



## AICPA Alert

by Paul Regan, CPA

The AICPA has made substantial progress in finalizing the Body of Knowledge (BoK) to support its CFF credential. It has also established the courses that it will be offering to support this BoK. The three subject matter modules used to present the BoK, their subject areas and hours, totaling 37.5, are:

### Fundamental Forensic Knowledge:

Professional Responsibility (2.5), Applicable Professional Standards (2.5), Information Gathering (2.5), Interviewing (2.5) and Reporting (2.5)

### Specialized Forensic Knowledge:

Bankruptcy (2.5) and Computer Forensics (2.5)

### Economic Damages:

Businesses (2.5), Individuals (2.5), Intellectual Property (2.5), Family Law (2.5), Financial Statement Misrepresentations (5.0), Fraud Prevention, Detection and Response (2.5) and Valuation (2.5).

Fundamental Forensic Knowledge is the core knowledge of all forensic engagements that should be mastered by all CPAs providing

forensic services. It includes a discussion of the applicable Code of Professional Conduct, Statement on Standards for Consulting Services No. 1, Statement on Standards for Valuation Services No. 1 and the non-authoritative guidance provided by Consulting Services Special Report 03-1, as well as the other practice aids relating to forensic and valuation engagements. Also covered is how information is gathered from the parties to the dispute; information from public sources; and effective interviewing techniques of client, third party and opposing party personnel. Finally, the reporting requirements (and non-requirements) and techniques will be presented.

The Specialized Forensic Knowledge and Economic Damages modules are designed to provide a broad overview of these areas. Although the subject areas chosen will not always be encountered by every CFF, they are sufficiently common that the CFF candidate should be aware of their special challenges and techniques. Also, although there are other areas of specialized knowledge and economic damages, by exposing the CFF candidate to both the fundamentals of forensic knowledge and these specialized forensic and damages areas, the candidate will possess the core skills to be equipped to learn and master the other areas not included in these modules.

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and a return to profitability, particularly for small businesses?

To further complicate the use of the income approach, how do you develop a supportable discount rate or cost of capital to apply to the cash flow stream in this environment? The cost of capital compensates an investor for the passage of time, the expected rate of inflation, and the additional risk premium associated with investing in a business opportunity vs. a less risky or possibly risk-free scenario.

Traditionally, investors in closely held businesses are looking for 20 percent to 35 percent rates of return on a per annum basis. Is that still the market? In this risky environment, wouldn't you consider changing your requirements for your hurdle rate of return? And, to top that off, our traditional build up approach is less scientific than ever! With the risk-free rate hovering around 3 percent, the supply side equity risk premium at 5.7 percent and tenth decile small stock premiums close to 6 percent, we are now at approximately 15 percent for a build up rate before consideration of specific company risk factors, which are subjective. And guess what? I find myself wanting to get my discount rates between 25 percent and

30 percent because of my perspective on risk in this economy, which means that I am adding a 10 percent to 15 percent specific company risk factor which continues to add more subjectivity than ever to the discount rate and accordingly to the valuation!

Consider the underlying asset or cost approach. Traditionally, operating companies are valued using an income or market approach, or a combination of both. If the business being valued has neither cash flows nor meaningful comparisons in the current market place, we are pretty much resigned to using some form of the asset approach. A significant number of businesses that have previously been valued using traditional approaches are now resigned to live with the fact that their values under the current economic climate are the fair market value of existing assets minus liabilities. This raises the next question: What is the true value of the underlying assets for the business that may well be in trouble? It certainly isn't the carrying or book value. The valuation analyst has to look at each asset grouping and make a determination as to whether there will be an upward or downward adjustment to the balance sheet. This may well require the valuation analyst to get sub appraisers involved for equipment and real estate appraisals. To complicate matters further,

these appraisals may have to be done both under a going concern and a liquidation premise.

Developing a valuation conclusion that an appraiser is comfortable with is difficult and complicated. The market approach is more suspect than ever due to the lack of meaningful comps in the market place. The income approach is problematic because of potential wild judgments in both cash flow assumptions and discount rates. How about the underlying asset approach? Valuing each and every group of assets probably under two scenarios—going concern and liquidation. Is there an answer? Yes. Caution! Stay with the basics and use your best judgment.

There is a silver lining in the valuation industry during these economic times: this is a phenomenal time in the non-litigation arena to consider shifting ownership of family businesses to the next generation! These values may be at all-time lows and present a perfect opportunity to take advantage of a difficult economy and transfer illiquid business interests to family members by using creative gifting or sales techniques. **James A. Andersen, CPA, ABV, CFF, ASA** is a partner in the consulting, business valuation and litigation practice area of Burr Pilger & Mayer, LLP in San Francisco.

# HAPPENINGS

## LITIGATION SECTIONS MEETINGS

Business Valuation	Thurs., Nov. 5	OAK
Economic Damages	Tues., Sept. 15	LAX
Family Law	Fri., Nov. 6	OAK
Fraud	Wed., Sept. 16	LAX

Each section will send individual meeting notices.  
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## EDUCATION FOUNDATION COURSE OFFERINGS

(800) 922-5272 or [www.educationfoundation.org](http://www.educationfoundation.org)

2009 ABV Examination Review Course	Mon.-Wed., Oct. 5-7	SF
Business Valuation Fundamentals: Part 2	Mon.-Wed., Aug. 24-26	LA/BH
California Community Property	Wed., Oct. 28	SFO
Family Law Conference	Thurs., Oct. 22 Fri., Oct. 23	LAX SF
Fighting Fraud Using Data Analysis	Fri., Aug. 28 Mon., Oct. 26	Monterey OC South
Financial Fraud Investigation Methodology	Tues., Nov. 10	SD
Forensic Auditing: The Audit of the Future Today	Thurs., Aug. 27 Tues., Sept. 22 Tues., Oct. 27 Wed., Nov 11	Monterey SF OC South SD
Incorporating Forensic Professionals Into the Audit	Wed., Sep. 23	SF

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The other dilemma is that support orders are often of limited duration. For example, child support is generally only valid until the child turns 18 or graduates from high school. Thus, a spouse obligated to pay support can use a “temporary” downturn to depress income long enough for a support order to expire.

So what is a court to do with these construction contractors and real estate agents? Since no one has a crystal ball that will tell us how quickly these industries will

recover, is it fair to charge these spouses with earnings from the boom years? However, as with imputation of income, trying to sort out the intentional versus unintentional decline in income is tricky, if not impossible. It may be helpful to determine how the parties addressed earlier economic downturns when they were a family unit.

*Debt Relief.* Debt relief has become increasingly commonplace with property foreclosures and short sales. Any debt or portion thereof that was not incurred for the actual purchase or improvement of a

qualified personal residence will probably be considered taxable income.

How should the Court address forgiveness of debt for a line of credit that was used for the party’s lifestyle? This represents cash received that will not be repaid. This seems to fit the definition of income, but when is it considered income? When the proceeds were received or when the debt is forgiven? Either way, the funds are now gone, so is it realistic to charge a spouse with support on those funds? Where will the spouse now get the cash to pay that support? Should the courts start including draws on lines of credit as income and then future repayments as reduction of income?

### Lack of Answers

This article contains a number of questions and few answers because there is little case law to provide guidance in these areas. Family law practitioners and the courts are approaching these questions with reasoning and a sense of fairness to both parties. These are interesting times for those of us who practice in family law, so stay tuned.

**Leslie O. Dawson, CPA, ABV, CFF, CVA**

*is a partner of Glenn & Dawson, LLP in Walnut Creek.*

*The Witness Chair* is published three times a year by the Litigation Sections of the California Society of Certified Public Accountants.

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# THE Witness Chair

Leading-edge Ideas for CPAs Providing Litigation and Dispute Resolution Services

SUMMER 2009

California Society of Certified Public Accountants

ISSUE 50

## Valuing Businesses In Distressed Economic Times: What Makes Sense?

by James A. Andersen, CPA

**What a ride** we have been on for nearly two years. Near collapse of the financial markets, the biggest tanking of real estate values in more than 50 years, a 40 percent drop in the stock market, many business segments hanging on by the skin of their teeth ... the list goes on and on.

What makes sense in the valuation arena based on the difficult economic times that we are encountering? Fundamentals are fundamentals; however, we have to take a harder look at underlying data to make sure that the information we are using for our valuation conclusions truly makes sense.

### Three Valuation Methods

Businesses, like real estate, are valued using three methodologies: the market approach, the income approach and the underlying asset or cost approach. Any way you slice it, all three methods of valuing businesses in today's marketplace result in dramatically reduced values when compared with pre-2008 numbers.

The market approach requires the research of "comps" in the market place. This is accomplished by considering both the guideline company method (publicly traded companies resulting in a marketable minority value) and the transaction method (sales of typically smaller businesses valued as a controlling interest).

The guideline company method attempts to develop a correlation between a closely held family business and the publicly traded counterpart. The problem with this methodology is that most publicly traded companies are too large to be considered truly comparable to small businesses because of a number of factors: diversification of product mix; layers and sophistication of

management; deeper capital resources; etc. My experience has been that occasionally a guideline company search may assist in common sizing key economic data, and that is about it. Conclusion: this method is rarely used in valuing companies in the private sector, particularly in these volatile times.

The transaction method relies on the use of transactional databases that provide statistical data by industry regarding sales price, terms and pricing multiples in relation to revenues, earnings, book value, etc. The key difference when using the transaction method as opposed to the guideline company method is that the comparative data is from transactions involving large interests in companies, typically controlling, and often the entire company.

Several databases are available that have completed transactions listed by SIC code or NAICS code. Some of the more commonly used databases include *Bizcomps*, published by Jack Sanders; *The IBA Market Database*, published by the Institute of Business Appraisers; and *Pratt's Stats*, published by Shannon Pratt.

Prior to January 2008, I used this method as one of my primary valuation metrics in coming up with a reasonable valuation conclusion. However, when considering the use of transactional databases as a primary valuation methodology in today's market, it is nearly impossible to find reliable data points for business sales after 2007. How do you rely on pre-2008 transactional data when the world is a different place today?

Under today's market conditions, I recommend the market approach be used only as a sanity check due to insufficient market comps and the fact that, if comps are available, then they may well be driven by distressed sales.

The income approach is based on the theory that the value of any asset is based on the premise of the present value of its expected future returns. When utilizing the income approach, two things need to be determined: the sustainable cash flow on a going forward basis and the cost of capital, or discount rate.

The starting point with the income approach is developing a cash flow model and determining the most likely sustainable cash flow on a going-forward basis. Two methods are considered: using historical data as a proxy for what will take place in the future or developing a reliable forecast model based upon anticipated future results. Where are the holes when considering either of these two methods?

Let's say that prior to 2008 your business had a predictable and constant profit stream that would indicate the use of a single period cash flow model. Now your business is hemorrhaging cash. Is historical performance a good indicator of what will happen on a going-forward basis, particularly in light of today's tailspin?

How about developing a reliable forecast model so we can implement a discounted cash flow method? Who has the crystal ball that will indicate turnaround probabilities

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## SectionAction

### Business Valuation

by Scott T. Dye, CPA

In recent tax court cases, it has been rare that we have seen verdicts in favor of the taxpayer. However, in *Estate of Miller v. Commissioner* (May 27, 2009), the case was decided for the taxpayer ... almost. In this case, there were two separate transfers to the family limited partnership. The initial transfer that established the FLP in 2002 consisted of approximately \$3.8 million of marketable securities. An appraisal for gift tax purposes performed at the time took a 35 percent discount for lack of marketability.

Shortly after formation, Miller was diagnosed with a terminal illness and the remaining assets in her estate were transferred to the FLP. She died within a few weeks of the transfer. The second transfer was for about \$900,000. After her death, assets from the FLP were used to pay estate taxes. In the estate, the FLP was valued at approximately \$2.6 million after a 35 percent discount for marketability. The IRS audited and assessed a deficiency of more than \$500,000.

Interestingly, the IRS did not attack the discount, a win in itself, but wanted the value to be included in the estate at full value under IRC Sec. 2036(a), claiming no valid business purpose.

The estate argued that the primary reason for the FLP was a family specific investment strategy. In regards to the initial funding, the court agreed with the estate, stating that an FLP's activities "need not rise to the level of a business" to qualify as a transfer under 2036(a). It was noted that the first transfer left assets in the control of Miller and the transferred assets were managed by the son as managing partner of the FLP. However, it was deemed that the only purpose of the second transfer was to reduce the estate and therefore reduce estate taxes. Thus, this transfer would be included at full value in the estate.

**Scott T. Dye, CPA, ABV, CVA** is Business Valuation Section chair and a shareholder of Stoughton Davidson Accountancy Corporation in Fresno.

### Economic Damages

by Christian D. Tregillis, CPA

Following on recent years' rulings which have applied limitations to the size of punitive damages awards, the California Courts of Appeal have issued four unpublished opinions reversing punitive damage awards as a result of plaintiffs' failure to present adequate evidence of the financial condition of defendants.

California has a unique requirement that a plaintiff must introduce evidence of the defendant's financial condition to recover punitive damages. The evidence must provide meaningful insight on the defendant's ability to pay, as of the time of trial. Evidence of earnings or assets, without evidence of liabilities, is not enough. The California Supreme Court set out this rule in *Adams v. Murakami* (1991) 54 Cal.3d 105, 112.

In *Adams*, the court held that evidence of the defendant's financial condition is a prerequisite to an award of punitive damages and that the burden of introducing such evidence is on the plaintiff. (Id. at pp. 109, 116, 123.) The court reasoned that, although the determination of whether an award is excessive is an unscientific process, when provided with evidence of the defendant's financial condition the reviewing court can at least reach a reasonably informed decision. "Without such evidence, a reviewing court can only speculate as to whether the award is appropriate or excessive." (Id. at p. 112.)

The California Court of Appeal (Fourth District, Division Three) recently reversed a \$50 million punitive damages award in *Electronic Funds Solutions, LLC v. Murphy* (2009) on the ground that plaintiff failed to put forward evidence of defendant's net worth, writing that "net worth may be subject to manipulation, requiring the court to consider other financial indicators of a defendant's ability to pay."

As an example, the court cited *Zaxis Wireless Communications, Inc.* (2001) 89 Cal. App.4th 577, 582-583 for the proposition that a "\$300,000 punitive damage award

[can be] upheld despite large negative net worth where defendant had annual gross revenues in excess of \$100 million and cash on hand of \$19 million." By contrast, the punitive damages award in this case had to be reversed because: "Here, plaintiffs point to the income calculations for [defendant] used in supporting their compensatory damages claim, in which they determined [defendant] earned \$8,128,800 per year in net income. Viewed in this light, the \$50 million punitive damages award represented approximately six times [defendant's] annual income. Such an award would be ruinous to any company, not to mention its owners."

In *Monier-Kilgore v. Flores* (2009) the California Court of Appeal (Third Appellate District) issued an unpublished opinion reversing \$1.1 million in punitive damages where plaintiff put on evidence regarding the plaintiff's income and bank deposits, but no evidence of the defendant's liabilities and expenses. Without such evidence, the court found the jury had no basis for determining the defendant's net worth or ability to pay punitive damages, especially since many of the defendant's assets would be needed to satisfy the compensatory damages award.

**Christian D. Tregillis, CPA, ABV, CLP** is Economic Damages Section chair and managing director of LECG in Los Angeles.

### Family Law

by Lionel T. Engleman, CPA

The level of financial volatility continues to pose many issues for CPAs with family law practices. It has created additional possibilities for divergent opinions by different experts. The financial strains are also requiring family law practitioners to be more vigilant about fees.

It appears that the framework for determining income and cash available for support is expanding, and the more inclusive definition of "income" for child support has increased. A recent case indicated that continuing gifts from grandparents may be used for a basis of child support (*Marriage of Alter*, California Court of Appeal, 6 Civ H032390, 171 Cal.App.4th 718, 89 Cal. Rptr.3d 849, 2009 FA 1380).

At the same time, the use of past levels of income for spousal support has taken on less weight as courts focus on current income. The formulaic approach that divides

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income into the base or recurring income and the discretionary or bonus income has become more popular. A percentage of the discretionary or bonus income can be paid as additional support. The use of this approach requires a more detailed analysis of the underlying income, even in the area of wages.

For business valuation, the use of past income or cash flow has to be analyzed in more detail. Today's level of financial volatility has raised questions about the use of estimated future levels of income or cash flow and the discounted cash flow model for valuation. However, because of the separate property nature of future services and activities, this approach has not received family court approval. In addition, the valuation of a business as of a certain date places limitation issues as to subsequent events. A subsequent event now needs to be more fully analyzed as to the likelihood of that event occurring versus the knowledge that it has occurred.

At the same time, there are changes occurring in the document discovery process with more and more information being stored on electronic devices. The family law courts are beginning to understand some of the related problems. The process of matching these problems with the cost of solving them is only just the beginning. As expected, attorneys often rely on the accountants to gather and control documents. In these cases, the additional fees need to be clearly understood by the attorney and the client, or the chance of not being able to collect for this work may be high.

There is going to be more reliance on the CPAs work in family law with a lagging appreciation for fees to accomplish it. CPAs must be cautious to make sure their bridge is built firm over these troubled waters.

**Lionel T. Engleman, CPA** is Family Law Section chair and shareholder in Engleman Accountancy Corporation in San Mateo.

## Fraud

by Jennifer Ziegler, CPA

**At the last** Fraud Section meeting, Stephanie Sessions Perkins from Chapman, Glucksmann & Dean started the day off with a presentation about "Why CPAs Get Sued in Audit Litigation." Perkins reviewed the pitfalls accountants have fallen into based on her experience representing accountants in professional liability and malpractice matters. A few take-away points included

## Message From the Chair

by Ronald L. Durkin, CPA



**As a member** of the AICPA's National Accreditation Commission, I am one of the commissioners responsible for a new program to attract younger professionals to the forensic practice through the Certified in Financial Forensics credential.

In thinking about how to best reach the target audience, I thought there would be no better way to achieve that goal than to have a younger professional make the statement for me. I've asked Daniel P. Dehner, CPA, CFE, a senior consultant with my firm, to share his perspective with you. Dan is just shy of the five-year experience requirement for a CFF.

Dan writes: The Certified in Financial Forensics credential will provide the opportunity for younger professionals to be exposed to the various disciplines in forensic accounting. When I began my career at a Big Four firm, it was widely understood that the average lifespan of a new staff person was somewhere between three and five years. While many CPAs do make working at a Big Four firm a lifelong career, most of my colleagues gradually started leaving the firm to go into the common second lives of CPAs, mainly internal audit, private accounting and financial reporting positions. The common misconception of professionals looking to leave the large firms is that there are only a few options available to them. There is an abundance of top professionals going into industry never knowing that forensic accounting is an area that would be a perfect fit for their skill sets.

While I enjoyed working at a Big Four firm, I was always interested in a more stimulating long-term career. I was fortunate to receive an opportunity to go into the forensic accounting field, and have since had the chance to speak to students and other young professionals about the many options available within the CPA profession. The main reaction I receive is that they had no idea that forensic accounting even existed, let alone know that becoming a CPA is the perfect pathway to a successful career.

In today's economic climate, forensic accounting is expanding far beyond a niche specialty, providing more career opportunities to younger professionals. Our challenge in forensic accounting is recruiting those with the necessary skill sets who will serve as the model next generation of CFFs. If we simply educate students and young professionals about forensic accounting, the allure of the profession will take care of the rest.

— **Ronald L. Durkin, CPA, CFF, CFE, CIRA** is senior managing director of Durkin Forensic, Inc. in San Diego.

assessing the type of clients that you accept, considering declining work in an area in which you have inadequate experience and documenting your work and client communications as if you were being sued.

After Perkins, I gave an update on the body of knowledge for the Certified in Financial Forensics credential and Cookie Lewis, of Ask Infomania, discussed new cases and issues related to fraud and litigation.

Nina Marino, Esq. of Kaplan Marino APC, then spoke about "The Role of the Audit Committee." Marino explained the basics of the audit committee, as well as its relation to other parts of the corporation.

Our final speaker was Steven Katzman,

Esq., of Bienert, Miller, Weitzel & Katzman, who spoke about "Navigating Between Bankruptcy and Criminal Corners in the Face of the Mortgage Meltdown." Katzman rolled with the punches as attendees asked questions that led to an in-depth discussion of the fraud investigations landscape. He also educated the attendees with his experience as a bankruptcy trustee.

Not attending the meetings? You are missing out on up-to-the-minute information. Please join us at the next meeting Wednesday, Sept. 16, in Los Angeles. **Jennifer Ziegler, CPA, CFF, CFE** is a director at Hemming Morse, Inc., CPAs, Litigation & Forensic Consultants in Los Angeles.



## Keepin' It Legal

# Income for Support in a 'Down' Economy

by Leslie O. Dawson, CPA

During divorce, determining the “income available for support” for a spouse who is self employed or has fluctuating income is a subjective and highly debated issue. Throw in the economic downturn and the issue becomes increasingly complex yet more interesting.

### Review of Income for Support

California Family Code Sec. 4058 defines income for child support as income from whatever source derived. The definition includes gross business receipts less the expenses *required* for the operation of the business. It also may include employment benefits that reduce living expenses (housing and automobile allowances).

In *In re Marriage of Riddle* (125 Cal. App.4th 1075), the appellate court discussed its view of the term “income” as it pertains to family law statutes. It stated that “cash flow is not necessarily income.”

“While we recognize that family lawyers and forensic accountants sometimes use the phrase ‘cash flow’ as a sloppy synonym for the word ‘income’ as it appears in the support statutes, it isn’t. In particular, the support laws are very exacting as to the definition of income. The language was ‘lifted’ straight from the Internal Revenue Code.”

*Riddle* also discussed that the time samples for determining income available for support must be fair and representative.

Easy, right? Straight from the tax code, right?

Here are some differences between taxable income and income available for support:

1) *Capital gains*. Income for support typically does not include taxable capital gains. Most family courts consider capital

gain a liquidation of assets versus income. While there have been a few exceptions [*In re Marriage of Pearlstein* (137 Cal.App.4th 1361)], the mainstream still excludes capital gains from income for support purposes.

2) *Depreciation*. Depreciation expense is allowed for income tax purposes, but generally excluded for income for support. Often, there is a distinction between assets used and consumed by a business (copiers, computers, equipment) versus real estate investments.

3) *Stock Options*. Courts are typically considering stock options as income available for support. However, there is no consensus or California case detailing when options are income for support and how to quantify that income. Are options income when they vest or when the spouse actually exercises them—which is the taxable event? Are subsequent gains and losses taken into consideration for vested but unexercised options?

### Complexities Caused by a Down Economy

In determining income available for support, further discussion is warranted regarding the treatment of depreciation, imputation of income, representative time period and treatment of debt relief.

*Depreciation*. As indicated above, generally the courts will allow depreciation for the cost of equipment that is consumed by a business, but will disallow depreciation for the cost of real estate. This is under the theory that real estate is an appreciating asset and the cost of the asset is really a form of investment. Given California’s real estate market, is this still a valid assumption? If one has a rental property and the asset continues to decline in value, is there now a real cost for producing the rental income? Or does the spouse have an obligation to liquidate that asset and invest in an income producing asset, as in *In re Marriage of Destein* (91 Cal.App.4th 1385)? Under the assumption that California’s real estate market will eventually recover, is there any basis for changing the traditional treatment of depreciation on real estate?

*Imputation of Income*. It is common to see a decrease in a self-employed spouse’s business income while the parties

are divorcing. To some degree, this is understandable. The spouse is under emotional stress, focusing on separating the family finances and dealing with changing responsibilities for the children. These distractions are temporary and it is anticipated that income will recover in the near future.

Often, however, a decrease in the business income is an intentional attempt to reduce support obligations. Or the managing spouse may have an epiphany, decide that life is too short and not work as hard.

California family law cases have allowed imputation of income to spouses whether the income decline was intentional or not. However, *In re Marriage of Bardzik* (165 Cal.App.4th 1291 – 9/15/08) emphasizes that it must be proven that a spouse has the ability and opportunity to earn the imputed income.

So how does the economic downturn affect the imputation of income? Most businesses have seen a decrease in income over the last year due to the circumstances beyond anyone’s control. Is it appropriate to impute income under these circumstances? How does one prove a spouse has the *opportunity* for receiving imputed income with our current unemployment rates? How does one sort out the portion of the income decrease attributable to temporary distractions, intentional manipulation and pure economic factors?

*Representative Time Period*. Self-employed spouses in the construction and real estate industry are flocking to family courts requesting support order modifications. Both industries have suffered major losses during the last couple of years. However, this bust followed a number of boom years for these folks. When trying to determine a reasonable income for support going forward, should an average of the last five years be looked at or just the most recent year?

The difficulty with any type of economic downturn is that a spouse may take advantage of the excuse to intentionally manipulate income. Within weeks of the Sept. 11 attacks in New York, divorcing spouses were lamenting how the event negatively impacted their business and ability to earn income. Clearly, anyone in the travel industry had a legitimate claim, but spouses in many other sectors were also claiming a negative impact.

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