



When the Numbers Get Ugly — Forensic Accounting May Uncover Hidden Earnings

When applying for a loan or courting an investor, a business owner generally wants to make his or her business look especially attractive. But there are times when a business owner might actually benefit from having the business appear to be less valuable than it really is.

For example, in the case of a divorce or minority shareholder dispute, a business owner may be motivated to hide earnings to diminish the perceived value of the company. When a business valuation expert is called upon to assess the value of a company as part of these proceedings, it is not uncommon to find that the numbers on financial statements and tax returns just don't add up. Suspicion is usually raised by someone close to the business — a spouse or shareholder who believes that the earnings are greater than those disclosed on the tax returns or financial statements, and therefore the business is worth more than what the numbers reflect.

When suspicion arises, a forensic accountant may be called upon to investigate and uncover unreported or underreported income or inappropriate expenses that diminish the profits of the business. Whether hidden intentionally or simply accounted for improperly, this income must be considered when calculating the true value of the business.

Red Flags

Generally, earnings can be hidden in three ways:

1. The business doesn't report or record all of its sales.
2. The business pays for personal or non-business expenses of the owner or owner's family, thereby artificially lowering the amount of income reported.
3. Dummy companies or multiple bank accounts are used to conceal transactions, thereby negatively affecting earnings and value.

Certain categories of expenses and transactions often warrant further investigation:

Cash businesses — Is all income being reported? Certain industries seem to invite skimming. Service businesses such as restaurants, repair shops or other cash-intensive businesses may trigger further inquiry.

Industry norms — Are gross profits out of line with the industry? If they are significantly lower, it may be an indication of unrecorded sales.

Expenses — Are personal or other non-businesses expenses being deducted from the business? Hotel rooms, jewelry, flowers and trips to luxury locations raise questions.

Self-dealing — Are profits being reduced by sham transactions with family members? Are relatives on the payroll actually working for the company?

The timing of certain business events is also important. For example, if the business suddenly became less profitable just as the marriage failed or the shareholder dispute came up, it may be more than just a coincidence.

Good valuations are based on good numbers. To determine the true value of a company, it may be necessary to dig deep. When suspicion arises, hiring a forensic accountant can quickly pay off.

If you would like more information about forensic accounting as it relates to business valuation, please contact our firm.

When a Spouse Tattles ...

In hopes of getting an estranged spouse in trouble, the other spouse sometimes snitches to a lawyer or accountant about phony numbers on tax returns. While pursuing this potential deceit can be quite emotionally liberating for the tattler, it can also backfire.

When spouses sign a joint tax return, they are jointly and severally liable for its veracity. “Innocent spouse” rules protect a spouse who didn’t know or didn’t have reason to know that the return was fraudulent. However, if the spouse knew or had reason to know of the tax fraud, he or she shares the risk. Both spouses face the same interest, penalties and tax liabilities.