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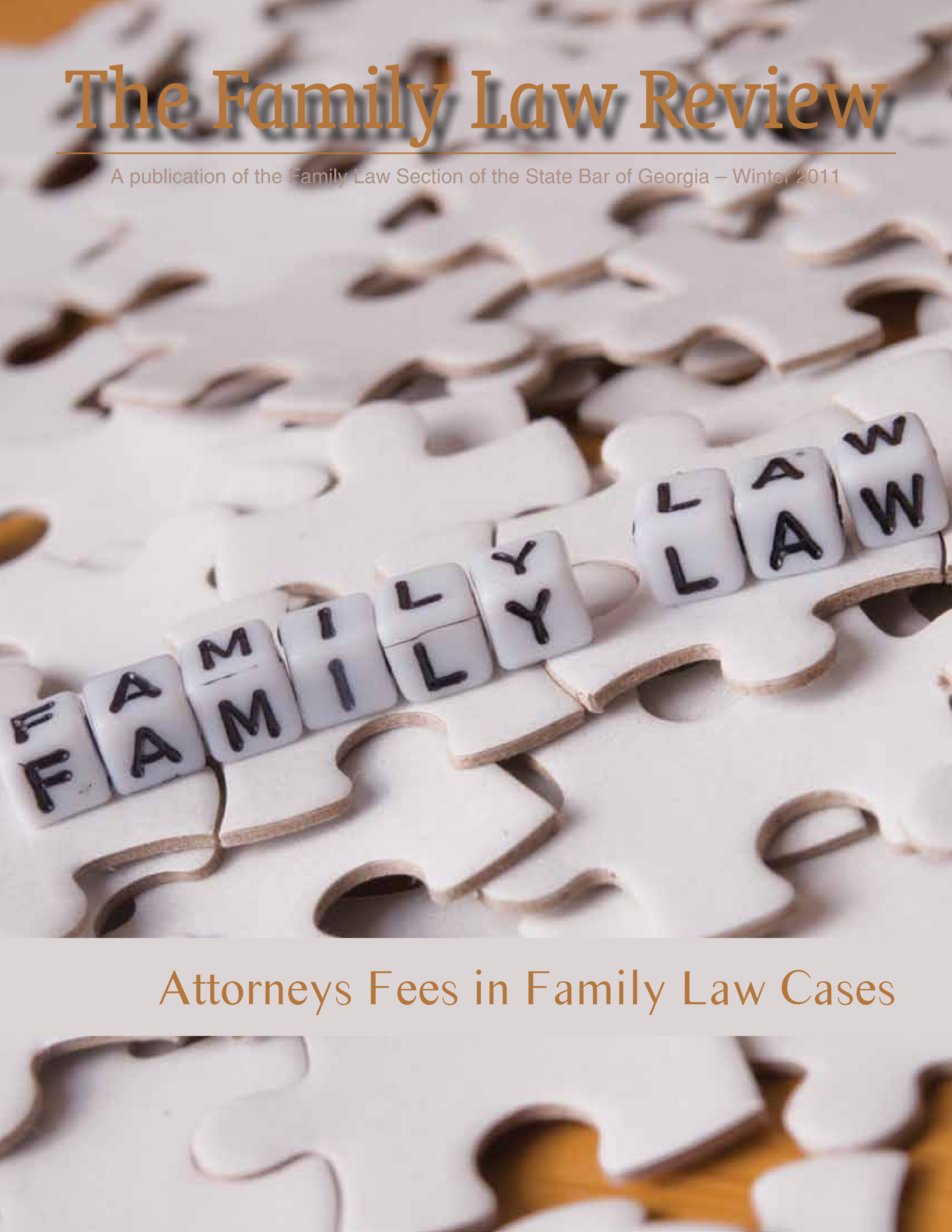

Attorneys Fees in Family Law Cases

Uncovering Hidden Income in a Closely Held Business*

by Tracy L. Coenen

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When a divorce or a child support issue is looming, it's amazing how a quickly a closely held business starts "losing money." I use quotes because such a situation is so predictable. One party wants to protect her or his assets, and when there is a business involved, the motivation to hide money can be stronger than usual.

The types of businesses that can be prone to manipulation of the books include restaurants, retail stores, doctor or dentist offices, construction companies, auto dealerships, and law practices. This list isn't exhaustive by any means, but it provides good examples of businesses at risk of financial maneuvering.

Any business that is closely held and has finances that are easily manipulated by the owner is at risk. A lawyer filing for divorce from his wife may suddenly stop taking a paycheck and then claim he has no earnings from the practice. A restaurant owner could stop reporting cash receipts from customers, thereby claiming much lower revenue for the business while secretly pocketing the cash. A carpenter may offer customers a discount if they pay with cash and don't request a receipt, never reporting that money as income.

In just about any business, there are many ways to hide income, but there are also many ways to find that income. Family law cases require a keen eye to the finances of a closely held business. It is not unusual for a company to appear to experience a downturn in business following a divorce filing or child support action. It is important to take a look at the books and records to determine if there is any evidence of hidden income.

Third Party Records

The most reliable and obvious way to prove that a company has unreported earnings is through the examination of third party records, such as bank statements and credit card statements. Barring some unusual circumstance, those types of records are nearly impossible to manipulate. So if such records can be obtained directly from the third party, the data within them really doesn't lie.

The bank statements and credit card statements might show a different picture than what has been reported by the spouse. Deposits may show a much higher level of revenue, and credit card receipts may also add to the revenue. The clever fraudster likely isn't going to deposit income into the business bank account if she or he is intent on concealing income, but this is still an area that should be examined because there may be other clues in the documentation.

Costs Fluctuate With Revenue

When people underreport their income for tax purposes or to avoid child support or alimony, they often make one critical mistake: They still report all of their business expenses. They are eager to hide income, but they typically don't want to miss out on any expense deductions.

In almost all businesses, there are some expenses that fluctuate with revenue. For example, in a manufacturing business, cost of goods sold is usually closely correlated to sales. In a restaurant, food costs are generally predictable based on revenue. In any business that is labor-intensive, hourly wages often move along with sales. A dental practice will typically have materials and lab costs that follow with revenue.

To find hidden income in a business, we can isolate the expenses that track with income based on historical tax returns and financial statements. The results of this analysis can be applied to current figures. If the variable expenses that should track with income are suddenly much higher than expected, a good case can be made for unreported earnings.

Capital Improvements

A business that appears to be contracting and losing money (or not making as much as before), likely doesn't need new capital assets. Check the tax records to see if new buildings, machinery, and equipment have recently been purchased. If so, we need to investigate the reason why these purchases were made.

Such purchases are usually a sign of an expanding and flourishing business, although sometimes they simply relate to replacing old items. There is a big difference, and it is important to get to the bottom of these purchases when searching for hidden income. Capital improvements that appear to be for the purpose of expanding a business can point to hidden income. Such an item alone won't prove that there is concealed revenue, but it will be one more item in support of that theory.

Cash Versus Credit Sales

A telltale sign of a business owner concealing revenue is a change in the ratio of cash to credit sales. Retail stores, restaurants, and bars accept both cash and credit cards from customers. Many times, there is a predictable relationship between the two. If we look at sales over a period of a few years, we can often see that the ratio of sales made for cash and sales made on credit cards is within a narrow range.

A sudden change in this ratio is cause for concern. If we see that a much higher than normal percentage of sales are made on credit cards, we have cause for concern that cash sales are being concealed. It is easy to pocket the money from cash sales and leave little to no paper trail. Thus, these sales are more likely to be manipulated.

Billing Records

In a service-based business, a look at billing records can point to hidden revenue. Doctors, dentists, lawyers, and accountants are usually meticulous in keeping records of time and procedures, as they want to bill clients for all services provided.

The source records may present a much different picture than the financial statements by themselvesd. It is easy to manipulate financial statements, while manipulating the underlying timekeeping or procedural records is much more difficult and labor-intensive. Therefore, it is important to look at the underlying records to have a better chance at finding hidden income.

Lifestyle Analysis

One way to find hidden earnings is through an analysis of the of the person suspected of hiding income. The purpose of such an analysis is to determine whether the person's lifestyle could be supported by the level of income that is being reported. This is done by examining all known expenses, using available documentation and public records to substantiate the numbers.

Items such a mortgage payments, utilities, car payments, and the like are relatively easy to determine. Other spending, such as groceries, dining out, and vacations are not as easy to determine, but conservative estimates can be used. The goal is to tally up the known spending and compare that to the reported income, and determine whether the reported income is sufficient to pay those expenses. If it is not sufficient, then there is some other unknown source of income.

It may also be important to look for evidence of the business paying the personal expenses of the owner. In divorce and child support cases, personal expenses paid by the business harm the other party in two ways.

First, running the expenses through the business reduces the net income of the business, giving a lower base for any support order. Second, the business owner often reduces her or his paycheck from the business simply because there are now fewer expenses that need to be paid out of the personal income. Therefore, any wages or distributions from the business are lower than normal, again reducing the base figures used for a support order. *FLR*

Tracy L. Coenen, CPA, CFF is a forensic accountant and fraud investigator with Sequence Inc. She specializes in cases of embezzlement, financial statement fraud, white collar crime, securities fraud, and family law. She can be reached at 312.498.3661 or tracy@sequenceinc.com.