The High Costs of Expert Advocacy

Financial experts are routinely engaged to testify in a wide variety of litigation, addressing matters related to personal injury, damages, tax law, shareholder actions, and divorce.

It's important for attorneys to remember that, while they are charged with being advocates for their clients, experts are ethically and legally required to be unbiased and objective. When experts appear to step beyond those bounds, the results can be disastrous.

The Expert's Proper Role

The rules of evidence, as well as years of judicial opinions, make clear that an expert is in the courtroom to provide objective evidence to assist the fact-finder. As one court put it, the expert is obligated to present data, analysis, and opinion with detached neutrality and without bias. *Wagner Construction, Inc. v. Commissioner,* T.C. Memo 2001-160 (June 29, 2001).

If an expert is perceived to be advocating an attorney's client's position, courts will likely disregard the testimony. Numerous tax court decisions demonstrate that courts will reject biased testimony, instead resorting to their own analyses or the opposing expert's position.

The Tax Court Speaks

Two cases in recent years — *Caracci v. Commissioner* and *Wagner Construction, Inc. v. Commissioner* — illustrate the potential costs when experts fail to maintain their independence.

Caracci v. Commissioner, 118 T.C. No. 25 (May 22, 2002), involved the value of three nonprofit home health care providers. Each of the companies had a history of operating losses, and the book values of their assets were exceeded by their liabilities, although they held significant intangible assets.

The taxpayer obtained two appraisals, both of which determined that the fair market value of the companies' net assets was negative (one of these, however, placed a value of $2.1 million on a "workforce-in-place"). The Internal Revenue Service (IRS), on the other hand, appraised the companies at about $7 million.

The Tax Court rejected the taxpayer expert's testimony, holding that his finding of a fair market value of less than zero was "unconvincing" and noting that his conclusions seemed to conflict with articles he had previously written.

The court observed that the expert's reasoning "appear[ed] to be more an advocacy of petitioner's litigating position than a candid fair market value appraisal." It ultimately valued the companies at more than $5 million.

In *Wagner,* the issue was whether the compensation paid to Wagner Construction's two shareholders was deductible under IRS Section 162. The provision allows reasonable compensation to be deducted as a business expense; "excess compensation" is treated as a taxable dividend to the shareholder. Both sides in the case presented two experts, but the court rejected all four.

The court said that the expert reports were extremely disparate. It acknowledged that such differences aren't unusual, but said that these reports were so dissimilar as to call into question the experts' reliability.

The court declared that their conclusions "patently favored their respective clients and their reports were designed to support their conclusions." The court said the testimony of witnesses who display "unyielding allegiance" to their clients will generally be disregarded as untrustworthy.

The court ultimately reached a figure representing unreasonable compensation that fell far below the taxpayer's figures, so that more than $1.1 million of the compensation was considered taxable dividends.

Play It Safe

As the cases above demonstrate, in the long run, an expert's unbiased and objective presentation will be far more palatable to the court, as well as less risky financially. ❖

Brokers see surge in securities litigation

In recent years, many individual investors stood by helplessly as their retirement and other savings disappeared in the markets. But more and more, they're looking for ways to recoup their losses, and lawsuits against securities brokers alleging churning or unsuitability are increasingly common. Attorneys who understand the complexities of establishing these claims will be a step ahead of their competitors.

Securities churning

Churning occurs when a broker makes an excessive number of purchases or sales of investments, with or without the client's knowledge. Brokers, of course, generate commissions and fees with every transaction they facilitate, and it's perfectly acceptable as long as it's not detrimental to their clients.

To prove churning, it's not enough to merely show turnover in the account or that money was lost in the market; the client must have sustained an actual, compensable loss. The loss, however, can be unrealized. (That is, the poor quality stock is still in the client's portfolio and has yet to be sold at a loss.)

Churning claims require the examination of the nature, quality and volume of transactions to determine whether the account activity was excessive. CPAs can calculate the annualized rate of return necessary to cover the commissions the broker charged the account; the turnover ratio; the number of times the account's equity was turned over to finance purchases; and the buying and selling activity in the account. They also can quantify the loss.

Unsuitable investments

Suitability allegations deal with the appropriateness of an investment for a particular investor. Under the rules of the National Association of Securities Dealers, a broker can't recommend an investment until he or she has determined it's appropriate for the client's objectives. In the typical suitability claim, the investor alleges the broker convinced him or her to purchase an inappropriate investment. Suitability issues also might be implicated if a client didn't understand the loss risk of an investment or lacked the financial capacity to tolerate a potential risk.

A broker has a duty to work with clients to establish their financial needs and risk tolerances and handle their investments accordingly. Several factors will bear on whether a broker committed a suitability violation, including:

- Whether the broker inquired about the client's assets, liabilities and other investments,
- Whether the broker discussed and understood the client's income statement, including monthly income and expenses,
- Whether the broker considered the client's age, marital status, number and ages of dependents, employment, and needs such as health care and education, and
- Whether the broker and client discussed different types of investment objectives and their associated risks.

The client's investment objectives will be critical in a suitability case. Relevant evidence often will include account application forms, correspondence between the broker and client, the broker's research on the investment(s), monthly statements for all of the client's accounts, any evidence of similar claims against the broker, the names of all of the broker's clients who made the same investment and evidence of the client's actions upon first suspicion of unsuitability. CPAs can outline specific documents and data that should be sought in discovery and, in turn, provide detailed analysis.

Built to last?

Experts predict courts will be dealing with churning and suitability claims for at least a few years, precipitated by the recent rocky history of the stock market. With cases frequently involving reams of financial data and documents, CPAs may prove indispensable, whether trying to establish or disprove the claims. ❖

Detecting Fraudulent Timing Differences

Companies undergoing business valuation may have an incentive to show increased earnings or decreased losses through fraudulent timing differences, also known as cut-off fraud. Such fraud is frequently accomplished through early recording of revenues.

Methods of Fraudulent Timing Differences

According to Generally Accepted Accounting Principles (GAAP), revenue should be recognized only when the earning process has been completed and rights of ownership have passed from seller to buyer. Companies engaging in fraudulent timing often improperly record revenue in one of three ways:

- Holding the books open. Rather than closing its accounting ledgers on the designated last day of the period, the company holds the books open. By doing so, a company may be able to record greater sales revenue.
- Recording revenue before services have been completed. Under GAAP, the entire amount of revenue paid in exchange for a service cannot be recorded in the books until the service has been rendered in full. A company, however, may improperly include cash payments as income, disregarding percentage-of-completion contract terms; fail to record accruals when services are paid for in advance; or include refundable deposits as income.
- Shipping goods prior to final sale. In calculating its sales, a company may include goods out on consignment or in storage off-premises.

What to Look for

Certain signs indicate fraudulent timing differences. Inadequate internal controls send up one red flag. For example, allowing a single employee to be responsible for processing an entire transaction makes fraud easier to conceal. Instead, different staff members should handle order entry, shipping, billing, accounts receivable, and the general ledger. Discrepancies between the quantities of goods billed and goods shipped can also be cause for alarm. A random sample of transactions should be examined to discover such discrepancies. For each transaction, the examiner should:

- Scrutinize credit terms on the sales order.
- Compare invoice prices with published prices.
- Reconcile details within the sales order, shipping documents, and invoice.

In addition, overall shipping costs should be compared to those from prior periods.

A company's employees can also provide valuable information. To determine if fraudulent efforts have been made to increase the amount of cash on hand, for example, ask the accounts payable staff if they've been directed to conceal unpaid bills. (Fraudulent timing differences can also be accomplished through the delayed recording of expenses and liabilities.) To uncover inventory fraud in the absence of bills of lading, warehouse count sheets, and inventory forms, query the shipping and receiving staff about document alteration and off-site storage facilities.

Additional red flags include:

- Changes in sources of revenues.
- A material increase in sales compared to previous periods.
- Changes in product lines or service offerings.
- Unusually large sales recorded during the final weeks of the accounting period.
- Sales transactions with unusual terms.
- Material unsupported revenue.
- A significant decrease in the cost of sales. ❖

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

It appears that the credit counseling business is about to boom.

Significant changes are in store for consumer bankruptcy law. While this affects business bankruptcy, this new legislation will greatly affect consumers in added "higher" costs and efforts. These new costs and efforts are:

- Attorney costs
- Filing fees
- Credit counseling
- Higher required payments to creditors
- Financial education courses

Consumers who are filing Chapter 7 must now pass the ***means test***. The means test says that the previous six months of income must be below state median income. A significant percentage of consumers will fail to meet this test.

Attorney planning is a significant key to passing the means test. Many attorneys will time a bankruptcy case to ensure the previous six months of income is below state median income.

While the talk is that the means test is the biggest change, actually there are other provisions in the legislation that will affect consumers more:

- Credit and financial counseling requirements
- Higher filing fees
- Financial data requirements and additional paperwork
- Shortage of qualified bankruptcy attorneys
- Much harder to propose and complete a repayment plan, based on new Chapter 13 requirements

When bankruptcy is being considered:

- Consult with a qualified bankruptcy attorney to size up the situation
- Watch out for financial consolidators, requiring your home as collateral
- Financial or credit counselors -- better to consult an attorney rather than seeking one out independently
- Be careful to avoid scam and con artists!

At ***Forensic CPAs*** we believe the real reason for the new requirement for financial and credit counseling is the hope for a diversion from bankruptcy. What happens when Chapter 13 doesn't work? You pay attorneys…..

Then you pay:

- Domestic support
- State welfare agencies
- Trustees
- Health insurance
- Then creditors

Those phone calls and wage garnishment will continue for years to come as creditors will continue collection efforts. ❖

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