus, although it is not recommended, it is sometimes the practical approach that can work. Of course, it was understood that I was not going to perform any forensics, value the practice, or appear in court. My role was limited to the previously referenced assistance. If it turned out that the wife's expert was coming up with numbers that were simply unacceptable, my partner understood that he was going to have to engage his own expert.

> OUR FAMILY IS REALLY SPECIAL—*When your business is dealing with people, inevitably, you're going to deal with some who are on the mental fringes. In one such case, we were advised by the husband that the 32nd Congress of the United States (that goes back to the 1850s) had exempted his family from income tax. Of course, there were at least several things wrong with that statement, including the fact that his family hadn't come over from Europe until long after the 32nd Congress, there was no income tax in the United States at that time, and this never happened.*