

Forensic Accounting Techniques for Validating Income and Assets (provided by Sandra L. Popescu, CPA)

“Fraud and falsehood only dread examination. Truth invites it.” -Thomas Cooper.

This is the very premise forensic accountants rely upon for their investigations. In fact, the same techniques used to uncover hidden income and assets can be used to validate them as well. Not all ex-partners are attempting to hide their wealth, but unfortunately, this tends to happen more often than the opposite case. In either situation, the data must be accumulated and scrutinized to determine where truth lies.

As always, nothing is stagnant in life, nor are incomes. Incomes naturally increase and decrease depending on many different circumstances including good/bad business decisions, economic upturns/downturns, and just normal business cycles. Since support is generally based on “real” income, it is important to determine what “reality” really is. The income reported on a tax return is generally not the same income the courts use to calculate support. Most often, there are many adjustments to the tax return income by the courts. In addition, we all know that there is a strong tendency to understate income on tax returns to minimize the tax consequences. The opposite is true when it comes to income reported to obtain additional credit lines, to sell a business, or to obtain additional investment monies. When searching for income and assets for support calculations, we generally assume the mindset that wealth is being understated. Whether you believe your ex-partner is capable of this or not, it is important to obtain a certain comfort level that the amounts are reasonable. It also provides a baseline for future proceedings. As I stated earlier, nothing in life is stagnant. As situations change, you may be in a position to seek assistance from the courts for an increase (if you are receiving support) or a decrease (if you are providing support) in your current court order.

Detecting **hidden assets and unreported income** requires an understanding of the individual’s history and current situation relative to their personal life and financial affairs (business, investments, and employment). Based on the individual’s “Income and Expense Declaration” and the history you have acquired about him or her, you will want to develop your own hypothesis as to whether the declaration appears realistic. A basic strategy can then be developed bearing in mind the time and cost constraints as well as your ultimate goal. As we focus in on the more significant pieces of the puzzle, we begin applying certain investigative techniques linking the various clues together so that a “picture” begins to emerge. While success is never guaranteed, certain techniques may produce successful results. Here are a few to consider:

The Individual

Lifestyle Check

Generally, the first step taken is to look at the lifestyle of the person earning the stated income. Is there a correlation between the lifestyle and the income? Are the basic living expenses (mortgage/rent payments, property taxes, homeowner fees, utilities, gardeners, housekeepers, etc.) in line with the income? How about the car(s) being driven? (Are they leased or purchased? How often? Who makes the payments?) What local restaurants or clubs are

frequented? (How often? Are they moderate or pricey? Is there a big tipper here?) What scale of department stores is frequented for clothing and home furnishings? Are there any extravagant hobbies indulged in or expensive activities like gambling, racing, collecting cars, wines, virtual shopping, etc.?

Travel: Does the person do a lot of traveling and to what destinations? Does she or he fly first-class or coach, stay at three-star or five-star hotels, and is there generally a companion along? Are the trips for business or pleasure, or a combination?

Frugality: Maybe the person lives well within his or her means and there's really no mystery here. Or maybe, the individual is deliberately trying to put you off the scent. Is the individual claiming loss of income and if so, was the loss of employment voluntary or involuntary? Could the person be purposely living the life of a pauper or are there real economic issues here? Whatever the case, the circumstances need to be investigated to determine if there is a disparity between his or her work experience and years of education with the level of employment or income. If the party was laid off, perhaps there was a substantial severance pay package paid out that would allow the party to take a year or so off. Don't just assume the person is in a financial crisis because of being unemployed! At the same time, don't assume a high wage earner can just find a new job tomorrow when he or she gets laid off. Being a president of one company does not automatically qualify you to be president of another company! These positions are few in comparison to the many other positions and with the uncertainty of today's economic times, we all know jobs are not just waiting for you! While some people may deliberately try to manipulate the court system, others may truly have economic hardships. Whatever the situation is, be prepared to present your evidence to the courts. You can always contact the local employment companies with the person's credentials in hand to get an indication of their employability. If the individual is not actively seeking employment nor made substantial modifications to the lifestyle, then there may be some indication that income is being foregone intentionally.

Disparities between the lifestyle and the reported income may exist because the person has incurred additional debt to support it. If not, then there may be other possible explanations such as a recent inheritance, significant other investment income, a new well-to-do spouse, etc. Discovering the justification for the disparity may or may not have an impact on the current support amount. However, if nothing seems to justify the lifestyle in excess of the reported income, then there is a good possibility that unreported income is funding the lifestyle. This hypothesis, with its justifications, may not, by itself, be convincing to the court, but it will lend significant support to other evidence. In the end, it is up to the judge to make the decision, but hopefully, your forensic accountant has deciphered the information well enough to put the "big" pieces of the puzzle together for the judge to make an equitable decision. The judge may even decide to use the individual's earning capacity rather than actual earnings to determine support.

Cash Flow Check

We already obtained some idea of the income and expenses from above, but now we need to see the cash flows for ourselves. We need to review the bank statements. By tracing the monies in and out of the accounts, we can determine our own estimate of the expenses and income and possibly identify the sources as well. Wire transfers should also be scrutinized closely as well as

significant cash transactions, which may suggest illegal activities or some other interesting arrangements. We can also examine the cancelled checks for suspicious payees and amounts, or curious endorsements. The endorsements may indicate other bank accounts or transfers to related parties. Based on what is discovered here, we may want to review more in-depth documentation such as credit card statements and receipts, telephone bills, or even small package carrier receipts. Perhaps we will discover a lot of activity in a particular foreign country suggesting perhaps another business venture or a bank account. As in all puzzles, one piece generally leads you to another!

The Business

Business “Lifestyle” Check

We all know there are plenty of ways to try and hide income through a business endeavor if one so desires. While most people try and run an honest business, some individuals are not so honest and others are downright incompetent. In any event, it is imperative that you have a basic understanding of the business and its related “lifestyle.” An initial visit to the business premises can be very helpful. Many times it can expose some potential areas for investigation and likewise, rule out certain areas, which might otherwise be explored. It is essential to understand how the business is run, how involved the owner is with the business, and what his relationship with the employees is, etc.

Revenues: It is important to look at how the money comes in and who receives it. We need to identify what kind of internal controls are in place and how effective they are. If there are checks and balances between the monies coming in, the recording of the receipts, and the actual deposits, then there is good internal controls over the funds. In that situation, it is probable that all receipts are being recorded. However, if the owner or another partner can (and does in fact) override these controls, then the controls are not very effective even though they appear to be in place. It is extremely difficult in small businesses to be able to segregate duties when there are few people employed. Therefore, it is possible that the same person receiving and recording the receipts is actually making the deposits. In small professional practices, the name of the person is often the name of the business. Therefore, a client may issue payment in the name of the partner who provided the services and perhaps these monies get deposited directly to the partner’s personal account? Or, perhaps the partner goes directly to the customer’s bank to cash the check. In situations where the owner might receive the payments directly, the accounts receivable records should be reviewed in conjunction with the cash receipts records.

Appointment calendars should also be reviewed. If payments are made at the time of service, there should be a correlating receipt. The write-offs need to be reviewed to see if they are merely cover-ups for receipts that were simply not deposited into the business account. Write-offs should be supported by the actual attempts to collect, such as related correspondence, letters from/to the company’s attorney, lawsuits, etc.

Expenses: The nature of the business dictates the kind of expenses generally incurred. Large travel expenses and/or professional fees may or may not be typical for the type of business identified. Likewise, an electronic retail store would normally not purchase multiple cases of wine. While the company might claim to be sending gifts to customers at year-end, that

wouldn't make sense if the purchases were throughout the year. Besides, the company should also have a list of the customers the gifts were given to, postage for the mail outs, and other evidence documenting the assertion. At the same time, if we can determine the amount of goods purchased for resale, we can fairly accurately determine what the sales should be given the amount of usual markup.

Industry. Statistics generally exist for most businesses, and the statistics of the subject business should be compared with others similar to it. At a minimum, the gross profit margins and the overall profitability should be compared. If disparities exist between what it costs the subject company for each dollar of sale compared to the industry, then one should examine the expenses to see if personal or unusual expenses inflate them. While a logical explanation for the variance from the industry norm may exist, the variance itself is an indication that something is unusual, and deserving of additional analysis.

Cash Flow Check

Again, we need to review the bank statements to ascertain that the financial statements agree with the funds flowing through these accounts. Once again, we will look for tell tale signs of disparities as noted previously.

Conclusion

It is often times very difficult to find unreported income and hidden assets, but generally there are clues left behind that can prove very meaningful to a forensic accountant. Finding enough clues to paint a meaningful picture for the judge is what really matters in the end and that may require more than what meets the eye!

Sandra Popescu, CPA, CVA, CDFA, has been in private practice since 1988 providing accounting services to individuals and small businesses. Coupled with the investigative accounting skills she acquired as an auditor with the prestigious firms of Peat Marwick Mitchell & Co. along with Arthur Young & Co., Ms. Popescu has expanded her services to include the field of Forensic Accounting, Business Valuations, and Collaborative Divorce. This career move has proven to be her most challenging and rewarding endeavor to date. She has an office in San Diego and in Rancho Santa Fe and can be reached at ProDATA Financial Solutions, (858) 759-5027 or sandy@prodataFS.com