The Expert

Perspectives on Litigation Services

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Spring 2006

Read their minds

Guide offers insights on judicial handling of statistical evidence

The Federal Judicial Center's (FJC's) *Reference Manual on Scientific Evidence* includes a *Reference Guide on Statistics* that acknowledges the prominent role statistical assessments play in a wide range of litigation. The guide gives practitioners in federal courts some idea of what to expect when the courts are asked to evaluate such evidence — which can help you get the most out of your expert statistical testimony.

The limits of statistical expertise

Among other issues, the guide addresses the qualifications for experts offering statistical testimony. It expressly states that statistical expertise isn't limited to those with degrees in statistics. But not every expert passes muster for statistical testimony. While forensic scientists and technicians frequently testify to probabilities or statistics derived from data compiled by others, some lack the necessary training or knowledge to understand and apply the information.

Conversely, an expert statistician might lack the requisite subject matter expertise to know which data to examine or how best to model a particular process. As the guide cautions, qualifications in one field don't necessarily imply qualifications in another.

The FJC suggests that some cases call for two experts offering interlocking testimony. Once an issue is defined by legal and substantive knowledge, some aspects of the statistical analysis depend on statistical considerations alone, and expertise in another subject isn't likely to prove pertinent. For example, a labor economist can define the relevant labor market in an employment case, while a statistical expert compares the makeup of the employer's workforce to that labor market.

A judge might permit the combination of expert presentations, with witnesses questioned as a panel, when their reports fit together.

Enhancing expert testimony

The FJC guide outlines several procedures to strengthen statistical testimony:

Professional autonomy. Expert witnesses need to use the same objectivity they would in a nonlitigation contest. They must feel free to perform any analysis required to address the issues posed by the litigation in a professionally responsible manner. Judges can be expected to delve into the freedom of inquiry given testifying experts and the scope and depth of their investigations.

Other analyses. The guide states, "There is much to be said for looking at the data in a variety of ways," which statisticians typically do via multiple models and methods. To allow a fair evaluation of the analysis applied, an expert should be able to explain the history behind the development of the statistical approach he or she eventually used.

Data and analytical methods before trial. Judges are encouraged to use pretrial procedures to require disclosure of data and methods. This should help minimize the possibility of distracting debates at trial over the accuracy of data and choice of analytical techniques and permit informed expert discussions of methods.

Expert statistical testimony. The sequential presentation of evidence at trial isn't necessarily the only structure that might work when presenting statistical evidence. The Federal Rules of Evidence permit other structures that might be more effective. A judge might, for example:

- Permit the combination of expert presentations, with witnesses questioned as a panel, when their reports fit together,
- Allow more narrative testimony — including a brief tutorial on statistics — as a preliminary to an expert's testimony,
- Require opposing experts to testify around the same time, rather than amidst other evidence, or
- Put opposing experts under oath and allow them to engage in a dialogue in which they can state whether they agree or disagree on specific issues. In this case, the judge and attorneys may interject with questions.

The guide encourages the use of nontraditional formats that might improve the judge's understanding and reduce tensions associated with experts taking adversarial roles.

Forewarned is forearmed

The FJC guide represents a wealth of information for attorneys who practice in federal courts. At the very least, familiarity with the guide can help you better plan cases and select experts likely to withstand judicial scrutiny. ■

Accurate valuations call for normalization

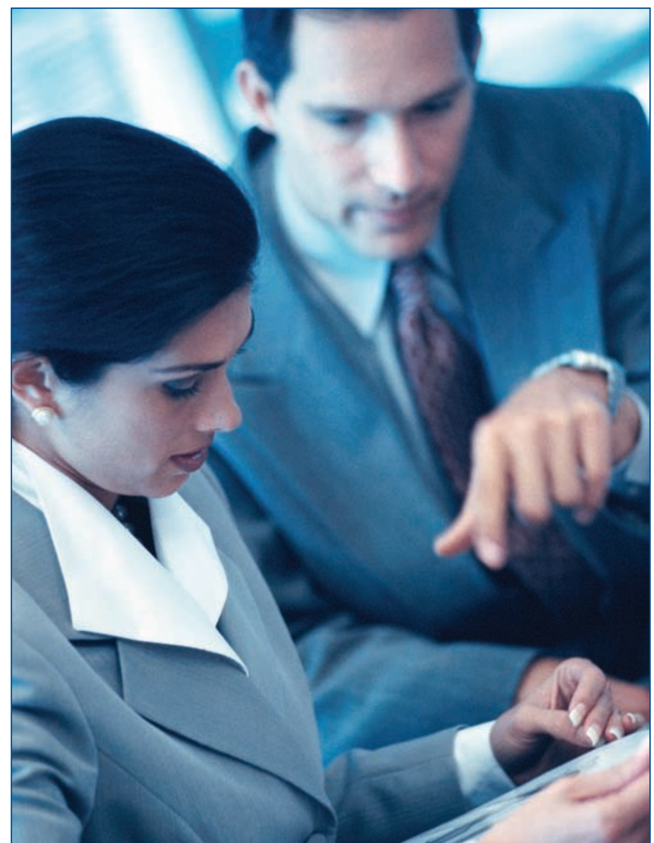
When valuing a business — for a sale, divorce or other purpose — qualified valuators know they can't rely solely on its balance sheet. While a balance sheet provides a snapshot of a business's assets and liabilities at a point in time, it may not reflect the worth of all assets and liabilities that affect a business's market value.

The problem with balance sheets

The discrepancy between balance sheet value, or book value, and fair market value (FMV) can usually be attributed to a business's accounting practices. Many businesses — especially small and midsize ones — record their assets at their historical cost. For example, a computer purchased for $5,000 is recorded at that amount for the duration of its life, regardless of its current market value.

Even accounting for depreciation over time, an asset's book value probably won't equal market value because depreciation methods are usually selected based on tax considerations, instead of economic value. Thus, assets are recorded at an amount far below market value. And if they have depreciated fully, they aren't recorded at all despite remaining in use and having value.

Businesses that use cash basis accounting — rather than accrual — also distort their value on balance sheets. Cash basis accounting records income as it's collected and expenses as they're paid, as opposed to when earned or incurred. The balance sheet, therefore, doesn't show accounts receivable (A/R) or payable.



Adjusting value

For these reasons, a balance sheet may well require "normalization" adjustments before a valuator can reach an accurate FMV. Valuators usually make adjustments in several areas:

Accounts receivable. A/R is recorded at face value, with a deduction for estimated uncollectible accounts.

Don't forget the intangibles

A business's true value encompasses certain intangibles that don't show up on financial statements. "Intangibles" may include assets like intellectual property, but also characteristics intrinsic to the business itself, including:

- The stability and skills of its workforce, availability of replacement employees and union relations,
- Dependence on a single individual — with increased value if it's open to professional management that doesn't need specific skills or knowledge,
- Dependence on a single client or vendor, which generally reduces value,
- Proximity to necessary resources and customers, the applicability of zoning laws and variances, assignability of leases, and availability of suitable alternative locations, and
- Competitive environment, including barriers to entry, regulations, licensing, startup time and ownership of critical intellectual property.

Work in process. Unbilled A/R, with adjustments for collectibility, is recorded.

Inventory. Valuators record inventory at current replacement cost value by reducing or writing down obsolete or aging inventory. Inventory that was purchased as assets is recorded, and phantom inventory that doesn't actually exist is eliminated from financial records.

Property, plant and equipment. Real estate is generally reported at FMV for valuation purposes, although it is sometimes dealt with separately from the overall business value. In that case, the valuator also removes real estate–related income items from other financial statements and records reasonable rent expenses.

If the improvements increase the business's value, valuators record them as assets even though they remain with the landlord when the lease expires.

Furniture and equipment are recorded at used replacement value — current replacement value less a depreciation adjustment for the length of time the asset has already been in service. Leased equipment is recorded as assets — with the remaining balance listed as a liability — if the lease is fairly characterized as a purchase agreement.

Leasehold improvements. If the improvements increase the business's value, valuators record them as assets even though they remain with the landlord when the lease expires.

Taxes. Overpayments of taxes are recorded as assets.

Prepaid expenses. If a business prepays expenses like insurance, valuators make an adjustment to the extent of the prepayment, thereby erasing future liability and increasing the business's value.

Unrecorded obligations. The business's obligations to pay for goods and services it has received but not yet paid for are recorded. These include lease payments, accrued sick and vacation pay, unfunded pension liabilities, unpaid payroll, and payroll taxes.

Contingent liabilities. Valuators estimate contingent liabilities such as potential lawsuits and record them as debt.

Getting the full picture

Professional valuators understand the need to go far beyond the numbers on the balance sheet to attain an accurate business value. They may also make corresponding adjustments to a business's income statement. Businesses and their attorneys wanting the full valuation picture need to understand something of the normalization process as well. ■

Appellate court holds support payments taxable to recipient

A federal appellate court has held that support payments made in the initial phase of a divorce under a *pendente lite* order that fails to allocate between alimony and child support are considered alimony. The payments are therefore deductible by the payor and taxable to the recipient spouse. The unanimous decision of a three-judge panel in *Kean v. Commissioner* demonstrates the critical role careful drafting plays in managing a divorcing couple's tax obligations.

The Keans' story

Mrs. Kean filed for divorce in 1991. In April 1992, while the case was pending, the judge issued an order requiring her husband to deposit $6,000 each month in a joint checking account managed by both spouses. The court instructed the wife to use the funds to maintain herself, their children and the household.

In March 1993, the judge again stated that the wife had exclusive use of the deposited funds. The following month, according to the appellate court, the divorce judge "further explained that the monthly $6,000 was to be used to pay for all shelter, transportation and personal expenses of Ms. Kean and the children."

The court order, however, didn't specify the individual amounts allocated to child support and spousal support. Alimony is deductible to the payor and taxable to the payee, while child support is not taxable at all. The husband deducted the payments on his tax returns as alimony, and the IRS eventually issued the wife a deficiency notice of almost $75,000 for failing to report the payments as income. The Tax Court sided with the IRS.

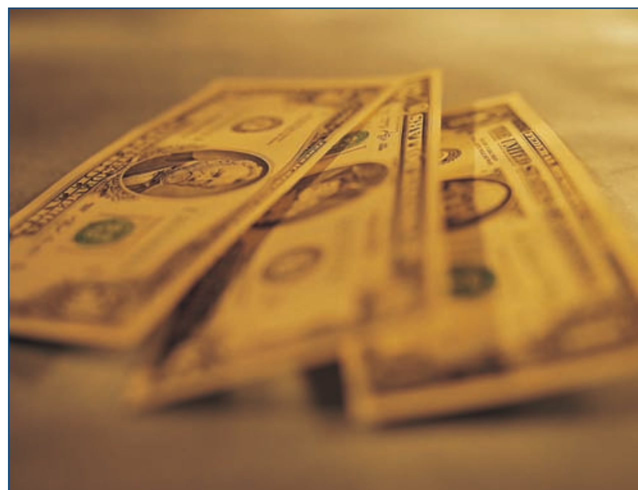
Evaluating the claims

On appeal, the wife challenged the characterization of the payments as alimony under Internal Revenue Code Section 71(b)(1), which outlines prerequisites for payments to qualify as alimony. Sec. 71(b)(1)(A) mandates that an alimony payment be "received by (or on behalf of) a spouse under a divorce or separation instrument." The wife asserted that she didn't receive the payments because they were deposited into a joint checking account and the divorce court placed conditions on the use of the funds.

The Third Circuit Court of Appeals disagreed. It found that the wife had "unfettered access to the funds," referring to the March 1993 order stating she was to have exclusive use of the funds. And, "although the divorce court offered only broad guidance as to how the money was to be spent," her use of the funds was sufficiently unrestricted.

For payments to qualify as alimony, Sec. 71(b)(1)(D) requires that the payor carry no "liability to make any such payment for any period after the death of the payee." The wife in *Kean* argued that the husband would have been required to continue making the support payments even if she had died.

Because the *pendente lite* orders failed to specify whether liability for the payments would terminate at her death, the appellate court was compelled to examine the relevant state law to determine whether the liability would terminate. It found that a support order issued *pendente lite* in a New Jersey divorce proceeding doesn't survive the death of the payee.



Intricacies of state family law

The court next tackled the wife's claim that, because the payments were unallocated between her and the children, the obligation would continue. She cited the Tenth Circuit's decision in *Lovejoy v. Commissioner* for its holding that, under Colorado law, support payments made during divorce proceedings don't constitute alimony. She also cited the Tax Court's holding in *Gonzalez v. Commissioner* that New Jersey law would not relieve the payor of his obligation to pay family support if the payee dies before entry of judgment.

The *Kean* court rejected those decisions as relying too heavily on the intricacies of state family law. It criticized them for disregarding the overall purpose of Sec. 71, as well as the interplay between Sec. 71(b) and Sec. 71(c) in distinguishing between alimony, child support and property settlements. Here, the husband wouldn't have been liable for payments to the wife's estate or on her behalf, and his responsibilities to the children if she died would be determined under New Jersey family law, independent of any *pendente lite* orders from divorce proceedings.

> *The court found that a support order issued* pendente lite *in a divorce proceeding doesn't survive the death of the payee.*

Watch your words

When drafting proposed orders and separation agreements, many attorneys refer only to "family support," rather than allocating amounts between alimony and child support. As the Third Circuit noted, "Child support payments may be separated out of alimony payments for tax purposes, but only if the amount intended for child support is sufficiently identifiable." You will likely benefit your clients by keeping this guidance in mind as you draft *pendente lite* documents. ■

Do you need a CPA or an economist?

Attorneys often turn to CPAs or economists for damages testimony, but the two specialties aren't necessarily interchangeable. And received wisdom about which expert is better suited for certain cases isn't always accurate.

The usual suspects

Attorneys often reflexively base their choice of expert on the type of case at hand. For example, CPAs may first come to mind for commercial cases because of their business backgrounds. CPAs can present evidence and testimony on what would have happened financially but for the alleged wrong. Their training and forensic skills allow them to examine a company's industry, markets, economic conditions and internal conditions — as discerned from financial statements and other data — and then prepare or critique damages calculations.

An economist's damages report, on the other hand, would likely reflect the effect of national, regional and local factors on the company. Economists, therefore, are more frequently retained for personal injury cases, where general economic and industry trends and statistics come into play — as in the calculation of lost wages. An economist can testify about expected economic trends over a plaintiff's lifetime, business trends and wage predictions, as well as the time value of money.

But CPAs usually have training in economic modeling and trend analysis, too. Further, because they rely more on actual financial data specific to the plaintiff than on general trends, CPAs might actually provide more specific, and therefore more convincing, testimony.

Moreover, economists tend to operate in academic, theoretical environments, while CPAs work in the trenches, routinely performing nuts-and-bolts work. Some cases may necessitate the former type of background, but, more often, a CPA's hands-on experience with financial and tax issues and the analysis of actual business data will prove more valuable.

Look at the individual

Ultimately, however, whom you retain may come down to the qualification of the individual expert. As Judge Alex Kozinski of the Ninth Circuit Court of Appeals has noted, "One has to look not only at the credentials of the expert but also at the experience of the expert and whether his testimony is going to be relevant to an issue that's in dispute in the case."

Lapping it up

How employees can shift funds to hide larceny

Lapping — the use of receipts from one account to cover misappropriations from another — is among the most common cash misappropriation schemes. The Association of Certified Fraud Examiners estimates a median loss for such fraud at $80,000, giving businesses and their attorneys strong incentive to uncover and prevent lapping.

Variations on a scheme

In one type of lapping scheme, an employee laps customer payments to hide the skimming of accounts receivable (A/R). Instead of crediting customer A's account for its payment, the perpetrator pockets the payment. He posts a payment from customer B to A's account, and C's payment to B's account, and so on.

Similarly, an employee might lap deposits. She takes money from one day's deposit and replaces it with money from the next day's deposit, so that deposits are always one day behind. The scheme can continue undetected unless the business performs up-to-the-minute reconciliations, someone notices a drop in the daily receipts or it is discovered during the employee's absence.

Uncovering fraud

Lapping schemes may start small and simple, but often grow more complicated as more accounts become involved. The perpetrator may need to move more and more money to cover his or her tracks. This could require a second set of books or detailed records. Discovery of those records can obviously help a business prove fraud when it's suspected.

Most signs of lapping are more subtle, though. They include:

- Reduced cash coinciding with increased expenses or reduced revenues,
- Increased billing errors,
- Slow A/R processing,
- Excessive write-offs of A/R,
- Decreasing A/R payments,
- Delayed posting of payments, and
- Customer complaints that their accounts aren't being credited for payments.

Also, because lapping requires a perpetrator to remain constantly vigilant and on the scene to avoid detection, businesses should scrutinize employees who don't take vacation time, requiring all employees to take at least one week of vacation every year. Failure or refusal to do so isn't always a sign of diligence and loyalty.

Prevent it from happening

As with most types of fraud, the best defense against lapping is a strong offense, and attorneys can lead the charge for their clients. Advise businesses to start by maintaining the proper segregation of duties among employees. The person handling checks received from customers should be walled off from the recording of A/R receipts.

Attorneys should also urge clients to consider assigning a different employee to handle customer complaints — fraudsters who receive complaints about billing have a strong incentive to hide them from others. If an owner or manager suspects lapping or any type of fraud is nonetheless going on, financial experts can help uncover solid proof. ■

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