

ADVOCATE'S EDGE



Are you ready for e-discovery in the IoT age?

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Understanding financial misstatement

The least common type of fraud can also be the costliest

Spotlight on divorce

3 critical issues to consider *before*
valuing a professional practice

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purposes. With so many layers to wade through, securing access to data is rarely a simple matter.

Difficulties also can arise when it comes to locating relevant data. Forensic collection methods often lag behind the development of new technologies and may not yet be equipped to find data from a specific device. Moreover, IoT devices frequently aggregate individual data from multiple users in a structured database, further complicating the identification of relevant data.

The IoT gives attorneys and their clients much to think about regarding the collection, storage and securing of data. Beyond discovery, the IoT presents additional concerns, such as the risks of costly data breaches and privacy-related claims.

Considering both sides of the coin

The IoT will likely bring great change to all stages of litigation, especially the discovery phase. For those who are informed and prepared to deal with this type of data, it presents great opportunities and threats that you can't afford to overlook. ■

Wealth of information at our fingertips

Is the Internet of Things (IoT) *really* revolutionizing our world? You might not realize it, but the IoT has already taken hold in homes and workplaces around the world.

One infiltration of the IoT in our everyday lives is the fitness tracker. Examples include Fitbits, smart watches or smartphone apps. At any given time, someone nearby is doubtless tracking his or her steps, heart rate, calories burned or sleep patterns.

But IoT applications go far beyond that. Cars can now collect information on driving habits for insurance companies. Thermostats, lights and household appliances can respond to real-time data — and they can be controlled remotely. Employers have even jumped on the IoT bandwagon, using sensors on company-owned vehicles and employees' clothing to monitor their location and productivity. Such devices are expected to become increasingly common in the workplace, as they become less expensive, smaller and more accurate.

Attorneys who ignore the data gathered by this technology could be missing out on valuable evidence that could support their clients' cases — or used against them if discovered by the opposing side.

Expert report fends off *Daubert* attacks

From divorces to business disputes, the linchpin in all types of litigation often turns out to be expert testimony. Before they're able to testify, however, many expert opinions must first survive a *Daubert* challenge. A detailed written report can be the deciding factor in persuading the court to admit an expert's opinion, as demonstrated

by a recent ruling from the U.S. District Court for the District of New Jersey.

Landlord gets burned

MSKP Oak Grove, LLC v. Venuto involved a corporation (Hollywood Tanning Systems or HTS) that



operated tanning salons and sold franchises and tanning equipment to independent salons. In 2003, HTS leased retail space in a Florida shopping center. The landlord consented to a sublease to a franchisee, but HTS remained liable in case of the franchisee's default.

In 2007, HTS entered an asset purchase agreement in exchange for \$40 million, 25% of the issued and outstanding preferred units of the buyer, and contingency payments. When the deal closed, the four shareholders of HTS each received distributions of about \$5.8 million. HTS substantially ended operations that day, and the buyer ultimately declared bankruptcy.

A year later, the landlord notified HTS that the sublessee had defaulted on its lease. It subsequently sued HTS for breach of contract and obtained a judgment of about \$412,000.

Defendants apply heat on expert

After the judgment went unpaid, the landlord brought another action, contending that the distributions to the shareholders represented a fraudulent transfer because HTS, at the time of the sale, didn't have the

funds to pay all of its creditors. The landlord hired an expert who produced two reports within a few days of each other: 1) a fraudulent conveyance report, which examined HTS's solvency before and after the shareholder distributions, and 2) the valuation report, which opined on HTS's fair market value at closing.

The expert found that:

- HTS didn't receive reasonably equivalent value for the shareholders' cash distributions,
- HTS's remaining assets were unreasonably small with respect to its operations,
- HTS knew (or should have known) that the distributions would result in debt beyond its ability to pay,
- The distributions left HTS insolvent immediately or soon after, and
- The buyer's liabilities exceeded its assets the day before the sale and at closing.

The defendants (the four shareholders of HTS) challenged the testimony. They asserted, among other things, that the solvency report cited no reliable methodology.

Expert's reports shine

As the court explained, the disposition of the defendants' motion to exclude depended on the reliability of the methodology employed in the expert's report. As an initial matter, the court dismissed the defendants' argument that the fraudulent conveyance report was per se unreliable because it didn't include a summary of the methodology. The court read the two reports as one cohesive report and concluded that, "taken together, and augmented with [the expert's] explanation, the combined report supplies an ample summary of [her] methodology."

The expert had clarified at the *Daubert* hearing that the valuation methodologies and valuation approaches sections in her valuation report, as well as the AICPA standards and valuation treatises attached as exhibits, were intended to cover *both* reports. They described the normalization

adjustments in the first report that were required to ascertain HTS's financial health from the incomplete records she received. The court, therefore, concluded that the expert adequately described her application of reliable, recognized principles of accounting and valuation analysis and denied the defendants' motion.

Protect yourself

This expert survived her *Daubert* challenge because she came prepared. Detailed written reports are a proven way to show that expert reports are based on industry-accepted practices. ■

Understanding financial misstatement

The least common type of fraud can also be the costliest

When a dishonest CFO or controller cooks the books, it can be devastating for the victim organization. In addition to direct financial losses, financial statement frauds erode trust between management and other stakeholders, including lenders, investors and employees who own company stock. Unfortunately, it's common for smaller companies to associate financial misstatement with large public companies that focus heavily on earnings per share.

A recent study proves that the association may be flawed. In fact, smaller organizations need to understand how misstatement scams operate and work to reduce motives to commit this type of occupational fraud.

How much does financial statement fraud cost?

Less than 10% of the fraud schemes involve financial statement fraud, according to the *2016 Report to the Nations on Occupational Fraud and Abuse*, published by the Association of Certified Fraud Examiners (ACFE). The study found that financial misstatement scams were significantly outnumbered by asset misappropriation (which occurred in more than 80% of cases) and corruption scams (35% of cases).

Though relatively uncommon, misstated financials clocked the greatest median loss (\$975,000) of

all types of occupational frauds. By comparison, median losses were only \$125,000 for asset misappropriation and \$200,000 for corruption.

Further breakdown of fraud cases by the ACFE shows that financial misstatement cases don't strike just large companies. Of the fraud cases in the 2016 study involving companies with 100 or more employees, approximately 9% involved financial misstatement. But when it came to cases involving smaller companies with fewer than 100 employees, the prevalence of financial misstatement increased to 12%.

What makes financial statement fraud especially problematic is that the costs can easily snowball out of control. For example, when a CFO fudges the numbers to make a company appear more profitable, the company will likely incur greater liability for taxes or dividends. It might be necessary





intentionally circumventing the system of internal and administrative controls.

What causes employees to cook the books?

According to the ACFE, individuals who committed financial statement fraud were more likely to be under excessive organizational pressure compared with those who perpetrated corruption or asset misappropriation.

to take on debt to make those payments, leading to higher interest costs. Or the company might try to acquire a healthy business to hide its own underperformance.

What is financial misstatement?

The ACFE defines financial statement fraud as “a scheme in which an employee intentionally causes a misstatement or omission of material information in the organization’s financial reports.” Methods for committing such fraud aren’t just limited to the overstatement or understatement of assets or revenues.

For example, liabilities or expenses might be recorded improperly to make the company appear more liquid or profitable in the current accounting period. Or a dishonest employee could manipulate accounting cutoffs by recording revenues early and expenses late, which violates the accounting concept of matching expenses with the associated revenues in the same period.

Financial statement frauds also occur when the accounting rules call for the use of subjective estimates. A fraudster might conveniently forget to write off obsolete inventory or bad debts. Even more subtle are fraudulent financial statement disclosures that may skew or omit information to intentionally mislead investors. Most instances of financial statement fraud involve the perpetrator

Fraudsters may feel pressure to meet earnings expectations or satisfy merger criteria that are required to close a deal. They might commit financial statement fraud in an attempt to make the company look more profitable than it truly is, thereby boosting share prices, fulfilling loan covenants or allowing them to earn bonuses. Conversely, with family businesses, it’s common for next-generation family members to feel pressure to prove they’re worthy to take over the reins.

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How can companies prevent misstatement?

Based on the ACFE report, one way to prevent financial statement fraud is to eliminate internal pressure on employees to report exceptional financial results — and to set more realistic goals. Forensic accounting experts can review a company’s bonus plans, familial dynamics and financial condition to help identify (and alleviate) high-pressure situations. Doing so can create a healthier work environment and minimize the motive to cook the books. ■

Spotlight on divorce

3 critical issues to consider *before* valuing a professional practice

In divorce cases, the value of a spouse's professional practice — such as a medical practice or law, architectural or engineering firm — can affect rulings regarding marital property distribution, alimony and child support. State laws and legal precedent may vary. So, it's important for valuers to iron out three issues before calculating value.

1. Standard of value

The use of an incorrect standard can render a valuation report and the related testimony inadmissible. Fair market value and fair value are among the most common standards, but some jurisdictions now call for “intrinsic value.”

Intrinsic value is what an investor would consider to be the “real” value — and it's generally the same as fair market value if other investors are likely to reach the same conclusion. It also can be understood as the value of the business to the current owner.

2. Valuation date

Timing can have a significant impact on value. The appropriate valuation date could, for example, be the date of separation, the date the divorce complaint was

filed, the court appearance date or some other date. The proper date is often determined by state law.

The date of marriage may also be relevant in cases where only the *appreciation* in value over the course of the marriage is includable in the marital estate. In those situations, the expert might need to value the business interest twice — once when the parties said “I do” and again when they part ways.

3. Treatment of goodwill

Goodwill generally refers to intangible value that isn't attributable to other identifiable intangible assets, such as brands, patents and client bases. When combined with noncompete agreements, the value of goodwill may well exceed the value of tangible assets.

Courts generally recognize two types of goodwill. Personal goodwill is linked to an individual's knowledge, experience and abilities. Its value rests on the assumption that patients or clients would follow a practitioner to a new practice. Business goodwill can be separated from the practitioner. It relates to such factors as location, company name, assembled workforce, and established policies and procedures. Its value assumes the firm would retain clients and patients if the owner left.

Experts must understand the appropriate treatment of goodwill in a case's venue. About half of the states generally exclude personal goodwill from the marital estate. In those jurisdictions, only business goodwill may be included in the marital estate. Courts in other jurisdictions may either include all goodwill in the marital estate — or exclude it all, depending on relevant laws and legal precedent. It's important to consider relevant state laws and applicable state case law in determining goodwill. ■





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