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Contentious divorces: when to call in a forensic accountant

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It's a classic conundrum: On one hand you have a client's most recent tax return showing $100,000 of taxable income, and on the other hand the client's personal financial statement (Form 401) reports expenses exceeding $150,000 annually. How can this be?

The situation most likely occurs when the parties have ownership and control over the finances of a business. When facing a bad math equation in which personal expenses exceed business income, a deeper dive into the financial records may be warranted.

Here, we'll explore the benefits of engaging a forensic accountant in a marital dissolution involving one or both parties' ownership in a business.

Forensic accounting is often defined as the art and science of investigating people and money. The role of forensic accountants in divorce is often dependent on the facts of the case, availability of records, scope of procedures, time until discovery closes, and the funds available.

Unique facts, circumstances

The initial stage in planning an engagement with a forensic accountant is to understand the unique facts and circumstances of the case. Sometimes the need for outside assistance is triggered by potential red flags such as a cash intensive business or document manipulations. Other times it is not so obvious, such as a decline in business profitability in the year of divorce.

These signals may be resolved by verifying the changes in operations (such as the loss of a key customer, supplier or employee) or comparing to recent industry or regulatory changes. For example, the company's increased salary and wage expense may be attributed to the phased increase in the Massachusetts minimum wage from $9 an hour in 2015 to $11 an hour by 2017, and that would directly explain the decline in profitability.

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Availability, reliability of financial records

The next considerations are the availability of records and the reliability of those documents. The business tax returns should be obtained in their entirety and include depreciation worksheets, supporting schedules, K-1s, and any net operating loss — or NOL — carryovers. The simple task of making sure the ending balances on the prior year returns agree with the beginning balances on the current year return may help to identify areas for further investigation.

Financial results reported on a tax return are similar to looking at the outside of a car. It may look new and shiny on the outside until you look under the hood and open the doors to reveal the truth about the numbers.

The financial details are exposed and then verified through additional records such as statements for bank accounts, credit cards (business and personal), investment accounts and digital currency accounts.

Useful information also can be derived from point of sale reports, obtaining loan applications, agreements (loans, leases, franchise), social media accounts, work papers from tax preparers, and other regulatory filings such as excise tax returns.

When the veracity of information is questioned, the financial documents should be requested directly from third parties to limit any possible data manipulation. The financial information may also need to be corroborated with external data from suppliers, customers, regulators or employees. For example, a restaurant with unusual gross margins may need to request the invoice copies from key suppliers to analyze the purchase activity over time.

Prior to commencing the forensic investigation, the completeness of the records is critical. Counsel should ensure every page to a statement and all months are included.

Once received, the forensic accountant can reconcile the tax returns/personal financial statements with the volume of activity in the accounts. Items not affecting income such as transfers between accounts, loan proceeds or principal repayments, inheritances and gifts will be segregated, and any remaining cash receipts can be used for income determination. The reconciliation process can also help identify new accounts or hidden assets as the sources and uses of funds are analyzed.

Specifically, when one or both of the parties pursuant to a divorce has an ownership in a business, the situation becomes more complicated and the reliability of information is necessary for a defendable analysis.

The following illustrates the scale of reliability of business records for use by forensic accountants, with the least reliable on top and the most reliable at the bottom:

High Risk of Manipulation	Manual ledgers
	Invoicing software or other industry point of sale
	QuickBooks
	Self-Prepared Tax Returns
	Tax Returns Prepared by Third Parties such as a Certified Public Accountant (CPA) or Enrolled Agent (EA)
	Compiled Financial Statements
	Reviewed Financial Statements
Low Risk of Manipulation	Audited Financial Statements

The reliability of the data is increased when third-party professionals perform some measure of data verification, analytical procedures, internal controls analysis or actual testing of source documents.

Also, the use of external tax and accounting professionals reduces the business owner's ability to influence the reported results. However, even the most reliable audited financial statement may not remove all the discretionary spending from the business activity.

Scope of procedures performed

Beware the classic data dump, as not all reliable financial data is relevant to the forensic accountant. There may be thousands of financial documents available for the case but not a reason for counsel to copy and ship all those boxes of records to the forensic accountant.

It is important to work with the forensic accountant on the types and quantity of records to be analyzed. This can be determined by defining the scope of procedures and performing tests of full and false inclusion. Full and false inclusion tests are used to determine the appropriate "universe" of data under investigation. This ensures that no extraneous data is included and that no appropriate data is excluded.

Another key aspect of the forensic investigation is the extent of the periods to analyze. As a general rule, the periods analyzed should 1) establish a baseline for the spending/business activity and 2) include sufficient periods after the dispute occurs.

In divorce situations, the financial activity post-separation may be limited and the historical information is the de facto most reliable — especially when both parties were active in the business.

Developing a plan to identify discretionary spending classified as business expenses is a central issue in discovering the income versus personal expense differences.

Discretionary spending can be defined as fringe benefits to a business owner classified as business expenses. It should not be assumed that any discretionary spending found on credit cards or bank statements is automatically expensed on the income statements. These charges may be included in shareholder loans, distributions or in the owner's compensation and therefore not require an adjustment.

Adjustments for expenses such as meals, entertainment, travel, marketing and advertising may, by their description, be negotiated without the use of an expert. However, situations involving intentional deception (such as coding a casino charge to "purchases") or disagreements regarding the vendor and disputed transactions (either in part or entirety) will likely require the use of a forensic accountant.

A useful consideration in this process is how the company performs relative to industry benchmarks. If the profits of the business after adjusting for "strong indicators" of discretionary spending are at or above the benchmark data, further scrutiny may not be useful due to the costs or resources required to produce the source documents.

Available time and funds

Assessing whether there is sufficient time or financial resources is also a determinant in hiring a forensic accountant.

There simply may not be enough time to conduct the procedures described above to generate a detailed analysis from the financial consultant/expert. In such situations, it is important for counsel to discuss the essential procedures and funds available with the forensic accountant. The costs of analyzing the various accounts and periods covered must be weighed against the benefits conferred.

Close communication with counsel is essential throughout the process as it is not uncommon for forensic accountants to follow appropriate methodologies, obtain sufficient records and support, and still not be able to determine whether unreported income occurred or justify any adjustments.

Discussing the progress of the forensic accountant through discovery and the scope of procedures may determine the direction of the case and type of report required.

In conclusion, while the facts and circumstances are unique to each case, the key consideration is whether both parties can maintain the same lifestyle post-divorce based on the expected cash flows available. MLW