

USE AND MISUSE OF THE FORENSIC ACCOUNTANT

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State Bar of Texas
34TH ANNUAL ADVANCED FAMILY LAW COURSE
August 11-14, 2008
San Antonio

CHAPTER 44

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April 2008

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USE AND MISUSE OF THE FORENSIC ACCOUNTANT

I. INTRODUCTION

It sounds simple – identify, characterize and divide the marital estate – but as nearly every family law practitioner can attest, the actual identification, characterization, and division of the estate can be VERY complicated. Identification of the marital estate involves investigation of the assets and liabilities of the parties which may not be straightforward. Characterization involves the tracing of evidentiary documents that can span decades. Valuation involves investigation, research, calculations, and subjective expertise. Division of the community estate can often require a bit of creative financing. Forensic accountants may be used in a variety of ways to address the property issues of divorce and may ultimately make or break your case. This paper will have a particular focus on the use of the forensic accountant in the business valuation context.

II. ACKNOWLEDGEMENTS

The authors would like to thank Sherri A. Evans and Haran D. Levy for their generous permission to use their paper from the 2006 Marriage Dissolution Institute entitled “Forensic Accounts and Divorce: Asking the Right Questions” and Patrice L. Ferguson for her generous permission to use her paper from the 2006 Advanced Family Law Course entitled “Business Valuation – Concepts, Issues, and Trends.”

USE

III. WHEN SHOULD I USE A FORENSIC ACCOUNTANT?

There are numerous reasons to retain a forensic accountant. The following are some common situations when a forensic accountant may be an invaluable resource.

1. You are not so comfortable identifying and understanding financial and accounting issues.

As an attorney, you must recognize your own strengths and weaknesses and acknowledge your own limitations regarding financial information when determining whether or not to retain the services of a forensic accountant. You need to know what type of attorney you are. The less comfortable you are in identifying and understanding financial and accounting issues, the more likely it is that you should retain outside assistance. Though there may be a lot of self-motivated reasons not to hire a financial expert – i.e., it could limit the amount of funds available to pay your own fees; you are not billing as much time; you may

look less knowledgeable to your client – ultimately, the primary objective should be to provide the best representation to your client.

2. Assets in the estate are not easily identifiable and/or are complex or your client’s knowledge about the estate is limited.

A pivotal/important preliminary step in any aspect of a divorce case is to completely and accurately analyze the case. The issues involved in the case, rather than the size, should be a guiding light in deciding whether to retain a forensic accountant. A thirty million dollar estate may not require the use of an expert when the assets are comprised of easily identifiable brokerage and/or retirement accounts and a three million dollar home. A forensic accountant, however, may be extremely useful when your client has a relatively small estate but the primary asset is a local 7-11. Often, the spouse who controls or manages the business knows as much about the valuation of the business as an expert.

Additionally, you need to recognize and appreciate the extent of your client’s knowledge of the estate. Has your client been the party in charge of the finances or have they been primarily responsible for the children? Do they understand any and all benefits arising out of their spouse’s employment? If there is a closely-held business interest, did they equally participate in the business or is the business primarily run by their spouse? When you have a client with limited knowledge of their estate, a forensic expert can be an invaluable resource. These experts can sort through documents to identify assets that may not have been accounted for, they can conduct financial research and investigation, and they can help to expose potential tax liabilities that need to be addressed and divided.

3. When separate property has been sold and now exists in another form or separate property has been commingled with community funds.

All property owned at the time of divorce is presumptively community and the burden is on the party asserting a separate property claim to prove his or her case by clear and convincing evidence. Tex.Fam.Code §3.003. If the assets involved in the case are limited to property owned prior to the date of marriage, then probably little to no tracing will be required. It will only be necessary to secure the deed, title, or other proof of ownership showing that the asset was owned prior to the date of marriage. On the other hand, the question of characterization can get complicated when that separate property has been sold and now exists in another form of asset or it has been commingled with community funds. It is in these particular instances that it becomes necessary to ‘trace’

the chronology of the asset from date of origin to the date of divorce.

4. The case involves complicated valuation issues.

Assets held in readily identifiable accounts such as brokerage accounts, individual retirement accounts, and defined contribution plans are simple to value and do not require the use of a forensic expert. When there is a disagreement over the value of the marital residence, it is not necessary to hire a forensic accountant. In such instances it is necessary to retain a real estate appraiser with the necessary background and expertise to testify as to the value of the residence. On the other hand, there are certain assets that either should or must necessitate the use of a qualified and experienced forensic expert. In valuation issues more so than any other aspect of your property case, it is important to secure the service of an expert and to make certain that your expert is qualified to value the asset in question.

IV. HOWDO I USE THEIR EXPERTISE?

A. Valuation

Business Valuation

Cost, income, and market approaches are the three generally accepted approaches in determining value. An easy and logical way to think about a business' value is to understand the concept that, as a basic premise, the value of the business equals the present value of future benefits of ownership. The future benefits provide the underlying concepts for the primary methods of valuation: income and market approaches.

1. Income Approaches

Most income approaches – whether capitalization or discounted future returns – are based on the concept that the money an investor pays for a business (or an asset) is the function of the amount of money the investor will receive over time as a benefit of ownership.

a. Capitalized Income Method.

Generally, the capitalized income method means applying one divisor or multiplier to one earnings or cash flow figure which derives an indication of value from that single multiplication or division. This is a simple method in that only two variables are calculated: 1) the income or cash flow returns amount and 2) the appropriate capitalization rate or multiple. This method is most useful when future returns (i.e. earnings, cash flow) are expected to be consistent with

current normalized earnings and future growth is predictable. The variables may become drivers in the valuation. For example, if the sustainable or projected earnings or cash flow are too high or too low, the total value may be affected. The capitalization rate is also a driver that affects value. Important considerations are whether the rate is too high or too low or whether enough risk has been incorporated into the rate.

i. Net Income.

Net income is the most commonly used definition of earnings. Net income is that which is left over after all revenue expenses. After any necessary adjustment or normalization of the financial statements, an expert must decide what amounts of income are sustainable in the future. The expert may utilize historical adjusted earnings, either weighted or unweighted, or develop trend lines based on historical earnings to assist in estimating future earnings. The objective is to calculate what amount of earnings is sustainable in future years.

ii. Capitalization of Income

Capitalization of income also uses normalizing adjustments to arrive at net income which is adjusted for cash flow items. The standard accounting definition of cash flow is net income plus depreciation less increases in capital expenditures plus changes in working capital and debt.

b. Discounted Future Returns Method

The discounted future returns approach requires a quantified forecast of the benefits and is appropriate only to the extent that the projections and assumptions are reliable. This approach is most appropriate when the company's future returns can be reasonably estimated and are expected to differ significantly from its current operations because of changes in business structure, economic conditions, technology changes, and possible regulations.

c. Excess Earnings Method

The excess earnings method – also known as the formula approach – is used for the appraisal of small businesses and professional practices. It is a quasi-income approach. It is based on Revenue Ruling 68-609 which provides a method for valuing intangible assets. The model for this method computes a company's equity value based on the appraised value of tangible assets plus an additional amount for intangible assets. The net tangible assets are valued according to the adjusted book value method and the capitalization of excess earnings is used to value intangible assets. Excess earnings are derived by forecasting normalized annual net income for the entity

as described in the capitalized returns approach. A reasonable return on the net tangible assets is then subtracted from normalized net income to determine excess earnings. The excess earnings are capitalized to arrive at the intangible value of the business.

It is important to note that Revenue Ruling 68-609 mandates that this method be used only if there is no better basis for making a value determination – because this method essentially involves generating a random number or pulling a number out of the air. Thus, if your expert uses this method, be prepared that the other side may attack the use of this method pursuant to Revenue Ruling 68-609.

Conclusion: Determine the stream of earnings or cash flow, whether a single year or future returns (years), make appropriate normalizing adjustments, such as officers' compensation, then prepare to determine enterprise value. Significant drivers of value can include the assumptions used in determining normalizing adjustments (i.e. compensation) and future growth risks in determining discount and capitalization rates.

2. Capitalization Rates and Multiples

Selection of an appropriate discount and capitalization rate presents one of the more difficult tasks a forensic expert must address. Though often used interchangeably, the discount rate and the capitalization rate are different.

a. Discount Rate

The discount rate represents the total expected rate of return that an investor requires to justify investing in an asset because of the amount of risk associated with the investment. For example, an investor may be satisfied with a 6% return on U.S. Treasury notes and bonds, a 8% return on corporate AAA bonds, and a 14% return on corporate junk bonds. The higher the risk, the higher the required rate of return. Thus, the discount rate is used to calculate the future benefit stream (i.e. earnings, cash flow, dividends) to its present value.

b. Capitalization Rate

The capitalization rate (usually defined as the divisor used to convert a defined stream of income to an indicated value) is typically derived from the discount rate. The relationship of the capitalization rate to the discount rate is based on the assumption that the business has a perpetual life and its annual growth in the future will be constant. (This assumption is in conflict with small businesses because no one expects small businesses to have a perpetual life.) Thus, the capitalization rate is derived by subtracting the

expected sustainable growth from the discount rate. Discount rate – growth rate = capitalization rate. When calculating sustainable growth, the forensic accountant must use informed judgment in analyzing the company's historical growth, the projected growth of the industry, and many other factors. It is important that the expert not be misled with projected growth rates in the short term (2-5 years) as the growth rate assumption used to determine the capitalization rate should be the company's expected average annual compound growth rate long term.

c. Build-Up Method

The build-up method is often used in the valuation of closely-held businesses. Some forensic accountants estimate that this method is used 90% of the time. Using the build-up method to determine a discount rate involves adding rates of return and return premiums based on a risk analysis of the company involved. This method may be subject to attack by an IRS ruling similar to Revenue Ruling 68-609 because it also involves essentially generating a random number.

The usual components of the discount rate typically used in the build-up method are: risk-free rate, general risk premium (equity risk premium), industry risk premium, and specific company risk premiums.

i. Risk-Free Rate

This rate is generally considered the rate available in the marketplace on long-term Treasury bonds as of the effective date of the valuation.

ii. General Risk Premium

Also known as equity risk premium, this premium represents the excess return earned by an equity investor over that earned by an investor in long-term Treasury securities.

According to the Ibbotson SBBI 2008 Valuation Yearbook, the equity risk premium is 7.1%. When put in perspective, this number should raise eyebrows. If you had invested in common stock in 1926, you would have earned 7.1% above the yield of 20-year treasury bonds on an annual basis. Treasuries are currently earning approximately 4.5%. Thus, appraisers are thinking that the investor earns over 11%.

iii. Industry Risk Premium

This premium is where the expert looks at characteristics of the industry in which the subject operates. Roger Ibbotson has developed an industry premium methodology that forensic accounts may reference and cite in their appraisal reports.

iv. Size Premium

Forensic accountants often consult Ibbotson Associates' *Stocks, Bonds, Bills and Inflation Yearbook Valuation Edition* to determine equity risk premiums, industry risk premiums, and size premiums. Though a useful tool, this resource is limited to equity returns of publicly-held companies that may be considerably larger than the company being appraised or valued even after adding a size premium.

Additionally, Duff and Phelps has come out with a criticism of Ibbotson data. Thus, it is important for your forensic accountant to be prepared to defend against an attack if he relies on Ibbotson.

According to the Ibbotson SBBI 2008 Valuation Yearbook, the small stock premium is 5.82%. This 5.82% comes from companies that comprise the smallest 10% of Fortune 500 companies and have an average equity capital of \$141 million. Ibbotson is essentially saying that investors who invest in portfolio small businesses will earn 5.82% in excess of the 7.1% plus the 4.5%. Some experts believe this basic tenet of business valuation is pure fantasy.

v. Specific Company Risk Premium

These premiums are risks associated with the specific company being valued. These risks may include the size of the company, the financial risk (amount of leverage in the company), the industry in which the company operates, liquidity concerns, management depth, diversification, geographical location, customer and supplier concentration, etc.

This specific risk premium has to get the appraiser from the Ibbotson small stock premium to your subject company. Nearly all of the textbooks on this subject will say that there is no data on this specific risk premium. Therefore, this has to be a subjective guess. Thus, this is similar to the excess earnings method in that it essentially involves relying on a random number.

d. Multiples

Multiples may be used to translate a percentage capitalization rate to a single number. For example, if a capitalization rate has been determined to be 20%, the multiple would be five (1 divided by .20). Often forensic accounts will reference multiple "rules of thumb" being "three to five times EBITDA." EBITDA = earnings before interest, taxes, depreciation, and amortization.

Conclusion: A discount rate derived by the build-up method is used to calculate the present value of cash flows from future year. Long-term growth is subtracted from the discount rate to derive a capitalization rate. A single-period sustainable earnings or cash flow divided by the capitalization rate

is frequently used to determine enterprise value. Forensic accountants can simplify the mathematical calculations for readers by using multiples in discussion and reports. If the rate or multiple seems too high or too low, value is affected and the rate drives value.

3. Market Approach

The market approach attempts to estimate the value of a business enterprise or an interest in that enterprise by comparisons with similar businesses and/or by comparison with exchanges of similar property in the marketplace. Certain public and private data is used to compare to the target company, assuming an active marketplace exists for the similar information. This approach also includes previous transactions in the company's own stock, as well as the comparable sales method and the public company guideline method.

As a side note, this approach is time consuming and thus experts may not use the approach for that reason.

4. Control, Control Premium, and Discount for Lack of Control

When a publicly-traded company is purchased, a premium is often paid for its common stock. This acquisition premium is an amount paid over the pro-rata share of the minority interests to reflect the power of control as well as any synergies (real or perceived) considered by the buyer. Various studies and surveys attempt to quantify the amount of control premium and its corollary, a discount for lack of control ("DLOC"). Data from these published studies and surveys is extrapolated to determine appropriate discounts or premia to apply. None of the published data, however, allows users to ascertain how much is a control premium and how much is a synergy premium. Control in a company involves the rights of an owner or shareholder to exercise control in the decision-making of the company, such as the ability to declare dividends, to set and pay salaries, to sell portions of the business, to go public, and to set corporate or business policy.

Though the studies and surveys provide guidance, lack of control is not precisely measured. Each shareholder's ownership must be analyzed to determine the true effects of less than 51% ownership. Mergerstat/Shannon Pratt's Control Premium Study suggests that control premiums are in the range of 30-36% and that DLOC are in the range of 23-26%. This DLOC range should be used cautiously because many factors other than control may affect the premiums paid.

5. Discounts for Lack of Marketability

Discounts for lack of marketability (“DLOM”) involve the liquidity of an ownership interest and how easily and quickly it can be converted into cash. Whether a company is closely-held versus publicly-held, whether there are restrictions on the sale of the stock, whether there is evidence of a market, whether there is a meaningful history of dividends, the relative size of the company, and the attractiveness of the company’s industry are all important considerations related to a DLOM.

Numerous studies assist in estimating an appropriate discount for lack of marketability. Broadly speaking, business appraisers use two basic sources of empirical data to estimate the appropriate DLOM for a non-controlling (minority) closely-held interest: discounts on sales of restricted shares of publicly-traded companies and discounts on sales of closely-held company shares to prices of subsequent initial public offerings of the same company shares. (Be aware that the IRS is no longer accepting the latter source of empirical data.) Studies indicate that an average DLOM is between 31-35%.

For an in-depth discussion of the discount for lack of marketability for controlling ownership interests and the controversy surrounding the discount see: Patrice L. Ferguson, *Business Valuation – Concepts, Issues, and Trends*, 2006 Annual Advanced Family Law Course.

A word of caution. The business appraisal community may be biased. Many of the people who put the studies together regarding lack of marketability and minority interests are searching for high discounts/numbers because they want to market themselves to attorneys in support of high numbers to save federal estate and gift taxes.

6. Goodwill

Shannon Pratt has defined goodwill as “the ability to earn a rate of return in excess of a normal rate of return on the net assets of the business.” Pratt, *et al. Valuing Small Businesses and Professional Practices*, 726 (3d ed. 1998) For marital property purposes in Texas, business valuation experts must segregate the personal goodwill from the commercial goodwill of a business. Goodwill is an intangible asset of a business and, as defined by the Internal Revenue Code §197, includes workforce, patents, copyrights, know-how, customer and supply lists, covenants not to compete, business records, and trademarks. In a closely-held business, particularly a service business, the elimination of personal goodwill is frequently one of the most critical drivers in the valuation.

Conclusion: Discounts and elimination of goodwill also drive the value. Although ranges of these DLOC and DLOM (non-controlling) discounts can vary from 23-26% and 31-35% respectively, other studies may place ranges for DLOM as high as 40-50%. The elimination of intangible value rated to personal goodwill can be as high as 90-100% depending on the facts of the business. Therefore, use caution.

7. Cost Approach

The cost approach develops information from the cost of underlying assets and is typically used when the value of the company is heavily dependent on the value of tangible assets and there is little or no intangible value. With this approach the business can be valued as a going concern or on a liquidation basis. A going concern value assumes that the business is a viable operating entity with assets and inventory in place, a work force in place, and with no imminent intent to liquidate or cease operation. A liquidation value can either be an orderly liquidation or forced liquidation and may present itself in certain marital issues where the company is being liquidated to reduce it to a cash asset to be divided by the parties.

Defined Benefit Plans

A defined benefit plan is a plan that is established and maintained by an employer to provide for the payment of a defined annuity to participants over a period of years, usually for life, after retirement. These benefits are mathematically projected and defined, generally based upon factors such as years of service and compensation received by participants. The value of a defined benefit plan requires a determination of the present value of the annuity payments. This calculation involves a two step analysis. The first step requires a determination of the lump sum value of the annuity payments on the date of retirement. The second step of the analysis requires a determination of the value of that lump sum in today’s (date of divorce) dollars and involves applying a second discount to ascertain present value.

The value of a defined benefit plan certainly may be calculated without a forensic accountant. Ultimately whether a forensic accountant should calculate the value depends on your own familiarity and comfort with present value calculations and where you are in the preparation of your case. A preliminary calculation may be utilized for purposes of settlement negotiations and mediation. Due to the subjective nature of the discounts applied, however, it is highly advisable to have a forensic accountant prepared to testify at the time of trial. It is important to note,

however, that a CPA may not be qualified to value a defined benefit plan; you may need an actuary.

Stock Options

Valuation of a stock option can be quite complicated. Many family law attorneys simply estimate the option's intrinsic value – the current fair market value of the stock less the strike price of the option multiplied by the number of options held. 'Intrinsic value,' however, is actually a term, not a true valuation method. Reliance on the intrinsic value of the options fails to account for the time value of the options. The time value of the option is the potential growth of the intrinsic value from the current market price through the end of the option's expiration period. In other words, time value is the incremental amount, over and above intrinsic value, a buyer would be willing to pay for the option. Time value is primarily a function of the time remaining until expiration, the projected volatility of the stock and the option's intrinsic value.

Though the most fail-safe way to limit the volatility of an option is to divide any and all vested options in kind upon divorce, in some circumstances division of the options in kind is not a viable alternative for the parties. For example, the employee spouse may want to maintain all of his employment related benefits. Or if the options are non-transferable, the non-employee spouse may not want to have their ex-spouse serve as a constructive trustee for the options.

Any stock option valuation method depends on assumptions that may or may not hold true. The variables that go into each method are in a constant state of change, limited by the most current information available. In fact, stock options are subject to the ups and downs of the issuing company and the market even more so than the underlying stocks. While the owner of the stock can hold on to the stock and wait for a recovery in a stock's price, options generally become exercisable only at staggered intervals and then expire after a defined length of time. Fixed expiration dates mean that options cannot be held indefinitely like stocks can. However, the right to buy the stock at preset price over a defined period is worth something, i.e. the time value that has no direct counterpart in stock valuation. The applicability of the various methodologies and value calculations will necessitate the use of a forensic expert.

1. Annual Percent Growth Method

The Annual Percent Growth Method is the most common and comprehensible method of valuing stock options. This method takes an annual growth rate for

the company's stock and uses this value to estimate the future value of the stock options. In other words, the Annual Percent Growth model uses the stock's current price and applies a growth rate that yields a projected future value for the stock. For example, assume a stock is trading at \$100 per share. If an annual percent growth of 12% were applied to this stock, in two years it would be worth \$125.44. If the strike price of the option were \$120.00, the future value of this option in two years would be \$125.44 - \$120.00, or \$5.44.

2. Potential Realizable Value Method

The Potential Realizable Value method calculates the potential value of the stock option by assuming annual growth rates of 5% or 10% of the stock price over the term of the option, usually 5 or 10 years.

3. The Black-Scholes Method

The Black-Scholes option pricing model is an extremely complex method of valuing stock options. This method uses interest rates and the stock's price, volatility, yield, and time to exercise to estimate the future value of an option. Market and accounting professionals generally use the Black-Scholes option pricing model. The Black-Scholes model estimates the present value of an option based on several assumptions, including the future volatility of the stock, the risk free rate of return of an U.S. Treasury security, the future dividend yield, and the expected length of time the option is exercisable. This method of valuation is designed only to value options for publicly traded stocks and is inapplicable to options for privately held stock.

The Black-Scholes formula does not rely on investor preferences towards risk. One must determine the range of possible ending intrinsic values and then weigh the range to determine the expected ending. The expected ending is then discounted to present value.

A. Tracing

Tracing involves establishing the separate origin of property through evidence showing the time and means by which the spouse originally obtained possession of property. *Hilliard v. Hilliard*, 725 S.W.2d 722, 723 (Tex.App.--Dallas 1985, no writ). Separate property will retain its character through a series of exchanges so long as the party asserting separate ownership can overcome the presumption of community property by tracing the assets on hand during the marriage back to property that, because of its time and manner of acquisition, is separate in character. *Cockerham v. Cockerham*, 527 S.W.2d 162, 167 (Tex.1975). As long as it can be definitively traced and identified, separate property remains separate even if it undergoes mutations and changes.

Norris v. Vaughan, 260 S.W.2d 676, 679 (Tex.1953). The more complicated the sequence of events, the more necessary it becomes for a forensic accountant to analyze the transactions, prepare the chronology, and, possibly, to testify regarding the separate character of the asset.

1. Commingled Assets

If separate property and community property have been so commingled as to defy resegregation and identification, the statutory presumption of community property will prevail. However, when separate property has not been commingled or its identity as such can be traced, the statutory presumption is dispelled. *Estate of Hanau v. Hanau*, 730 S.W.2d 663, 667 (Tex.1987); *Tarver v. Tarver*, 394 S.W.2d 780, 783 (Tex.1965); *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex.App.--Houston [14th Dist.] 1989, writ denied). The principles of tracing can be applied to bank accounts (see *Sibley v. Sibley*, 286 S.W.2d 657, 659 (Tex.Civ.App.--Dallas 1955, writ dismissed). Proof that community and separate funds are deposited in the same account does not divest the separate funds of their identity and establish the entire amount as community when the separate funds may be traced and the trial court is able to determine accurately the interest of each party. *Holloway v. Holloway*, 671 S.W.2d 51, 60 (Tex.App.--Dallas 1983, writ dismissed).

2. Income from Separate Property

Tracing principles may also be applied to brokerage and retirement accounts. In addition to tracing commingled funds, brokerage and retirement accounts present a different tracing problem. These accounts often pay interest and dividends. When the interest and/or dividends are paid out to the parties, it is easy for the account to maintain its separate character. More often, however, the interest and/or dividends are reinvested back into the account. Income from separate property realized during marriage is community property. Tex.Fam.Code §§3.001, 3.002. Depending on the value of the account, the length of time a party has held the account, and the activity within the account during the marriage, additional tracing issues may be presented that may require a forensic expert to establish the separate character of the account. When the accounts at issue have been actively traded, the tracing can become even more complex.

For example, Wife owns a brokerage account comprised of 50 shares of Exxon and 25 shares of Microsoft at the time of marriage. To the extent these same shares are held at the time of divorce, they will retain their separate character irrespective of the value of the shares. In most brokerage accounts, however, shares of stock are sold and other shares are purchased

(proceeds from separate property remain separate), interest and dividends are paid and reinvested back into the account (community property), additional funds are deposited into the account (community property), and thus tracing complexities emerge.

3. Developments

The tracing of funds through a defined contribution plan is a fairly recent development in the Texas Family Code. Historically, the separate property of a defined contribution plan was limited to the value of the account at the date of marriage. See, e.g. *Hetteberg v. Hetteberg*, 933 S.W.2d 522 (Tex. App.--Houston [1st Dist.] 1994, no writ). As of September 1, 2005, however, the separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to a non-retirement asset. Tex.Fam.Code §3.007(c).

Another fairly recent development in the Texas Family Code necessitates the tracing of post-divorce assets. The characterization of stock options and restricted stock was in dispute for many years. The law evolved and the inception of title rule was applied to the entirety of the grant. The character was determined when title to the options or stock vested. Thus, all options or restricted stock, whether vested or unvested, were deemed community property to the extent they were granted during the marriage. See, e.g., *Charriere v. Charriere*, 7 S.W.3d 217 (Tex. App.-Dallas 1999, no pet.). Today, however, the inception of title rule no longer applies. The Texas Family Code has adopted a rule of proportionality based on the service performed by each marital estate. This rule takes into account options and restricted stock granted before marriage, as well as options and restricted stock requiring service after divorce. One must allocate according to the vesting period before marriage and after. Tex.Fam.Code §3.007(d),(e),(f).

An interesting question arises when the vesting schedule changes after the divorce. For example, assume a 5-year vesting schedule. Options vest one year before marriage, one year during marriage, and the remainder vest each year for three years after marriage. What if, after the divorce, the vesting schedule changes so that all of the remaining options vest in year three. Do you reopen the lawsuit and change the valuation of the options?? Some people say yes.

Even with the developed law, 401K plans in large companies are notorious for not providing enough documentation to do tracing. Thus, often the only option is to take the value of the plan at the time of marriage.

4. Assets Belonging to More Than One Marital Estate

In assessing the character of the assets on hand at the time of divorce, it is worth noting that the answer may not always be as simple as community or separate. Sometimes a situation may arise where the asset will belong to *both* the community estate and a separate estate. Assets purchased during the marriage are presumptively community property. What if separate funds are used as part of the purchase price? What if credit was extended to purchase the asset? In *Gleich v. Bongio*, the court specifically addressed these issues and held that the acquisition of property for consideration paid out of community funds in part and separate funds of one of the spouses in part, creates "tenancy in common" between separate and community estates, each owning an interest in proportion to the consideration provided. 99 S.W.2d 881 (Tex.Com.App.1937). Essentially, the separate interest will be protected to the extent the funds used by the separate estate can be traced back to funds on hand at the time of the marriage. As a proportional owner of the asset, the separate estate will benefit from any increase in value to the asset and will be entitled to a fractional ownership of the asset at the time of divorce, not just a mere return of the amounts originally contributed.

5. Economic Contribution and Reimbursement

If the opposing party may have a separate property claim, then it is necessary to determine whether your client may have an economic contribution or reimbursement claim against the asset. Remember, there can only be an economic contribution or reimbursement claim in a situation where there is more than one marital estate involved. Even where parties have each held control of their own financial accounts and have had sole management of their respective incomes, there is no such thing as a reimbursement claim from one party's community property to the other party's community property. A forensic accountant can help identify any potential economic contribution or reimbursement claims, outline the documents necessary to prove the claim, and calculate the amount of the claim.

B. Identification Of Marital Assets

One of the most frustrating aspects of any property case can be trying to identify the assets in the community estate. Many clients often have extremely limited knowledge regarding the assets and liabilities in the estate. A forensic accountant can be a valuable resource in helping the attorney verify that an asset has not been overlooked. Nevertheless, when a party seeks to defraud their spouse to the extent that they have

filed a false tax return or no tax return at all, things can get complicated. A forensic accountant can help provide the due diligence necessary to best advise your client.

1. Know where to look

An experienced CPA can take a tax return and identify possible red flags that need to be addressed in the preparation of the case. This process usually begins with a comparative analysis of the historical tax returns to determine trends, illustrate significant changes, and identify issues for further discussion. Schedule B – Interest and Dividends can help to identify saving accounts, brokerage accounts, stocks, bonds, and notes receivable. A historical review of this schedule can illustrate account changes, depleted funds, and possibly undisclosed accounts. Schedule C – Profit or Loss From Business will detail all of the income and expenses of a party's sole proprietorship. Schedule D – Capital Gains and Losses will identify the date of acquisition for specified assets and can be helpful in proving a separate property claim. Schedule D will also identify other potentially related tax returns that should be reviewed for pass-through items such as gains or losses from partnerships, S-corporations, or trusts and estates. Schedule E and the supporting schedules of the tax return will outline the specific partnerships, S-corporations, or trust and estates owned by the parties. The forensic CPA can also analyze banking and brokerage statements, financial statements, and benefits packages to help identify marital assets that may or may not have been previously disclosed.

2. Tracing of known accounts

The same methodology of tracing as applied to separate property can be used to help identify missing or unaccounted for assets. Starting with a known source of funds, a forensic CPA can trace funds deposited into and withdrawals coming out of known accounts. Having the CPA prepare an accounting can often answer the common question of "where has all the money gone?" On the other hand, when there are in fact funds that cannot be accounted for by the opposing party, then you as the lawyer have an identifiable amount that you can request the court award to that party as part of their division of the estate. In fact, what you have done is award them a 'phantom asset.' Nevertheless, whether they have spent the money or have it hidden somewhere, you have identified the missing funds and have brought them back into the community estate. The burden of proof is on the managing spouse to prove that a gift or disposition of community funds is not unfair to the rights of other

spouse. *Mazique v. Mazique*, 742 S.W.2d 805, 807 (Tex.App.-Houston [1st Dist.] 1987, no writ).

3. Identify non-traditional assets and liabilities

Failing to identify potential tax liabilities or overlooking possible tax benefits can be detrimental to your client's overall property division. For example, as with any other community liability, if you fail to account for a federal tax liability that your client will ultimately be responsible for and will be paid out of the assets awarded to them in the divorce, then the effective percentage awarded to them will be less than calculated at the time of mediation and/or trial. A CPA can review pay stubs or W-2s and compare the amount of withholdings to the estimated tax payment for a given year. When dealing with a closely-held business interest, a CPA can also examine the estimated tax payments made to date in relation to the historical and potential tax obligation for the year of divorce.

On the other hand, there are also potential tax benefits that should not be overlooked. Many times a party, as part of their divorce planning, will actually increase their withholdings in the year of divorce. If overlooked, this could result in less income during the year of divorce, and yet a possibly significant refund following the divorce. Again, it is important to have the CPA examine both historical and current withholdings and estimated tax payments to identify possible overpayments. The CPA can also help to identify long-term or short-term capital loss carryforwards which can provide significant future tax benefits that should be identified and divided at the time of divorce.

C. **Division Of The Community Estate**

Unfortunately, the complexity of the property division is not always directly related to the size of the estate. In an estate where the sole asset is the family-owned business, it may be difficult to ensure that both parties walk away with their fair share of the community estate. On the other hand, once the assets have been allocated to the appropriate marital estate and have been properly valued, a complex property case could turn out to be relatively easy to divide. Most cases fall somewhere in between these two extremes.

1. Consideration of Taxes

Many family law attorneys have long believed that it was only fair to consider the tax effect of the division of the estate. However, prior to 2005 there was no definitive basis for this position, one way or the other. Texas Family Code Section 7.008 now provides that a court may consider (1) whether a specific asset will be subject to taxation; and (2) if the asset will be subject to taxation, when the tax will be required to be

paid. By specifically using "may" rather than "shall" it is clear that the legislature did not intend for all pre-tax assets to be tax-effected at the time of division. There are circumstances, however, when it would be inequitable not to tax-effect. For example, when one party is awarded primarily pre-tax retirement assets and the other party is awarded primarily liquid, post-tax brokerage accounts, an intended equitable division would be impacted by not only the penalties incurred in making the retirement account into a liquid asset but also by the taxes to be paid at the time of withdrawal. There are also tax consequences to the division of stocks, stock options, and other types of deferred compensation. A CPA can help identify potential tax implications and calculate the tax liability associated with that particular asset.

2. Alimony

Some marital estates do not lend themselves to a clean division. Often the forced sale of a residence or business interest is not practical. Nevertheless, the attorney is still charged with trying to determine a fair and equitable way to divide the estate. Such instances may require creative financing. Contractual alimony is a vehicle often used to facilitate an equitable division. Alimony also poses a number of issues that the CPA can help to address. If your client is the payor, what is the potential tax savings by paying alimony over time as compared to a traditional 'buyout' of the other party's community interest? If your client is the payee, what is the net present value of the income stream?

In negotiations, it is important to ensure that the payments qualify as alimony under the Internal Revenue Code. For example, to qualify as alimony, which is tax deductible by the payor, the payments must cease upon the death of the payee. Although the payee would want to negotiate that the payments would continue as an obligation to their estate, if such a provision were included in the decree or agreement incident to divorce, the payment would not qualify as alimony and the payor would lose the benefit of the alimony deduction. A CPA can also help to ensure that the payments are structured in such a way that they avoid the dreaded 'recapture.' While recapture is a calculation that only a true bean counter could appreciate, in a nutshell if the alimony payments are considered front loaded then a portion of the payment will have to be recaptured and reported as income to the payor, despite the intended tax effect of the payment.

MISUSE

There are likely many ways an attorney may misuse the forensic accountant. Hiring a forensic

accountant who does not have appropriate or adequate qualifications and not effectively using the accountant as part of the case emerge as two significant areas a forensic accountant may be misused. Thus, we will address two areas: Who to hire and How to use the forensic accountant effectively.

V. WHO SHOULD I HIRE?

A. Historical Overview of Expert Testimony

The primary purpose of any expert witness is to present an intelligent evaluation of facts based upon the application of scientific, technical, or other specialized knowledge. Whether the situation is a proper one for the use of expert testimony is to be determined on the basis of assisting the trier of fact. "There is no more certain test for determining when experts may be used than the common sense inquiry whether the untrained layman would be qualified to determine intelligently and to the best possible degree the particular issue without enlightenment from those having a specialized understanding of the subject involved in the dispute." Ladd, *Expert Testimony*, 5 Vand.L.Rev. 414, 418 (1952). Historically, the only limitation placed upon the use of expert testimony was the Rules of Evidence. In 1999, the Federal Rules of Evidence provided "if scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise." Fed.R.Evid. §702 (1999). Although not completely free from challenge or objection, courts routinely permitted most expert testimony absent gross speculation or lack of factual basis.

1. Daubert v. Merrell Dow Pharmaceuticals, Inc.

In the now infamous *Daubert* case, the United States Supreme Court charged trial judges with the responsibility of acting as gatekeepers to exclude unreliable expert testimony. *Daubert v. Merrell Dow Pharmaceuticals, Inc.* 509 U.S. 579 (1993). *Daubert* sets forth a non-exclusive checklist for trial courts to use in assessing the reliability of scientific expert testimony. The specific factors explicated by the *Daubert* Court are (1) whether the expert's technique or theory can be or has been tested – that is, whether the expert's theory can be challenged in some objective sense, or whether it is instead simply a subjective, conclusory approach that can reasonably be assessed for reliability; (2) whether the technique or theory has been subject to peer review and publication; (3) the known or potential rate of error of the technique or theory when applied; (4) the existence and maintenance of standards and controls; and (5) whether

the technique or theory has been generally accepted in the scientific community.

2. Kumho Tire Co. v. Carmichael

Following *Daubert*, most appellate decisions focused specifically on scientific evidence and limited the application of the factors set forth in the case to scientific experts. As a result, most forensic accountants continued to testify without challenge or objection. However, in 1999 the United States Supreme Court again ruled on the admissibility of expert testimony and specifically clarified that a court's 'gatekeeping' obligation applies to all expert testimony, not just testimony based in science. *Kumho Tires Co. v. Carmichael*, 119 S.Ct. 1167 (1999). The Supreme Court held that the rules of evidence do not distinguish between 'scientific' knowledge and 'technical' or 'other specialized' knowledge, but make it clear that any such knowledge might become the subject of expert testimony and that the rules of evidence grant all expert witnesses, not just 'scientific' ones, testimonial latitude unavailable to other witnesses on the assumption that the expert's opinion will have a reliable basis in the knowledge and experience of his discipline. 119 S.Ct. at 1174.

3. Amendments to the Rules of Evidence

In response to *Daubert* and the other cases specifically addressing expert testimony, the Federal Rules of Evidence were amended in 2000 to affirm the trial court's role as gatekeeper and to provide some general standards that the trial court must use to assess the reliability and helpfulness of proffered expert testimony. If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data; (2) the testimony is the product of reliable principles and methods; and (3) the witness has applied the principles and methods to the facts of the case. Fed.R.Evid. 702.

Following *Daubert*, *Kumho*, and the subsequent amendments to the Texas Rules of Evidence, courts have primarily focused on qualifications and acceptance of methodology in evaluating accounting expert testimony. For valuation issues, however, courts tend to focus more on the general acceptability of the valuation method used than with the expert's credentials. Therefore, it is important to carefully identify the issues of your case and the particular expertise required to present the evidence to the ultimate trier of fact.

B. Expert Qualifications

There are no official criteria for determining who is an ‘accountant.’ Rather the designation is usually determined by the curriculum of a particular university or business school. Anyone that performs accounting, bookkeeping, tax, and related services is generally referred to as an accountant. Depending upon the case and the issue, general accounting education and experience may be sufficient to qualify a witness to assist the trier of fact with understanding accounting issues. In circumstances where the issues are more financial in nature it may be beneficial to have an expert with the additional education required to earn an MBA or Masters of Business Administration. In most instances however, the accounting expert should be a Certified Public Accountant, or CPA. A CPA license is earned only through a combination of education, experience, and testing. Most CPA candidates must have a college degree, thirty or more course hours in accounting subjects, two or more years of accounting experience, and they must pass a rigorous examination focusing on theory and practice in auditing, business law and professional responsibilities, accounting, and financial reporting. Like attorneys, CPAs are licensed on a state-by-state basis. CPAs who are also members of AICPA are subject to both state and national professional standards and continuing education requirements. The primary accounting standards that govern accounting and auditing practice are Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS).

C. Professional Accreditation

In addition to the standards established to become a certified public accountant, an expert may hold other designations, especially in the area of business valuation, that are relevant to the selection of the most appropriate expert for your case. Following *Daubert* and the case law specifically applicable to forensic accounting, the educational background, credentials, experience, and knowledge of accepted methodologies of your expert will ultimately determine whether or not that person is qualified to render an opinion.

1. American Institute of Certified Public Accountants (AICPA)

The AICPA is the governing body for all certified public accountants. In addition, the AICPA offers the following business valuation certification:

a. Certified Public Accountant Accredited in Business Valuations (CPA/ABV): certification requires that an applicant be a member in good standing of the AICPA; hold a valid and unrevoked CPA certificate or license; pass a comprehensive business valuation

examination; provide evidence of ten business valuation engagements or projects that demonstrate substantial experience and competence; and provide evidence of 75 hours of life long learning related to the business valuation body of knowledge.

2. National Association of Certified Valuation Analysts (NACVA)

NACVA is a global, professional association that supports the business valuation, litigation consulting, and fraud deterrence disciplines within the CPA and professional business advisory communities and provides the following certification programs:

a. Accredited Valuation Analyst (AVA): professional trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a business degree from an accredited institution of higher education and demonstrate substantial business valuation experience among other requirements.

b. Certified Valuation Analyst (CVA): professional trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a valid license as a Certified Public Accountant.

c. Certified Financial Forensic Analyst (CFFA): this credential is designed to demonstrate to the legal community that the designee possesses a level of experience and knowledge deemed acceptable by the National Association of Certified Valuation Analysts (NACVA) and the Forensic Institute for Financial Experts (FI) to provide competent and professional forensic financial litigation support; the training includes economics, statistics, and calculating damages, followed by a five-day practicum in which participants learn about commercial damages and participate in a damages study, which takes them through the processes of deposition, mediation, and jury trial.

d. Certified Fraud Deterrence Analyst (CFD): professional who has undergone rigorous training and testing to address the broad spectrum of the types of fraud and their ramifications, and includes training in computer fraud and security, both common and uncommon fraud schemes, the newest techniques in internal accounting controls, criminal and civil proceedings and protocols when fraud has been detected, corporate compliance programs, codes of conduct, federal legislation, SEC and Sarbanes-Oxley

requirements and developments, and employee interviewing techniques.

3. American Society of Appraisers (ASA)

The ASA is a self-supporting and independent organization of appraisal professionals and others interested in the appraisal profession. The ASA originated in 1936 and is the oldest and only major appraisal organization representing all of the disciplines of appraisal specialists. The ASA has a mandatory re-accreditation process whereby designated members must regularly submit evidence of professional growth through participation in professional activities and continuing education. The ASA provides the following certification programs:

a. Accredited Member (AM): each accredited member of the American Society of Appraisers has earned a professional designation in one or more specialized areas of appraisal; must complete intensive coursework and pass written examinations, including an examination on the Uniform Standards of Professional Appraisal Practice (USPAP); must submit representative appraisal reports and an appraisal experience log for at least two years; requires a college degree or its equivalent.

b. Accredited Senior Appraiser (ASA): in addition to the qualifications set forth for an accredited member, the ASA designation demonstrates a minimum of 5 years of full-time equivalent appraisal experience and a college degree or its equivalent.

c. Fellow of the American Society of Appraisers (FASA): to achieve the Fellow, an Accredited Senior Appraiser must be recognized by ASA's International Board of Governors for outstanding services to the appraisal profession and/or the society.

4. Institute of Business Appraisers (IBA)

The Institute of Business Appraisers is the oldest professional society devoted solely to the appraisal of closely-held businesses and provides the following valuation certifications. All holders of the designations are required to document 24 hours of continued professional development every 2 years. The IBA provides the following certification programs:

a. Accredited by IBA (AIBA): must possess a 4-year college degree or equivalent; successfully complete an 8-day workshop in valuing closely held businesses, or hold a journeyman level designation in business valuation from compeer organizations recognized by the Institute of Business Appraisers; pass a

comprehensive written examination on current business valuation theory and practice.

b. Certified Business Appraiser (CBA): available to those members of The Institute of Business Appraisers, Inc. who are able to demonstrate that they have attained a high level of professional competence and conduct; requires a 4-year college degree or equivalent; in addition to the 4-year college degree, the applicant must have successfully completed at least 90 classroom hours of upper level course work; at least 24 hours of this coursework must have been in courses offered by the Institute of Business Appraisers; in lieu of the 90 classroom-hour requirement, the applicant may demonstrate 10,000 hours active experience as a business appraiser; experience must include valuation of a variety of business types and appraisals for a variety of purposes; complete a 6 hour, proctored, CBA written examination covering the theory and practice of business appraisal.

c. Master Certified Business Appraiser Accreditation (MCBA): the Master Certified Business Appraiser is the highest professional designation awarded in the business valuation industry; requires a 4-year college degree and a 2-year post-graduate degree; must have held the Certified Business Appraiser designation for not less than 10 years, and must have 15 years full-time experience as a business appraiser; experience must include valuation of a variety of business types and appraisals for a variety of purposes; must hold a professional designation awarded by one or more compeer professional business appraisal societies such as those issued by the American Society of Appraisers, the National Association of Certified Valuation Analysts, and the American Institute of Certified Public Accountants.

d. Business Valuator Accredited for Litigation (BVAL): this designation is designed to recognize experienced business appraisers who demonstrate their ability to competently present expert testimony which supports their objective conclusion of value; must attend 5 days of IBA course; must pass the 4 hour proctored written exam; hold a business appraisal-related designation from IBA, ASA, AICPA or NACVA, or be a CBA candidate who has passed the CBA examination; provide references of trial performance from at least two attorneys.

VI. HOW DO I EFFECTIVELY USE MY FORENSIC EXPERT?

A. Setting the Stage

Even in the most contested custody disputes, it is imperative that you take the time to assess the property issues of the case from the onset. Some times it may be preferable to address the children's issues and the property issues in separate client meetings. Though it may be too premature to address the division of the estate early on in the case, it is important to clearly and succinctly analyze the estate and identify issues that could require the assistance of a forensic expert. Such an expert will certainly be required to perform a valuation of the parties' business interests, trace the separate property or reimbursement claim of a party (or rebut the other party's separate property or reimbursement claims), value and characterize retirement benefits or stock option grants, or testify as to the tax implications of the division of the community estate. These experts should be retained immediately. If a forensic expert is required to help identify or divide the marital estates, that expert can be retained as needed and as the economics of the case permit.

The significance and necessity of retaining a forensic accountant should be discussed with your client in the initial client meeting or the first meeting specifically set aside to address the property issues. The client must understand the services that the expert can provide, the anticipated costs of those services, and the risks associated with not hiring the expert. The purpose of this is twofold. First, the client will understand from the outset that his case is complex enough to require the service and expense of a professional with specialized forensic skills, avoiding debates later over whether or not such services are necessary. Furthermore, the client will know from the beginning that you and the expert are a 'team' who will be working together to protect his or her interests. Second, though there are cases where a forensic accountant can be considered an optional benefit to the client, there are other cases where the expert should be considered a necessity. A client with substantial issues to be addressed, but who does not want to spend the money necessary to hire experts to work on his or her case, should send up a red flag to the attorney.

For example, a client comes into the marriage with a separate property brokerage account. During the marriage, dividends and interest are reinvested into the account, thereby creating a community interest in the account. During the marriage, the client also purchases shares of stock in a booming company out of the brokerage account. At the time of divorce, the value of the stock has increased tenfold. Client claims all of the shares at their enhanced value as their

separate property because the shares were purchased out of his or her account. This client needs to understand that their refusal to spend the money to properly trace the brokerage account could not only limit their interest in the account to the value as of the date of marriage but could also result in the shares of stock in the booming company to be deemed community property. On the other hand, if properly traced, the shares of stock would in fact be their separate property and he would be awarded those shares at their current fair market value.

The attorney should always defer the ultimate decision as to whether or not to hire a forensic accountant to the client. If the client fully understands the issues, the risks and the potential harm to their case, and they still elect not to retain an expert the attorney should document that decision with a follow up letter to the client. It is only when the attorney fails to go through these requisite steps that they can get themselves into trouble in the case.

B. Lining Up the Expert

Sometimes it is helpful to have a prospective expert available at the client meeting. These experts are often in a better position to outline the issues and services that they can provide than the attorney. Even if the client still decides against their expertise, you as the attorney have made an added layer of advice available to the client. On the other hand, if the decision is made to retain the expert, that expert is readily available to outline the scope of their work and outline the documents necessary to begin their work.

Another benefit of getting the expert involved at the very beginning of the case is being able to ensure that you can retain the expert of your choice. Most CPA firms do not limit their practice to litigation support. Often they are involved in preparing personal tax returns or providing accounting services for closely held business interests. They may also provide tax or consulting services for other business entities. In these circumstances a conflict of interest could arise that would prevent the expert from being retained by one of the parties. You also stand the risk that your preferred expert will be retained by the other side. Therefore, it is wise to have the client interview and retain a forensic accountant as soon as the necessity has been addressed and the client has consented.

C. Making the Expert Part of Your Case

The forensic accountant will do most if not all of the investigative work during the preparation of your property case. The expert may have to analyze ancient brokerage statements to prepare a tracing schedule or review aged receivable reports to perform a business valuation. The working relationship and

communication between the attorney and the expert is crucial to the preparation and trial of the client's case. The proper utilization of the expert during the preparation process can strengthen your position and allow you to better advocate for your client. Particularly when the expert's work involves a substantial and complex aspect of your case, it is crucial that your expert is kept in the loop.

1. Securing and Producing Documents

When your client owns the closely held business interest or is trying to assert a separate property claim, the expert can help to identify those documents that must be assimilated and analyzed to help prove your case. On the other hand, if you represent the other side of the case, the forensic expert can help to identify those documents that need to be requested and reviewed. In many instances, a standard production request can be insufficient. For example, what if the case involves the valuation of an oil and gas company or a medical practice? Your forensic accountant knows exactly what documents they need to review; therefore, get their document request and incorporate it into your request for production.

While the forensic accountant will provide the necessary qualifications and expertise to protect your client's financial well-being, the use of such an expert also mandates an added layer of organization for the attorney. Most attorneys are used to securing and producing documents between the parties. However, when you utilize an accounting expert, the documents also have to be provided to that expert. It is imperative that the attorney organize the documents received from the other side and provide them to their expert. It is also important to ensure that all documents provided to the expert are also made available to the other side. Remember, parties are required to disclose "all documents, tangible things, reports, models, or data compilations that have been provided to, reviewed by, or prepared by or for the expert in anticipation of the expert's testimony." Tex.R.Civ.P. 194.2(f)(4)(a). Failure to do so can result in the court denying that expert's testimony at the time of trial. Tex.R.Civ.P. 193.6(a). An organizational tip for the attorney to consider is the use of a production index. By keeping a master document outlining all documents produced and received, and by providing this document to your expert, you can ensure your expert has all necessary documents available to perform their designated task in a timely manner.

2. Deposition Preparation

It can be extremely frustrating, as well as very detrimental to your case, to take on an opposing expert at the time of trial only to be bombarded with a series

of columns indicating comparable profit or loss, ratios, indexes, averages, medians, etc. In the hands of an experienced expert witness, the truth can often become clouded. In lieu of addressing these issues for the first time during trial, a deposition prior to trial can provide an invaluable tool. A deposition can provide a system for discovering the raw data the expert relied upon to formulate his valuation report. It can also be used to determine the methodologies that the expert relied upon in tracing a separate account. Whatever the issue, it is important to identify and understand the expert's opinion and the testimony that they intend to present at the time of trial.

Prior to the deposition, make sure that you have been provided a copy of the other side's expert report. Make sure that this report is immediately provided to your expert. Since your expert has presumably been provided the same information and documentation, they will be in a position to provide feedback and suggest lines of inquiry. They will be able to highlight the strengths and weaknesses of the other side's expert report. You should also have your expert prepare key questions for the deposition that can assist you in understanding or undermining the expert's opinions.

Depending upon the economics of your case, having your expert attend the deposition of the opposing experts and the opposing party can often be extremely helpful. It is critical to remember, however, that the expert will not be allowed to attend the deposition unless notice of his appearance has already been provided to opposing counsel. As a precautionary measure, you should include a sentence in your deposition notice, announcing that your expert may attend the deposition, simply to ensure that he will be allowed to attend without necessarily committing your client's money and your expert's time if you later determine attendance is not necessary.

3. Mediation

Having your accounting expert attend mediation is another important option to consider. In many instances, a major point of contention will be the difference in the experts' opinions, especially relating to characterization or valuation issues. If the experts are made a part of the mediation process, they are then available to discuss the underlying facts, their assumptions and calculations, and the basis for their expert opinion. Remember, part of the calculation of 'value' includes the application of certain subjective variables. At mediation, experienced forensic accountants can also review the assumptions and calculations made by the other side and provide a range of legitimate values that should be considered as part of the mediation process. Furthermore, your accounting expert can work with you and your client in

preparing and evaluating settlement proposals, they can discuss any financial or tax implications of various settlement scenarios, and they can perform present value alimony calculations.

D. Protecting Your Expert Testimony

1. Designation of Expert Witnesses

Texas Rule of Civil Procedure 195.2 requires any party seeking affirmative relief to designate their testifying experts 30 days after receipt of a Request for Disclosure or 90 days prior to the end of the discovery periods, whichever occurs later. This means that there is a duty to designate experts 120 days prior to trial, even when no Request for Disclosure has been propounded. More importantly, the rule requires that the expert be designated by furnishing information requested under Rule 194.2(f). This information includes the expert's name, address, and telephone number; the subject matter on which the expert will testify; the general substance of the expert's mental impression and opinions and a brief summary of the basis for them; all documents, tangible things, reports, models, or data compilations that have been provided to, reviewed by, or prepared by or for the experts in anticipation of the expert's testimony; and the expert's current resume.

2. Providing the Expert Report

In most family law matters, it is very difficult to designate the expert and produce a report 120 days prior to trial. There is no requirement that parties automatically produce expert reports. However, in such instances, a party is required to tender that expert and make them available for deposition. Another alternative is to enter into an Agreed Scheduling Order or Rule 11 Agreement specifically outlining deadlines for expert designation, production of expert reports, expert depositions, and supplementation. Unless a party can show good cause or lack of surprise, a party who fails to make, amend, or supplement a discovery response in a timely manner may not introduce in evidence that material or information that was not timely disclosed, or offer the testimony of a witness (other than a named party) who was not timely identified. Tex.R.Civ.P. 193.6(a).

3. Supplementing Deposition Testimony

To the extent a party's retained testifying expert changes or modifies their opinion, the party must amend and supplement the expert's deposition testimony regarding the expert's mental impressions or opinions and the basis for them. Tex.R.Civ.P. 195.6.

E. Expert Testimony

1. Prepare Yourself and Your Expert for a *Daubert* Challenge

a. Surviving the Challenge

Prior to your expert's deposition or trial testimony it is important to take the time to anticipate and prepare both yourself and your expert for a *Daubert* challenge. Educate your expert on the factors set out in the *Daubert* and *Robinson* cases and provide them with the latest case law applicable to their field. Allow your expert time to carefully consider the point of the inquiry and its specific applicability to the testimony they plan to offer. Once a *Daubert* challenge is raised, the burden is on the proponent of the expert to establish both the qualifications of the expert and the reliability of the methodology relied upon by the expert in drawing their eventual conclusions. The key is to remember the point of the *Daubert* factors collectively – to establish the reliability of the methodology used either directly by the expert or the reliability of the underlying methodology of the theory, test, or technique relied upon by the expert. Finally, take the time to demonstrate through your line of questioning that your expert not only based their conclusions upon reliable methodology but that your expert followed it in this particular case.

The build-up method used in business appraisal may actually not meet the reliability standards of *Daubert*, et al. because it cannot be tested and a critical component -- specific risk -- is completely subjective. Be warned. Just because a method is universally used by the business appraisal community does not necessarily mean it is reliable.

b. Raising the Challenge

The other side of the coin is, of course, bringing the challenge yourself – essentially putting opposing counsel and their expert on the proverbial 'hot seat.' An unprepared attorney will be hard-pressed to not only recall the *Daubert* factors but to craft those factors into a series of questions in order to successfully bring their expert through a challenge. In your cross-examination of their expert, use the same careful and methodical series of questions that you would use to sustain your own expert to illustrate to the judge the deficiencies of the opposing side's expert on the issue of reliability. At the conclusion of testimony at the *Daubert* hearing, point out to the court that, regardless of the expert's qualifications, *Daubert* and the line of cases following it require reliability and argue that based on this expert's answers, or lack thereof, they cannot get there. Irrespective of the court's ruling, make sure that you get a ruling from the judge to preserve error for a possible appeal.

VII. CONCLUSION

Experts can be invaluable resources for the property aspect of a divorce case and may be used in traditional and non-traditional ways. Always keep in mind that however valuable an expert may be, the expert can become useless if you as the attorney do not verify that the expert is qualified or effectively integrate the expert into your case. So start early on in the case with a carefully chosen expert so that you maximize the use of – and do not misuse – the forensic expert.