The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

SPRING 2006 ISSUE 41

The Current Debate: When Does an Audit Become an Investigation?

by Peter W. Brown, CPA

During a financial statement audit, information may be discovered that leads an auditor to suspect that material fraud or other improper activity may have occurred. The information could come as a result of procedures conducted during the audit or from sources within or outside of the company.

At this point, the auditor needs to develop an appropriate response. Many are asking when does an audit stop being an audit and start becoming an investigation? The follow-up question becomes: is it appropriate for auditors to conduct their own investigation?

'Investigative Techniques'

SAS 99 states than an auditor has a "responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

In practical terms, auditors apply what are traditionally referred to as "investigative techniques" to obtain sufficient audit evidence to satisfy the SAS 99 requirements. Typical investigative techniques include:

1. *Interviewing knowledgeable persons*, for instance, the CEO, CFO, general counsel, board members, et al., about the company's internal control structure, and whether any inappropriate activity has been reported that could materially impact the company's financial statements or the ability of the auditor to rely on management's representations. This also includes brainstorming among the audit team to share ideas about the potential for fraud and areas to focus audit test work.

> *There is no clear line between an audit and an investigation. Auditors certainly use investigative techniques when conducting an audit.*

2. *Analyzing financial transactions*, such as manual journal entries, to identify transactions that may require further investigation.
3. *Reviewing public documents*, such as stock trading activity, to understand potential pressures and motives, particularly for senior management.

Similarly, auditors are required to perform certain investigative procedures when they become aware of possible violations of laws and regulations.

According to SAS 54, when auditors become aware of information concerning a possible illegal act, they are required to "apply additional procedures, if necessary, to obtain further understanding of the nature of the acts." In other words, auditors must investigate the matter to evaluate quantitative and qualitative materiality.

The Securities Exchange Act

When auditing public companies, the Securities Exchange Act of 1934, Sec. 10A, states that "If, in the course of conducting an audit … the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act … has or may have occurred … the firm shall … determine whether it is likely that an illegal act has occurred; and if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer … ."

Continued on Page 5

In this Issue

Section Action

Business Valuation

by Ted D. Israel, CPA

A colleague recently confided to me that she preferred lost profits analyses to business valuation. In her view, business valuation is too hypothetical without an actual buyer and seller. She says actual buyers and sellers are more emotional than theoretical. Her experience has been that the real world values businesses on the back of an envelope, while in litigation, you have to analyze every specific element of the business and "make a master's thesis out of it."

Let me defend the process by first agreeing with everything she said. However, let me point out that there are buyers and sellers, either actual or proxy, in every case.

In family law matters, the operating spouse is in fact purchasing 50 percent of the community business from his or her spouse. When they cannot agree on the price, the court decides, based on the appraisal.

This reasoning applies to eminent domain and Corporate 2000 actions, as well. It is a little more abstract for estate and gift matters—with the buyer and seller absent or unable to negotiate, the appraiser has to take over the "back of the envelope."

Based on mountains of data related to the behavior of real buyers and sellers, the appraiser synthesizes the emotions of the buyer and seller regarding desired returns and tolerable risks to arrive at a value.

I appreciate my friend raising these questions. Scrutiny of theoretical processes results in stronger concepts.

Ted D. Israel, CPA, ABV, CVA is the Business Valuation Section chair and a partner at Eckhoff Accountancy Corporation in San Rafael.

Economic Damages

by Lynn Carl Jones, CPA

Sec. 58 of the California Board of Accountancy Regulations requires that licensees must "comply with all applicable professional standards," language often interpreted as including the AICPA's Code of Professional Conduct. Since 1988, Rule 102 of the Code of Professional Conduct has read: "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

Litigation practitioners should consider this language when accepting engagements from attorneys they do not know well. With a duty of zealous advocacy for their clients, a retaining attorney may withhold information from the practitioner that may be damaging to the attorney's client. Absent further investigation, the expert could develop opinions and damages estimates that would be different if the withheld information were known.

This is a perilous situation for both the retaining attorney and the expert. It is disastrous for the attorney if, at trial, a damages expert is confronted with facts that change the expert's opinions or demonstrate that the expert failed to uncover important information during the course of fieldwork.

On the other hand, litigation involves disputed facts, and the expert can rely on a retaining attorney's representation that a specific fact will be proved. This is different from "subordinating his or her judgment to others."

With an eye to Rule 102, the practitioner should consider reviewing discovery propounded by opposing counsel to understand disputed facts and the opposing version of events. Reports and testimony from experts engaged by opposing counsel highlight how disputed facts factor into alternative theories of loss. A review of such materials should provide enough information for experts to make informed and objective judgments, assuring that their opinions are not subordinated to the retaining attorney.

Providing an objective view also helps attorneys assess and respond to weaknesses in their case—valuable advice that too few litigators receive.

Lynn Carl Jones, CPA, CFE is the Economic Damages Section chair and managing principal of Jones & Co. in California and Louisiana.

Family Law

by Leslie O. Dawson, CPA

Goodwill is often the most contested item of a family law business valuation. Most managing spouses argue that goodwill does not really exist and cannot be sold. Most non-managing spouses argue that the community efforts were required to develop the business' reputation and customer base.

Some states make a distinction between "business" goodwill, which belongs to the community, and "personal" goodwill, which typically does not. Until recently, California family law cases have traditionally held that goodwill is a community asset to be valued and divided, even for a professional individual (see *In re Marriage of Iredale & Cates* (2004) 121 Cal.App.4th 321).

Enter *McTiernan v. Dubrow* (05 DJDAR 12855 – 10/28/05). In *McTiernan*, Husband was found to have no goodwill because, the court stated, he had no "business." He was a director of such motion pictures as *Die Hard*, *The Hunt for Red October*, and *The Thomas Crown Affair*, commanding six to seven figures in compensation for each film. Despite the high likelihood that Husband was operating in the corporate form and had employees (the case does not detail these issues), the court found he had no "business."

The court stated that McTiernan's "elite professional standing" could not be sold or transferred. Furthermore, the court seemed distressed with the notion of charging someone with an asset "predicated on nothing other than predictions about earning capacity." The court indicated that most "artists" would not have goodwill by stating that they are merely "persons doing business."

Unfortunately for accountants and attorneys, the court made a distinction indicating that we can buy and sell our practices.

In addition to the goodwill issues, *McTiernan* has an interesting spousal support component, plus informative concurring and dissenting opinions. This is a case with which family law practitioners should become familiar.

Leslie O. Dawson, CPA is Family Law Section chair and a partner in Glenn & Dawson LLP in Walnut Creek.

Message from the Chair

by Andy Mintzer, CPA

One more and final time. I feel that I have made a career telling you about the status of the AICPA's *Statement on Standards for Valuation Services*. The statement has been on the table for more than five years. There will be one more opportunity to comment on the proposed standards. In response to the recent round of comment letters, the AICPA has revised the proposed standard, which is scheduled to be released for comment after April 15.

However, reports indicate that the latest Exposure Draft will have a short comment period—probably only 30 days. It is my understanding that this version will be shorter, as it will not have cross-reference guidance to other services, such as compilations and prospective financial information engagements.

As to some of the controversial issues raised by tax practitioners, it will apparently hold them to the same standard currently required by federal tax guidelines, but it will permit oral reports in certain circumstances. When issued, the Litigation Sections Steering Committee will analyze it and respond.

When my two-year term as Litigation Sections chair began, my first message included my belief that much of the value of Litigation Sections membership could be found at the section meetings. Thanks to the hard work of our section chairs, my belief was realized. I want to thank outgoing section chairs Ted Israel, Business Valuation; Lynn Jones, Economic Damages; Leslie Dawson, Family Law; and Peter Salomon, Fraud, for their outstanding service. We were lucky to have them as our leaders.

Each of the sections has elected terrific successors to the outgoing chairs. My best wishes to incoming chairs Cindy Craig, Business Valuation; Colin Johns, Economic Damages; Tracy Katz, Family Law; and Marie Ebersbacher, Fraud.

I am looking forward to passing the leadership of our sections to our new Litigation Sections chair, Mark Luttrell. Mark has been an exemplary treasurer and vice chair, and I know we all will do well under his leadership.

Finally, I would be remiss if I did not remind you to renew your CalCPA and Litigation Sections memberships, due May 1. Don't miss out on all the services and resources your memberships provide.

Andy Mintzer, CPA, CFE is a sole practitioner based in Santa Monica.

Fraud

by Peter A. Salomon, CPA

Income tax fraud and the underpayment of payroll and sales taxes become apparent in many cases where expert witnesses are hired to calculate economic damages. Unfortunately, it is rare that these crimes are brought to the attention of the appropriate taxing authorities. I recently worked on a case in which the defendant was not so fortunate due to the actions of a Superior Court judge.

I was appointed by the California Superior Court as an independent Accounting Referee to determine the profits or losses of a restaurant during a given period. The plaintiff claimed it was entitled to a portion of the restaurant's profits, while the defendants claimed the restaurant had incurred losses.

I issued a written report to the judge and provided testimony in response to questions of the court. As I answered the judge's questions, it became apparent to the judge that the restaurant operator had grossly underreported sales and profits, filed false income tax returns with the federal and state governments, underreported sales tax collections, and failed to pay federal and state payroll taxes.

The judge then ordered me to calculate the amount of the restaurant's underreported taxes and, in writing, to contact the IRS, the California Franchise Tax Board, the California State Board of Equalization and the California Employment Development Department regarding the amounts of tax evasion for four individuals who operated the restaurant, as well as the judge's finding that the restaurant's corporate veil had been pierced.

Each of the four taxing authorities came to my office to review the working papers that supported my written findings. It was refreshing to see the judge take a proactive stance in assisting the taxing authorities with identifying individuals who had not paid their fair share of taxes.

Peter A. Salomon, CPA is Fraud Section chair and a director in Navigant Consulting's Litigation and Investigations practice in Los Angeles.

Keepin' It Legal

Separate is Not Equal– Part Two: Dissolution and Domestic Partners

by Roberta Bennett, Esq.

In Part One (*The Witness Chair*, Winter 2006) we examined whether a California Registered Domestic Partner (CRDP) is required to include in gross income all of his or her earned income or one-half of the combined income earned by the individual and his or her domestic partner on federal tax returns.

The IRS determined Feb. 28, 2006, that a CRDP must report all of his or her personal services income, citing case law relating to income-splitting in community property states as always arising solely in the context of spouses.

Under AB 205 (codified in Family Code Sec. 297.5 and 299), CRDPs gained almost all of the state-based rights and responsibilities of a married couple. The Domestic Partnership Act is retroactive to the date the couple registered their domestic partnership with the state. Most CRDPs will have to dissolve their partnerships in court the same as divorcing spouses.

Community property rights and liability for community property debts, in addition to possible payment of “spousal” and child support, and division of community property and debts on the dissolution of the domestic partnership have tax implications for CRDPs that differ from those of spouses.

Community property rights and liability for community property debts, in addition to possible payment of ‘spousal’ and child support, and division of community property and debts on the dissolution of the domestic partnership have tax implications for CRDPs that differ from those of spouses.

Spousal Support

Upon their separation or divorce, spouses are accorded special tax treatment that is not available to CRDPs. IRC Sec. 71 provides that spousal support paid by one spouse to the other is deductible by the payer and taxable to the recipient.

Since a CRDP is not a spouse, then it follows that payment of spousal support cannot be deducted by the payer. Arguably it is not a gift because it is a court ordered obligation. If it’s not a gift, the IRS will no doubt determine that it is income to the recipient, which results in double taxation, first by the payer, then by the recipient.

Under *US v. Davis* (1962) 370 US65, the “support payments” could arguably be characterized as a transfer of property in a settlement agreement, whereby the recipient has given up CRDP choate rights in exchange for property by way of periodic payments which, under case law and IRS rulings, are not taxable to the recipient (see Rev. Rule 67-221, 1967-2 CB63). Consistent reporting on the CRDPs’ respective tax returns is a must.

Transfer of Property

IRC Sec. 1041 provides for a tax-free transfer of property between spouses incident to divorce that is not available to CRDPs. Prior to IRC Sec. 1041, the potential tax liability of transferring property between spouses was, in part, governed by the holding in *Davis* and likely will apply as to property transfers incident to dissolution of CRDPs.

In *Davis*, a transfer of separately owned, appreciated property to a spouse or former spouse in exchange for the satisfaction of a mutual obligation resulted in recognition of a gain to the transferor.

The transfer was deemed a “sale” of the transferee’s marital rights to the transferor in exchange for the property. The transferee received a tax basis in the property equal to the property’s fair-market value at the time of the transfer and the transferor immediately recognized capital gain in the amount of the property’s fair-market value in excess of the adjusted basis in the property.

Note the *Davis* rule was neither applicable to an equal division of community property nor a partition of jointly held property. The holding in a later case, *Carrieres v. Commissioner* (1977) 552 F2d 1350, provided that if separate property of a spouse was used to effect an equal division of community property, the community portion of the transfer is tax free as long as the division was equal and there is only tax as to the portion of the transfer made with separate property.

For *Davis* to apply to CRDPs, the IRS will need to treat the community property of CRDPs the same as the community property of spouses.

If the IRS determines the CRDPs’ property is not community property for federal purposes, then transfers incident to dissolution may be treated as “deemed” sales between unrelated parties possibly triggering gain (see IRC Sec. 1001).

The retroactivity of AB 205 to the date that domestic partners registered their partnership in California, which

Continued on Page 6

AICPA Alert

by Jeffrey H. Kinrich, CPA

Members of the AICPA's BV/FLS Section should have received a copy of the new practice aid, *Calculating Intellectual Property Infringement Damages* (BVFLS Practice Aid 06-1).

Although not formally credited as authors, many members of CalCPA's Litigation Sections contributed to the practice aid.

This practice aid is a benefit of section membership. If you are not a member, the practice aid is available for $56 at *www.cpa2biz.com*. If you are involved in intellectual property damages, I recommend you obtain this document.

Work is under way on the next practice aid, which will address lost profits. Hemming Morse, Inc., CPAs has agreed to lead the development of the practice aid and, if all goes according to plan, it should be published near the end of the year.

The AICPA's BV/FLS Section Executive Committee recently held a strategic planning meeting to discuss the direction of the combined practice areas over the next few years. Topics discussed included the impact of the AICPA's relocation to North Carolina, member services, and practice aids.

The AICPA dedicates the equivalent of 7.5 full-time employees to support the BV/FLS practice. Unfortunately, but as expected, none of the support staff are planning to remain with the AICPA after it relocates its member support activities to North Carolina later this year. However, the staff is planning for the transition and intends to have replacements hired by June 15.

The AICPA's priority is to minimize disruptions to member services. Nevertheless, it is reasonable to believe that there will be some transition problems and resource constraints during the transition period.

To minimize disruption, the AICPA has established short-term priorities, including keeping the website up to date; continuing current projects, including development of practice aids, conferences, and webcasts on professional topics; revitalizing the Family Law, Economic Damages, and Fraud task forces; and continuing to provide value to members.

Practice aids in progress include updates of two older documents, *Financial Modeling* and *Financial Ratios*, as well as development of three new practice aids, *Lost Profits*, *Valuation in Bankruptcy*, and *Fraud Investigations*.

Finally, you should have received an announcement of the AICPA relationship with Daubert Tracker, *www.dauberttracker.com,* which enables members to research Daubert issues and opposing experts at significantly reduced prices.

Jeffrey H. Kinrich, CPA, ABV is a managing principal of Analysis Group in Los Angeles.

Audit or Investigation

Continued from Page 1

Authoritative literature governing auditing sets forth standards that require auditors to perform their own investigation after becoming aware of the possibility that material fraud or other misconduct has occurred.

However, violations of law are legal concepts and auditors are not in the business of making legal determinations. For this reason, auditors generally ask the client to provide an opinion regarding the possible violations.

This normally results in the client performing its own internal investigation or hiring outside legal and forensic experts to conduct an independent investigation. The auditors then evaluate the breadth and depth of the client's investigation and related findings and use this information when making their determination.

Auditors Can Conduct Internal Investigations–But Should They?

There is no legal prohibition for auditors to conduct an internal investigation for an audit client. In fact, the SEC has stated in its final Sarbanes-Oxley rules that "our rules do not, however, preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact finding engagements."

However, there is a growing belief within the profession that auditors should not conduct investigations for audit clients. The Big Four firms generally do not and CPAs are realizing that in some cases, they could be put in a position of investigating themselves—or at least creating the perception that their work is less than independent.

Most large firms will, however, involve their forensic specialists to assist in evaluating the client's investigation and proposed remedial actions.

There is no clear line between an audit and an investigation. Auditors certainly use investigative techniques when conducting an audit. However, if evidence presents itself that fraud or misconduct potentially having a material effect on the financial statements has occurred, best practices may indicate that the client initiate its own internal or independent investigation and openly share the results with its auditors.

Peter W. Brown, CPA is a director at KPMG LLP's Forensic Services Practice in Los Angeles. The views and opinions are those of the author and do not necessarily represent the views of KPMG LLP.

HAPPENINGS

Litigation Sections Meetings

Business Valuation	Thursday, May 18, SFO Thursday, July 27, LAX Thursday, Sept. 28, OAK
Economic Damages	Wednesday, July 26, TBA Wednesday, Oct. 25, TBA
Family Law	Friday, May 19, SFO Friday, July 28, LAX Friday, Sept. 29, OAK
Fraud	Tuesday, July 25, TBA Tuesday, Oct. 24, TBA

Each section will send individual meeting notices.
Download a copy at *www.calcpa.org/LIT*
or contact Bobbie Nochenson at (818) 546-3502

Education Foundation Course Offerings—(800) 877-5897 or www.educationfoundation.org

2006 Fraud in Audit, Accounting and Tax Conference	June 21, Universal City June 22, SF

Domestic Partners

Continued from Page 4

could have been as early as 2000, presents additional problems from a tax perspective [see Family Code Sec. 297.5 (m)(i)].

Since property acquired from date of registration through Dec. 31, 2004 was not community when acquired, it may be treated like quasi-community property, but for federal purposes will still be treated as separate property. CRDPs need to be advised to consider issues of gain or loss in dividing assets and debts.

Different Tax Treatment Advantages

When a spouse receives the family residence in exchange for his or her spouse receiving other community assets, there are no tax consequences. This is true even when the departing spouse is paid more than that spouse's tax basis in the property. Thus, the property is transferred at its original basis, resulting in potential built-in gain.

However, if a CRDP purchases his or her partner's appreciated interest in the family residence, this rule does not apply. The selling partner has the right to use his or her $250,000 exclusion to reduce or avoid the gain, and the purchasing partner receives an increased cost basis in the property (see IRC Sec. 121). This is at least one advantage of not receiving the same tax protections as spouses upon divorce.

Retirement Plans

If retirement plans of CRDPs are funded with community earnings and divisible upon dissolution, unlike spouses who receive tax protection via IRC Sec. 42, 402, and 408, CRDPs face significant tax implications.

ERISA pre-empts state community property law with respect to pensions. Since it is likely that CRDPs will not be entitled to a Qualified Domestic Relations Order, a distribution from an individual account plan paid to the alternate payee pursuant to a court order may be taxed to the owner. The recipient CRDP will not be entitled to roll over the distribution into his or her retirement account.

Family law courts may recognize the immediate and specific tax consequences in determining an equal division of community property. This could offer some relief to the above problem.

More Information

These are some of the potential tax issues raised when CRDPs dissolve their partnership. For a detailed discussion of tax issues involving CRDPs, see M. Jean Johnston, Chapter 15, Income, Gift and Estate Tax Considerations for Domestic Partners, in *California Domestic Partnerships* (Cal CEB 2005).

This article is for informational purposes only and does not constitute legal advice or a legal opinion on any specific facts or circumstances.

Roberta Bennett, Esq. is a Certified Family Law Specialist in private practice for 26 years. She is treasurer of the Los Angeles County Family Law Section and an expert in same-sex couples law.

The Witness Chair is published quarterly by the Litigation Sections of the California Society of Certified Public Accountants.

Editor
Susan Bleecker

Associate Editors
Leslie O. Dawson
Maria N. Nazario

Sections Chair
Andrew M. Mintzer

Individual Section Chairs
Business Valuation . . . . Ted D. Israel
Economic Damages . . . . Lynn Carl Jones
Family Law . . . . Leslie O. Dawson
Fraud . . . . Peter A. Salomon

CalCPA Staff Liaison
Maria N. Nazario

Nonmember subscription rate is $75 for one year. To subscribe, call CalCPA at (818) 546-3502 or (800) 922-5272.

We welcome your letters, articles, comments and suggestions, which may be sent to the editors at *bleeck@pacbell.net.*

The Witness Chair does not provide legal advice. The material published, unless otherwise specified, represents the views of the authors and the individuals quoted and not those of CalCPA or the AICPA.

California Society Certified Public Accountants

www.calcpa.org/LIT