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Mercer Capital's Family Law Valuation and Forensic Insights

Essential Financial Documents to Gather During Divorce

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We have written about the **benefits** of hiring an **expert** in family law cases, whether it's expected to settle or go to trial.

This booklet is designed to be a resource that will assist you and your clients during one of the most difficult times in their lives, both emotionally and financially.

Mercer Capital has compiled a list of financial documents that are typically needed in the divorce process and decoded common financial terms helpful to attorneys and their clients.

Financial experts can assist in determining the relevant documents based on the facts and circumstances of the case, which can reduce the burden of hunting down extraneous documents.

Most financial documents fall into one (or multiple) of the following categories, so we have organized this booklet to address each:

- Determining the value of the marital estate (aka marital balance sheet or net worth), and the individual assets and liabilities which comprise such
- Determining income and expenses for spousal and/or child support (akin to an income statement or budget)
- Determining the value of the business(es) or business interest(s)
- Providing support for forensic services

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PART I

Documents Needed to Prepare the Marital Balance Sheet

During the divorce process, one of the preliminary financial documents requested, unsurprisingly, is tax returns. We've written about this in Mercer Capital's ***Navigating Tax Returns: Tips and Key Focus Areas for Family Law Attorneys and Divorcing Individuals/Business Owners***, which is a great resource for understanding and reviewing tax returns, particularly for purposes of divorce.

Tax returns report income received from various sources, which is beneficial for various financial analyses, but are also beneficial in constructing the marital balance sheet. Tax returns provide insight into other financial situations such as passive income and even hidden assets.

However, tax returns are dense and may not give as granular of detail as the source documents provided to a CPA who might prepare the returns. While it makes sense that tax returns are a preliminary financial document, they may not be the primary source for information, depending on facts and circumstances.

The Personal Financial Statement

Another key document to request in the divorce process is a personal financial statement ("PFS"), which is more commonly available to business owners. This is often submitted to a financial institution like a bank when seeking a loan. While usually required for a business loan, it can also be used for a mortgage, and may be required annually by the bank. The PFS provides assets, liabilities and sources of income and assets, which can shortcut the process of "finding" all assets and sources of income for the couple when building the marital balance sheet or determining income for support purposes.

A PFS can also be helpful if a spouse has opined on the value of their business. When applying for a loan, a business owner might be incentivized to view the business through rose-colored glasses. Sometimes, the opposite may be true in divorce, where a divorcing business owner retains the business post-divorce. The term "divorce recession" may come to mind, and the term exists for a reason. As with everything, facts and circumstances matter. The value of a business is not stagnant over time, and the value of a company may look different following a record year as opposed to its worst year. As one of our colleagues likes to say, while the value listed on a PFS is not the data point, it is one of many data points that valuation professionals ought to consider when evaluating a company and preparing for the due diligence interview.

Documents for Marital Balance Sheet (Dividing Up Net Estate)

In most divorce cases, either the expert or attorney will need to prepare a marital balance sheet, or statement of net worth or net estate; this may be referred to differently depending on state and jurisdiction. Divorcing couples may reasonably disagree about the value of the assets and liabilities that they own, and they may further disagree on division of these items. Experts can assist both in developing the list of assets and liabilities and reviewing division scenarios.

Our job is easier once we receive documents including statements with contemporaneous balances. This includes:

- Bank statements (checking and savings accounts)
- Any safety deposit box and contents
- Investments/Brokerage accounts statements
- 401k, IRA, and other retirement account statements
- 529 plans (good to be aware of, but commonly not analyzed as these are “separate” assets for the benefit of children)
- List of real estate owned – these may require current appraisals if they were not recently purchased
- List of vehicles, boats, jewelry, etc.
- Airline miles
- List of all business interests
- Investments that have active interest in
- Trusts, wills, etc.
- Mortgage statement
- Credit card statements along with list of credit cards and accounts
- Student Loan statements
- Other debt statements
- Tax refunds/liabilities
- Credit reports
- Insurance (home, life, auto, other assets, etc.)
- Others may be needed depending on circumstances

PART II

Documents Needed to Analyze Support and Need (A Lifestyle Analysis)

In Part II, we discuss the documents needed for analyzing support and need, otherwise known as a Lifestyle Analysis or a Pay and Need Analysis.

Analyzing what would be a reasonable amount for alimony is based upon both a division of assets as of the divorce date (covered in Part I) and expectations for future income and expense.

We frequently perform a Lifestyle Analysis for divorcing parties. This analysis examines and documents each party's sources of income and expenses. As noted in our **article** on Lifestyle Analysis, it is used in the divorce process to demonstrate the standard of living during the marriage and to determine the living expenses and spending habits of each spouse.[2] It is typically a more in-depth analysis required in the divorce process and is prepared by an expert credentialed in forensics.

As part of the divorce proceedings, each party typically files a financial affidavit, which is simply an expected monthly budget post-marriage. The historical status quo, or lifestyle, usually serves as a basis for developing these expenses. However, two households going forward sometimes cannot be similarly supported by the historical marital budget. For example, a married couple with a mortgage provides shelter for both spouses whereas post-divorce, there will be an additional mortgage or rent expense. Sometimes the marital residence will be sold, and each party will live in accommodations more commensurate with what is affordable within the divorcing parties' new budget.

Documents for Support Analysis or Alimony/Child Support (Comparing Marital Income vs. Budgeted Expenses)

While rent/mortgage is one of the largest monthly expenses, the financial affidavit will include a variety of categories including home, maintenance, vehicle, utilities, food costs, and other typical "fixed" or "shared" monthly expenses captured in a budget. Sometimes financial experts help with this process, while other times attorneys and clients gather and determine these budgets. Attorneys typically provide a template for monthly expenses, but clients may need to corroborate their entries with the following documents:

- Utility bills (cable, internet, electric, water, gas)
- Insurance (health, life, etc.) premiums
- Mortgage statement ("PITI" – which stands for principal, interest (both from fixed monthly mortgage payment), taxes and insurance)
- Credit card statements which may further break down:
    - » Groceries
    - » Gas

    - » Subscriptions (Netflix, Amazon Prime, etc.)
    - » Travel
    - » Meals & Entertainment
    - » Health & Wellness
    - » Medical
    - » Etc.

It's important to note that these expenses, where possible, should reflect those of the divorcing spouses, not child-related expenses. Child expenses such as tuition, extra curriculars, etc. should be considered separately in the award of child support paid to the primary care-taker and/or spouse with lower income potential depending on the facts and circumstances of the case.

While understanding a couple's expenses is important to determining alimony, reasonable expectations for future income is also very important. For a couple with a simple W-2 job, this analysis may be more straightforward. Still, there are many instances where income fluctuates from year-to-year based on bonuses or company performance, requiring more analysis and more documentation than what is provided on a W-2, 1099, or tax return. Helpful documents for determining income include:

- Bi-weekly or monthly paystubs
- Payroll registers
- 401k/ESOP statements detailing annual contribution levels
- Owner draws
- Documentation about restricted stock units, phantom stock, stock options, and other equity instruments
- Incentive-based compensation agreements such as bonus agreements
- Employment history
- Employment contracts
- Non-compete agreements

As noted above, the goal of this analysis is to determine ongoing earnings capacity. If a divorcing party was recently promoted where his/her compensation structure either increased or was materially changed (i.e. equity vs. W-2), a simple average of historical compensation likely will not be sufficient.

In many divorce cases, one spouse has taken on the primary responsibility of raising children. Depending on the facts and circumstances, a vocational expert may be needed to opine on the potential earning power of that spouse based on their experience, qualifications, education, credentials, and other pertinent information. While a credentialed financial expert should be able to make a reasonable determination for someone currently in the workforce, a specialized vocational expert may be required for a spouse who has not recently worked. All else equal, a higher earnings capacity for that spouse tends to reduce the "need" in determining alimony, and it becomes a more contested area in the process, which leads to the potential use of a vocational expert.

TIP FOR BUSINESS OWNERS

It is important to understand how much the party's income is from services performed in his/her capacity as an executive versus how much of the income is a return on the capital invested in the business. How this gets analyzed in a Pay and Need Analysis can become complicated and is a hotly debated topic. Triers of fact may disagree on whether valuing the business also inherently considers some of this income, known as the "double dip." Because officer compensation can be a key discussion within the valuation of a business, we will cover it in greater detail in a future part of this series.

PART III

Documents Needed to Perform a Business Valuation

In Part III, we discuss the documents needed for performing a business valuation, the core competency of Mercer Capital.

There are many unique considerations and complexities to business valuation in divorce, often requiring more documentation and analyses. This includes personal goodwill, owner/operator compensation for valuation and income division purposes, formula clauses in buy-sell agreements, and active vs. passive, among others.

Documents for Business Valuation

As appraisers, we provide business valuations for divorce as well as many other purposes. Regardless of the industry, there are certain documents we request in every engagement:

- 5 years of financial statements (balance sheet, income statement,etc.)
- 5 years of business tax returns
- Budget/forecast/projections
- Compensation of owners and/or key management
- Corporate documents (operating/shareholder agreement(s), etc.)
- Recent valuations of the business or its underlying real estate
- List of top customers or relationships and revenue levels
- Key suppliers and any contractual relationships
- Available information on competition and/or industry
- Any documents provided to/received from a lending institution (bank) to receive financing
- Detail regarding recent transactions within the stock of the company
- Capitalization table (detailing ownership interests)
- Distribution policy
- Shareholder communications/Board minutes

Sometimes some of these documents/items do not exist at the subject Company, which will not necessarily prevent us from performing our work, but the more information we receive the better.

When valuing businesses, or really any stream of cash flows, valuation comes down to three variables: expected cash flow, risk, and growth. All else equal, investors want larger cash flows, that are growing faster, and that are less risky than alternative streams of cash flows. Financial documents show historical earnings and trends, which serve as a basis for expected future cash flows.

Other information requested like top customers, suppliers, and competition show both capacity for growth and risks associated with the earnings the company has recently generated. A business valuation involves both qualitative and quantitative information and analyses.

Personal vs. Enterprise Goodwill

In divorce, there are additional considerations when valuing a business. A common battleground for experts is personal goodwill, which is not a divisible asset in divorce in many states. For example, if a business is worth $5 million, but it is determined that $3 million of the value is attributable to personal goodwill, the value of the business for marital balance sheet purposes might be $2 million.

There is no one-size-fits-all methodology or approach to allocating personal vs. enterprise goodwill. It will depend on the industry, history of the company, and relative contributions of the divorcing party as well as contributions of all other employees, among other factors. From a theoretical perspective, personal goodwill should show the difference in value of the business with and without the contributions from the divorcing party.

Documents to help determine personal goodwill may include:

- Revenue generated by provider (what % of revenue is attributable to the divorcing spouse),
- List of roles/responsibilities of the divorcing spouse, among others.

The availability of documents will vary greatly. These complex analyses can be both a quantitative and qualitative analysis, and it will depend on the facts and circumstances what documents will be relevant.

Active vs. Passive Analysis

Like personal vs. enterprise goodwill, an active vs. passive analysis determines whether the appreciation of an asset or investment during a marriage is considered marital property. States differ in their treatment, and this analysis may be necessary for a business owned by a divorcing party prior to the marriage, which has appreciated during the marriage. However, it can also be necessary on investments in passively held retirement accounts. We will delve more into this in Part IV regarding documents needed based on the nature of the investment.

Owner Compensation

In all business valuations, an assessment of the reasonableness of management compensation needs to be considered relative to market rates. It is common for business owners to not pay themselves exactly in line with market rates, or perhaps the owner compensation structure includes base rates and profit sharing. We see compensation structures in many different forms and fashions, and above/below market comp is not necessarily nefarious.

In the end, the money ends up in the owner/operator's pocket, whether as W-2 earnings or distributions from company profits. In business valuation, particularly in divorce, it is more important to make a judgment on how much of the profits should be allocated to the owner's labor (wages) and how much to their investment in the business (return on investment). In divorce, the business owner's market wages may be utilized in determining alimony whereas the return on the investment in the business is capitalized into the present value of the business, which is placed on the marital balance sheet.

We consult available industry benchmarks to help determine reasonable compensation, but information about compensation for other key members of management and available industry-specific data is helpful in making these determinations.

Impact of Formula Clauses in Company Agreements on Business Valuations in Divorce

It is important to consider the purpose of the valuation, as this can influence the valuation conclusion. For example, some buy-sell agreements provide for how a business is to be valued upon the death of a shareholder. However, this may not be relevant to the valuation in a divorce context for a few reasons:

1. If a formula clause is included in a Buy-Sell prescribing how the company will be valued due to a "Triggering Event," but divorce is not listed as one of these events, then it may not be relevant to the valuation during a marital dissolution.
2. Even if divorce is listed as a Triggering Event, if the non-business spouse is not a party to and therefore does not sign the agreement, they are not necessarily bound to being bought out based on terms in a Buy-Sell or Operating Agreement.
3. The Standard of Value for divorce purposes is typically Fair Market Value.

PART IV

Documents Needed to Perform a Forensic Analysis

Finally, we discuss the documents needed for other forensics services and valuation services. There are numerous types of forensics services with which a qualified financial expert can assist, though many of the documents utilized in these analyses are already captured in other divorce-related analyses.

Here we discuss documents for arithmetic determinations of separate vs. marital, active vs. passive, and asset tracing. The appraiser/financial expert does not render legal opinions, though, assists with quantifying complex financial issues, while being aware of statutory and case law in varying jurisdictions.

Separate vs. Marital

When equitably dividing the marital estate, assets and liabilities must first be identified/categorized then quantified. As with personal goodwill, the analysis does not always stop there as the total value of an asset may or may not be fully marital. The increase in value of a business owned and operated by a divorcing spouse is more complicated (as discussed below).

However, in many jurisdictions, a retirement account balance that appreciates solely due to market forces is usually considered passive appreciation, unless, perhaps one spouse has a background in investing and is actively managing the account as part of his/her business activities.

If the appreciation of the date-of-marriage balance is deemed passive, the marital interest in an account can grow from $0 from marital contributions during the marriage and market growth/decline on said marital contributions.

For example, say a spouse saves $25,000 towards retirement prior to marriage and continues to contribute post-nuptials with marital money. If the balance at divorce is $100,000, some portion of that may be marital (contributions during marriage plus growth of those contributions), while the original $25,000 plus any market gains on that initial balance during the marriage, may be separate, depending on state statutes.

To perform this analysis, financial experts need:

- Monthly/quarterly/annual retirement account statements, sometimes dating back to date of marriage
- Paystubs and/or W-2s detailing contributions over time (if not shown on account statements)

The financial expert will also pull data from the market and maybe even industry indices. The math and methodology are straightforward, and it is likely that financial experts would come up with similar conclusions if each expert is given the same set of financial documents, use reasonable methodologies and both correctly understand how separate vs. marital works in the couple's jurisdiction.

Active vs. Passive

For active vs. passive analyses of business appreciation, two valuations will usually be necessary: one valuation as of a current date, and one as of the date of marriage. In some jurisdictions, a third is necessary for the date of separation.

If a valuation is not available as of the date of marriage, the appraiser can perform a retrospective appraisal. The financial expert should consult with the attorney on the matter to ensure they understand the active vs. passive precedent in the state in which he/she is providing services, as these may differ. The retrospective appraisal will require much if not all the same documentation as the current valuation, just backdated to the date of marriage.

We discussed the documents to obtain for valuation purposes in Part III. Additional quantitative and qualitative data may need to be obtained for active vs. passive analyses, including:

- Efforts of the divorcing spouse versus efforts of others (management, leadership, owners, employees)
- Efforts of third parties
- Relationships with vendors, customers, etc. (held by a divorcing spouse or other members of management team)
- Characteristics of the business at the various valuation dates (this may be already gathered in conjunction with the valuation process)
- Source of additional funding/capital, if applicable

The financial expert will also analyze changes in the industry, regulations, tax rates/law, and the general economy between the valuation dates.

Asset Tracing

Asset Tracing services can be performed in conjunction with analyses of separate vs. marital as well as investigative services for potential dissipation/waste claims. For the latter, before we pursue these analyses, there are typically two questions to consider.

1. What is being investigated?
2. How much time/effort/money may be required to investigate and corroborate the dissipation analysis?
   - This can be a difficult answer for forensic professionals, as we may or may not yet have an understanding of scope, level of documentation involved, etc. In our experience, progress updates typically assist the process.

Key documents to "follow the money" in tracing exercises are monthly bank statements and credit card statements.

This analysis can become complicated when there are numerous bank accounts, but money usually transfers in and out of a bank. Tracing cash that doesn't make its way to a bank, whether personal or business-related, becomes a bit more difficult but the analysis can be handled.

The documents requested will vary, but many such analyses will require relevant bank statements and general ledgers if a business is involved.

About the Authors

David W. R. Harkins, CFA, ABV has been involved with hundreds of valuation and litigation support engagements in a diverse range of industries on local, national, and international levels. He provides valuation analyses for family law, commercial litigation, gift and estate tax planning, transactions (M&A), fairness and solvency opinions, and employee stock ownership plans (ESOP), among other valuation-related service needs of privately held businesses.

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Karolina served as the 2020 and the 2021 Valuation Chair of the AICPA's Forensic and Valuation Services Conference and was a member of the AICPA's CFF Exam Writing Task Force.

In February 2022, Karolina joined the American Academy of Matrimonial Lawyers (AAML) Foundation, Forensic & Business Valuation Division. In addition, Karolina has served on the AICPA Business Valuations Committee since 2022.

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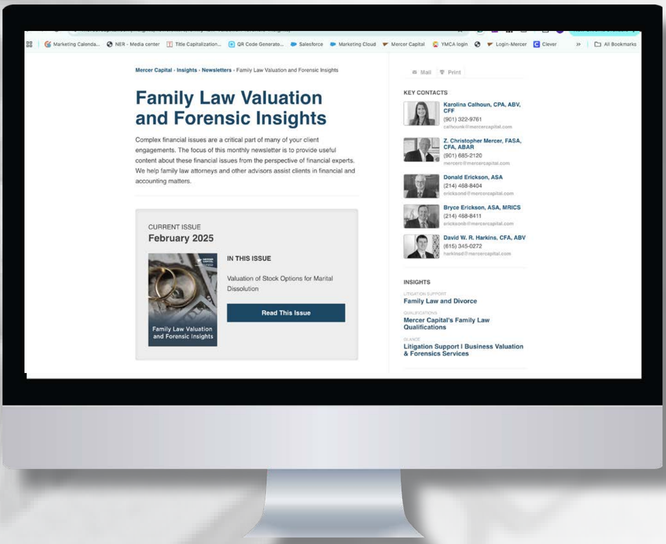
MERCER CAPITAL'S

MONTHLY NEWSLETTER

Family Law Valuation and Forensic Insights

Addressing Complex Financial & Valuation Issues

Complex financial and valuation issues are a critical part of many of your client engagements. The focus of this monthly newsletter is to provide useful content about these issues from the perspective of financial experts.



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Mercer Capital is a national business valuation and financial advisory firm. We are frequently engaged to provide support in family law and divorce disputes.

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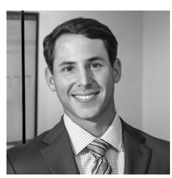

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Mercer Capital brings analytical resources and over 40 years of experience to the field of dispute analysis and litigation support. We assist our clients through the entire dispute process by providing initial consultation and analysis, as well as testimony and trial support. Our Litigation Services team brings national experience in subject matter and industry expertise.

For more information or to discuss a potential matter in confidence, contact one of our professionals.

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