FOCUS ON FUN

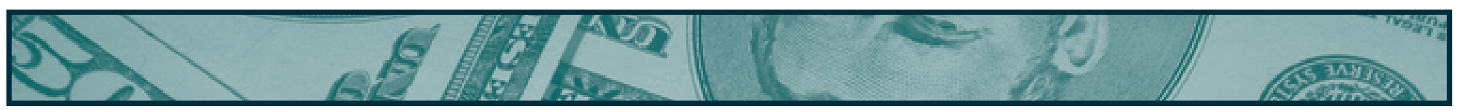
Accountants & Humor

– A Sociological Fable

1. Jeffrey P. of West Lafayette, Indiana, thought he had devised the perfect crime. He'd write checks using disappearing ink. By the time they were processed for collection, he reasoned, the ink would be gone and his account would not be charged. But enough traces of the ink remained so the police were able to easily figure out the scam. It also was simple for them to track Jeffrey down; his name and address were preprinted on the checks – in regular ink.

2. John, a Jacksonville, Florida dentist had grown tired of his profession and he wanted out. So, he hatched a plan with his two brothers to cut off one of his pinky fingers and claim it was a wood-chopping accident. That way, John would be disabled and could claim a large insurance settlement. The day of the crime though, he got cold hands – so to speak – but his brothers didn't; they forcibly held him down and hacked off his finger. Sure enough, John collected a 1.3 million dollar check from his insurance company. Part of the proceeds went to buy the digitless dentist a yacht named Minus One. And he paid his brothers a total of $45,000 for their assistance. That's when the real problem began; they wanted half a million bucks. Rather than pay up, John contacted the FBI and reported that the two were attempting to extort money from him. After hearing the whole story, the authorities charged the three brothers with insurance fraud. They all went to prison.

3. An unidentified man from Johannesburg, South Africa told three friends he hadn't been feeling well for quite some time and believed he was eligible for a monthly disability check. The man must have been worse off than he thought – he died a short time later. But his friends didn't tell anyone. Instead, hoping to collect the monthly check for themselves, the threesome dragged the man's lifeless body to the welfare office and propped him up for a required fingerprinting, telling the clerk he had just passed out. But, the corpse's cold, stiff hand was a dead giveaway. The clerk called the cops. Does this remind any of our readers of a really funny movie of a few years ago?



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Calendar

Recent & Upcoming Events

Speeches:

January 2009

6 - Hot Issues in Business Valuation – CPA Club (Saddle Brook, NJ)

March 2009

31 - Business Valuation – Family Law Inns of Court (Bridgewater, NJ)

May 2009

26 - Business Valuation – Family Law Inns of Court (Bridgewater, NJ)

August 2009

21 - Business Valuation in a Recession – ICLE (Atlantic City, NJ)

September 2009

10 - Current Issues in Business Valuation – Rhode Island CPA Society (Providence, RI)

15 - Business Valuation in a Recession – ICLE (TBD, NJ)

November 2009

5 - Unreported Income in a Divorce Action – Louisiana CPA Society (Lafayette, LA)

CLE Ongoing

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Articles:

January 2009 issue of Middlesex County Bar Advocate – Civil Unions – Uncivil Taxes

Janet Barson & Laura Johnson
(Editorial, Design & Layout)

Help Us Go Green!
We would like to save on paper, and can do so by sending this newsletter via email to as many of our readers as possible. If you are so inclined, we would appreciate you advising us – laura@barsongroup.com – to send future issues of Forensic Forum to you by email.

Nuggets from the Tax Return

Many times, before we have an opportunity to actually roll up our sleeves and do fieldwork analysis of a business' financial records, we are provided with tax returns – sometimes of the individuals, sometimes of the business, sometimes of both. While none of our readers should believe for an instant that merely having the tax returns to review is an adequate substitute for the type of analysis and investigation vital to the investigative accounting and business valuation procedures we need to employ in virtually all cases, having those returns at least gives us the ability to make some initial observations that will help us to better focus on what we need to do.

For instance, let us deal with the matter of business tax returns. A review of same might provided us with some or all of the following:

Gross Revenues – this gives us a basic idea as to the size of the business – which often weighs heavily on what we perceive to be the extent of analysis and discovery necessary, as well as the procedures we might employ in doing our work.

Gross Profit – assuming that we have at least a basic understanding of the type of business involved, we may be able to make comparisons of the reported gross profit to those considered normal for the industry. If we find that the reported margins are within a reasonable range of normal, we have that much more comfort as to the veracity of the reported revenues and costs. Alternatively, if there is a significant difference between industry norms and the subject company (generally meaning a much lower gross profit for the subject company), then our attention is immediately drawn to this very important area for further analysis.

Payroll – does the reported payroll make any sense? Some businesses may pay a portion of their payroll off the books – and the figures on the tax returns may be obviously too low. In other cases, there might be payments for no-show jobs or paramours – resulting in obviously inflated payroll levels.

Depreciation – how aggressive is the business in taking a depreciation deduction? Is it taking advantage of such accelerated depreciation methods as Code Section 179 and first year bonus depreciation – and therefore is depreciation far in excess of economic reality?

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Pension and Other Fringe Benefits – to what extent is the company deducting for a retirement plan, and perhaps other fringe benefits? Certainly, if for a retirement plan, we are now aware that such a plan exists, and that there is probably an asset (perhaps significant) that needs to be considered (if this, for instance, is a marital dispute).

Partners or Shareholders – depending on the form of the return, there may be considerable information as to who are the owners, shareholders and officers, how much compensation each is getting, and what percentage of the company is owned by each of them. There may also be information as to changes in capital structure, contributions or withdrawals by partners and other similar financial information. Each of these can be very important, and in some cases for several reasons. For instance, was there a change in ownership position during the year, or from year-to-year? If so, how did that come about, what consideration was paid, who sold what interest, how was it valued, etc.?

Net Book Value Equity – other than for a Schedule C for a sole proprietorship, most business tax returns (i.e. corporations, LLCs and partnerships) will have a balance sheet. The equity, or partners' capital, will give the reader at least a basic idea as to the book value net worth of the company. Usually, if the company is even moderately successful, that is the lowest value one would consider.

The above dealt with business tax returns. Let us now turn to personal tax returns.

Pension Income – even if not taxable (usually because it was rolled over into another account), there might be an indication of a distribution from a pension or an IRA. Where did the money come from, and where did it go? Also, in the same vein, there might be an indication of a contribution to a Keogh plan. Similarly as to a deduction on a corporate return, this indicates the existence of a retirement plan – an asset that might need further analysis.

Interest and Dividend Income – Schedule B lists the sources of interest and dividend income. The presence of same indicates the existence of bank accounts, brokerage accounts, CDs, and possibly other financial vehicles. These need to be considered as part of the discovery process.

Schedule D – the presence of this schedule generally suggests activities on the stock or bond markets. This then tells us that there are some assets, possibly many, possibly of significant value, in the form of stocks or bonds or both. We would want to see the brokerage statements so as to give us a comfort level as to what assets exist.

Schedule E – the presence of this schedule, depending of course on what parts of it are filled out, might indicate the existence of rental property, an asset throwing off royalty income, investments in partnerships or S corporations, an interest in estates or trusts.

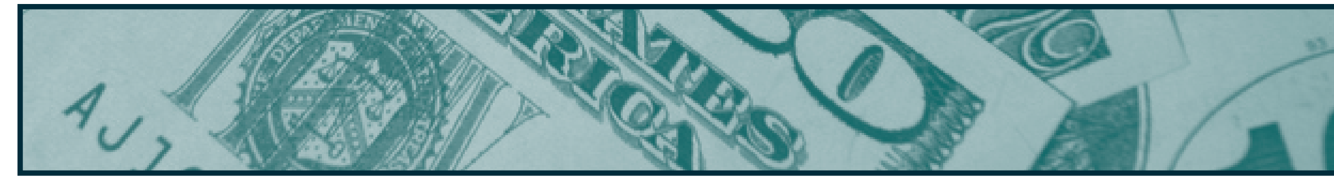
If understood and used correctly, tax returns can provide a wealth of information – and at the very least, raise many questions and help us focus our efforts. However, they are rarely, if ever, by themselves sufficient for the financial analysis and investigation necessary in almost any litigation matter.

Revenue Ruling 59-60
A Return to the Basics

In the world of business valuation, IRS Revenue Ruling 59-60 is widely considered one of the founding tenets from which most business valuation emanates, a dicta which lays the foundation upon which business valuation technique proceeds. As such, every once in a while, it is useful to revisit RR 59-60 so as to refresh ourselves with its all important foundational rules.

Clearly, what RR 59-60 tells us is that we need to proceed in a professional, thorough, informed and knowledgeable fashion in order to properly determine the appropriate value (or the appropriate range of value) for a closely-held business.

Section 4.01 of RR 59-60 states "… in the evaluation of the stock of closely-held corporations…all available financial data, as well as all relevant factors affecting their market value, should be considered." In that same section, the Ruling goes on to list eight factors which, while not necessarily all inclusive, are fundamental in business valuation. These factors, and a brief expounding on each, are as follows:



a) The nature of the business and the history of the enterprise from its inception – certainly, understanding the nature of the business is very important in being able to do an intelligent and reasonably accurate valuation. The more a business is well established, the longer it has been in existence, the relatively less important it is to take into account its history going back to its inception, as contrasted with its more recent history;

b) The economic outlook in general and the condition and outlook of the specific industry in particular – the relative importance of the general economic outlook as contrasted with the outlook for the specific industry will vary widely depending on the nature of the operation. A business dependent upon the nation's (or even international) financial well-being will usually be viewed differently than one whose fortunes are much more tied to a local economy. In either case, the particular nuances of the specific industry relevant to the valuation process may need to be considered;

c) The book value of the stock and the financial condition of the business – this provides us with certain basics, including the surface impression of the underlying financial strength of the business. It is one thing to suggest that a business has fantastic prospects for the future – it is another to show that perhaps this business is so fragile in its economic strength that, despite its great prospects, it may not live to realize them;

d) The earning capacity of the company (income generation) – unless we are looking to the assets of the company as the only source of value (the pieces rather than the ongoing operation), in a sense, income is everything. That is an oversimplification, since developmental stage businesses (as an example) may not have income, but can have substantial value – but nevertheless, in most situations, without income, where is value?;

e) The dividend paying capacity of the subject business – this is generally not applicable for a closely-held business, especially one where there is no history of dividends. However, we may find this a useful approach where we are dealing with a minority shareholder, and where the business does have a history of paying dividends;

f) Whether or not the business has goodwill or other intangible value – this of course is one of the most difficult and usually contentious aspects of the valuation process. Does the business have goodwill, and how do we go about supporting our position?

g) Sales of the stock and size of the block of stock to be valued – for most closely-held business situations, having a sale of stock to use for valuation comparison purposes can be most useful, but at the same time is quite unusual. Even when such a transaction exists, there are typically issues such as whether or not it was at arm's length, the relative size of the block of stock, how stale is the transaction, were there any disguised consulting or other financial arrangements, was it caused by family pressures or age/infirmary, was it estate planning motivated?;

h) The market price of stocks of corporations engage in the same or a similar line of business having their stocks actively traded in a free or open market, either on an exchange of over the counter – simply put, if there are comparable (that by itself can be a very difficult supposition to support) companies to the subject being valued, where the comparable companies are already public and actively traded on open markets, they may serve as excellent tools for determining the value of the company under consideration. A practical aspect is that this comparability concept can be difficult to apply to a closely-held company, especially to the smaller companies. How truly comparable are these public companies – size comparisons, diversity of product or service, depth of management, capital structure, geographic range, market position or level of influence, etc.;

There is no simple approach, no formula. Keep in mind that Revenue Ruling 59-60 has repeated references to the future – unless one is buying a business to break it up and benefit from its pieces, a business is valued or purchased for what it will yield in the future. Therefore, for whatever faults this brings to the process, the valuation of a closely-held business tends to be a prophecy of the future – as best as can be determined by an expert experienced appraiser.