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Certified Public Accountants/Business Consultants

Forensic Accounting Investigation in Divorce - When is it Warranted?

The sad fact is that almost 50% of all marriages end in divorce. It's also a fact that most marriages that end in divorce are in trouble long before the divorce petition is filed. This fact provides ample opportunity for either spouse to hide assets and income. The more animosity there is between the couple, the greater the chance that one or both is hiding income and assets.

Many spouses have significant experience hiding income or disguising non deductible expenses for income tax purposes. It's a simple matter for them to apply these skills to their pending divorce problems. Typically there will be little direct evidence that the income ever existed. If the client spouse suspects or knows that the other is engaging in these practices, a forensic accounting investigation is often necessary to provide supporting evidence of the hidden income.

The forensic accounting investigator brings valuable skill sets to the divorce process:

1. Analytical skills and industry experience necessary to investigate a wide variety of financial documentation.
2. Classic skills of a CPA coupled with financial investigation tools.
3. Ability to testify as an expert witness.
4. Advisor to the attorney in finance, tax and business practices

When a Closely Held Business is Involved

Usually a forensic examination is considered when one spouse is **actively** involved in running a closely held or single owner business. In this scenario, the opportunity to manipulate income and hide assets is limited only by the spouse's creativity.

Many spouses think they know approximately what the opposing spouse earns in compensation. However, they are often oblivious to the cash and other assets their spouse is taking out of a closely held business. It would be a rare case that did not warrant some level of investigation into the financial records of the closely held business.

The business may be used to purchase assets that are hidden from the other spouse. Often, the cost of these assets is buried in the fixed assets or written off as cost of goods sold or operating expenses.

Business funds are frequently used to pay family and personal expenses. Most of these types of expenditures are tax fraud, which gives the spouse more incentive to hide them. Typical non business expenses found during a forensic examination include:

- Salaries to "ghost" employees
- Social and health club expenses
- Automobile and boat expenses
- Non-business travel and entertainment
- Rent on non-business property and equipment

Financial Statements are often manipulated to hide income when a divorce is contemplated. A common trick is to “cook” the books so that revenue and expenses are moved between periods to report artificially lower profit. Another common trick is to record revenues as liabilities or record asset purchases as expenses. Contracts can be delayed to lower the value of the business.

In order to disguise the profitability of the business, a secretly owned or controlled vendor may be used to mark-up critical supplies so that the cost of sales is inflated and the reported profits suffer. Another common trick is to pay wages to a “ghost” employee who is often a girlfriend or boyfriend.

In deciding to call for a forensic investigation of the closely held business the attorney should discuss the following questions with the client spouse:

- . • Are family expenses paid by the business?
- . • Have family assets been purchased with company funds?
- . • Does the opposing spouse brag about hiding income from the IRS?
- . • Are cash transactions a significant part of the business?
- . • Does a CPA prepare audited financial statements for the business?
- . • Has the business been the subject of an investigation by the IRS?
- . • Is there more than one owner of the business?
- . • Does the business own or control other businesses?

When there is financial complexity

Individuals with significant income such as highly paid executives and professionals such as doctors, attorneys and accountants often have significant discretionary cash. Even if this type of opposing spouse’s primary income is from salary and wages, there will be plenty of cash available for investing and diverting from the marital unit. Likewise, when the opposing spouse has personal wealth or significant wealth and assets have been accumulated during the marriage.

A forensic accounting investigation may reveal previously unknown bank accounts, investments and other assets. Often the client spouse has observed activity by the opposing spouse that indicates a forensic accounting investigation is appropriate. The attorney should ask the client spouse:

- . • Does the client ever see the spouse’s paycheck stub?
- . • Do both spouses maintain separate bank accounts and credit cards?
- . • Does the opposing spouse frequently travel to the same location for business?
- . • Has the client seen out of state bank statements and other financial correspondence?

When there are claims of separate property

The division of property between the spouses is often a complex matter. A forensic accounting investigation can assist the attorney disclose hidden or transferred assets, validate claims of separate property, or identify transmuted assets.

When a premarital agreement exists

A forensic accounting investigation is warranted when the assets listed in the prenuptial agreement may have been transmuted or commingled with the marital assets. If the agreement called for specific income allocation of the premarital assets, a forensic accounting investigation is usually called for to determine compliance with the terms of the agreement.

Often, a forensic accounting investigation is needed to trace the assets listed in the premarital agreement to establish whether the assets remained as separate property, whether they were transmuted or commingled with marital property, and whether any incremental appreciation was created during the marriage that must be considered in the divorce.

When the premarital agreement specifies income disposition during the marriage or in the event of divorce, the forensic accountant will trace receipts and disbursements to determine if the terms of the premarital agreement were adhered to and, if not, how the variances affect property distribution and support obligations.

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