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Forensic accounting for divorce engagements : a practical guide

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FORENSIC ACCOUNTING

for

DIVORCE ENGAGEMENTS

A Practical Guide • Third Edition



AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



Ezra Huber, JD
Donald A. Glenn, CPA
ABV, CVA, CFE, CFF

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AICPA[®]

2538-356

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Notice to Readers

Forensic Accounting for Divorce Engagements: A Practical Guide, Third Edition presents the views of the authors and others who helped in its development. This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants. Therefore, the contents of this publication, including recommendations and suggestions, have no official or authoritative status.

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About the Authors

EZRA HUBER, JD

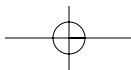
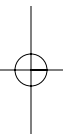
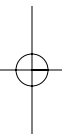
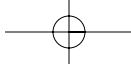
Ezra Huber is an admitted attorney in New York and California and has over 20 years' experience in the field of financial and asset protection planning. He is a prolific author of books and articles, and is a frequent speaker on a wide variety of financial and legal matters throughout the country. His publications include the first and second editions of *Forensic Accounting for Divorce Engagements: A Practical Guide*, upon which this current work is based.

DONALD A. GLENN, CPA/ABV, CVA, CFC, CFF

Donald A. Glenn is a Certified Public Accountant, Accredited in Business Valuation by the American Institute of Certified Public Accountants (AICPA), Certified Valuation Analyst, Certified Fraud Examiner, and Certified in Financial Forensics by the AICPA, with over 30 years' experience. He is a partner with Glenn & Dawson, LLP, in Walnut Creek, CA. (www.forensiccpa.com). He is frequently a court-appointed expert in the California Superior and Federal Bankruptcy Courts.

Mr. Glenn was the founding chair of the California Society of CPAs' Family Law Section and author of the California Society of CPAs' Family Law Workshop course. He is a member of the national standards committee of the National Association of Certified Valuation Analysts, and has served on the national board of directors of the Institute of Management Accountants and the state board of directors of the California Society of CPAs. Mr. Glenn also served on the technical review panel and as an expert for the California Board of Accountancy.

Mr. Glenn is a nationally known lecturer to judges, attorneys, CPAs, and other groups on forensic accounting and has written numerous articles. He was the first recipient of the California Society of CPAs' Family Law Section's "Distinguished Service Award" for his contributions to family law forensic accounting. Comments or questions regarding the subject matter of this book may be forwarded to Mr. Glenn at his e-mail address at donglenn@forensiccpa.com.



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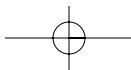
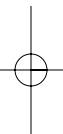
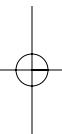
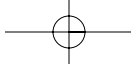
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Introduction

Even though CPAs have been assisting in family law for years, until recently, the forensic aspects of a CPA's assignments have been limited to a few specialists. This is no longer true. Judges and attorneys are increasingly relying on CPAs to find the answer to very complex financial issues. Litigation services in family law are experiencing a rapid expansion, with an ever-increasing need for additional forensic practitioners.

Forensic Accounting for Divorce Engagements: A Practical Guide, Third Edition provides the working knowledge and insights you'll need for the types of deceptions you may encounter. This edition is designed primarily as a how-to reference for divorce engagements, and features example-type situations and discussions of their practical applicability.

The divorce rate is high, approaching 50 percent in some areas. Divorce—even the “friendly divorce”—is a stressful, emotional, and difficult process. During the course of a marriage, spouses' assumed roles in marriage and money management usually evolve so that one spouse handles the money. Thus, the managing spouse has tremendous leverage because of his or her knowledge of and access to property and information in a divorce. All too frequently the managing spouse cannot resist taking advantage of his or her position to obtain a better financial settlement. When this is done by intimidation, concealment, deceit, or breach of spousal duties, it may be characterized as fraud. That's where the forensic CPA applies his or her skills and experience to discover, disclose, and assist the attorney in the recovery of property or rights obtained improperly or by fraud. This guide focuses on the seamy side of divorce.

A complete list of schemes used by fraudsters is not possible because they are a prolific and creative lot. And yet many times, schemes are not all that clever, but proof for court is difficult to gather. Whatever the assignment, this guide is intended to stimulate the creativity of the CPA as he or she proceeds through the labyrinth of a forensic investigation.

Highlights of This Third Edition to Forensic Accounting for Divorce Engagements

Role of Forensic Investigator—Relationship with marital attorney, expectations for reports and testimony, thorough discussion of engagement considerations and engagement letter.

Badges of Fraud—Categorized list of over 100 signs that a spouse may be concealing assets.

Forensic Accountant as Expert Witness—Detailed information and advice about the forensic accountant's role on the witness stand and in depositions.

Common Problematic Transactions—Personal expenses paid by business, inventory shrinkage, delay in invoicing customers, and large, unusual purchases and events.

Fraud and Misstatements—Decline in profit due to cost or volume changes, personal expenses hidden from disclosure, false vendors or employees, and other fraud schemes.

Executive Compensation—New chapter on marital fraud by corporate executives, covering SEC regulations, bonuses, stock options, retirement benefits, and myriad perks.

Marketing Forensic Services—Practical suggestions to market forensic services, including a new section on website marketing.

Appendixes—Real-world templates to assist with document requests, deposition questions, and data organizing templates; helpful to respond quickly to an attorney's request for a list of required documents for a CPA's assignment.

Note: For general information on family law, the AICPA has published *A CPA's Guide to Family Law Services—Forensic and Valuation Services Practice Aid 05-1*, a resource to assist CPAs who provide services to clients and attorneys in the family law area. *Forensic Accounting for Divorce Engagements: A Practical Guide* begins where Practice Aid 05-1 leaves off: It is a comprehensive guide to the full spectrum of marital fraud and how to discover it.

1

The Role of Forensic Accounting in Divorce

The Setting

Forensic accounting is important, if, for no other reason, because of the unique nature of divorce.

There are very few “friendly” lawsuits, to be sure, but nothing can match the sheer viciousness of people locked in battle over the division of marital property or assignment of child custody or support obligations. Stories abound of acts of bitterness. And sneakiness. And vindictiveness. And hatefulness. And . . . well, you get the idea.

Not every marital breakup is colorful, of course. Some are merely the ending point of a slow but steady deterioration of mutual affection. Some are even amicable, with both sides recognizing that it is for the best. Even when the dissolution itself is agreed upon, however, the division of property may not be. Sometimes this disagreement by itself presents no legal problem: It will be up to a judge to decide what is “fair” to both parties. The judge must have all the facts, though, and in some cases one or both parties will not be forthcoming. It is precisely in such cases that the forensic accountant’s skills become vital.

In the course of a marital breakup, it is understandable, albeit inexcusable, for one or both members of the couple to act in a deceitful and selfish manner. This, alas, is human nature and may have existed throughout the marriage, not just the divorce. Certainly each party has his or her own feelings about what is fair in terms of property distribution and support obligations. For instance, the breadwinner may feel entitled to more because he or she is, in fact, the breadwinner. The homemaker, however, justifiably points to the noneconomic factors contributed to the marriage, and in some cases to career sacrifices made.

No single rule governing how the spouses deal with each another exists. Whether the breakup is amicable or ruthless, whether the parties are capable of employing logic in their dealings; driven purely by emotion; or their behavior falls somewhere in the middle are issues of psychology well beyond the scope of this work. Suffice it to say that if the forensic accountant’s services are being considered, at least one of the spouses, or the attorney, has a suspicion that the other spouse is concealing assets. The question, of course, is how to root them out.

To understand the forensic accountant’s role in such an investigation, it may be helpful to have a bit of an understanding of the situation’s psychology. What makes divorce forensic accounting unique among financial investigations is that it seeks to uncover behavior that, although devious and designed to punish the spouse, may also have been planned as a tax-avoidance scheme. The parties’ very motivation in a matrimonial setting differs from that in any other type of investigation.

Let’s compare.

There are, to be sure, purely dishonest people in the world—people who may have the commission of an evil act as their primary goal. Picture such folks as they meticulously plot out an elaborate scheme for separating a victim from his or her possessions. Such a scheme may be as simple as embezzlement by the

company bookkeeper or as elaborate as a stock manipulation scheme that draws the attention of the Securities and Exchange Commission. One thing that such financial plots have in common, however, is that they are concocted with much forethought and little emotion, except, perhaps, for the heart-pounding that comes from the fear of being caught and prosecuted. Some of these thieves are so careful that it can take years for their schemes to be discovered. By then they may have simply disappeared with their loot.

In the matrimonial dissolution, however, the desire to deprive one's spouse of his or her fair share is likely a by-product of the even greater desire to deeply hurt, humiliate, and otherwise emotionally and financially devastate the soon-to-be ex. Unlike commercial fraud, a divorcing spouse may find normally law-abiding, honest people to assist in concealment. Parents, children, and close friends of the "victim spouse" seem willing to participate in the most obvious and disreputable schemes. Just consider the following possibilities in the waning days and months of the marriage.

- Your spouse has cheated on you. You want to punish him or her. "Let that other person you're sleeping with take care of you!" is a normal reaction.
- You feel that you've worked like a dog while your spouse has "only" taken care of the children—in between episodes of Oprah, that is. A 50-50 property split under those circumstances is simply unacceptable. If your spouse will not accept the settlement offered, you will make sure that he or she gets next to nothing.
- Your spouse has withheld sexual relations for months before the divorce action was filed. You're cranky and vengeful.
- Your spouse wants a piece of your "intangible" assets: a professional license, for instance, or a piece of your pension. The gall. A boot in the behind is all that he or she is entitled to, you think.

These scenarios are just the tip of the iceberg. There are as many possible reactions as there are couples. The common thread is that emotion is very apt to overshadow logic. For instance, you may hear of one spouse bragging about how he or she has disposed of assets to make them unavailable to the other spouse.

There is also the possibility that emotions drive accusations unsupported by evidence or facts. When a forensic investigation starts with limited or no facts or evidence, how much time should be spent before abandoning the investigation? Investigations require substantial commitments of time and perseverance, and it is far easier to prove that assets or debts were not disclosed than it is to prove that all were properly disclosed. How, after all, does one prove a negative? In addition, what if there is no wrong-doing to be found, as is sometimes the case? A wild goose chase is most frustrating not when the goose is elusive, but when there was no goose to begin with.

Communication with client and attorney during the investigation is appropriate even if the forensic accountant has not found any facts or evidence of fraud or misstatements. It may be desirable to establish periodic points to review the investigation's progress and costs.

Investigations are expensive. Initially consider a limited, focused investigation. Target the highest-value issues with the lowest time commitment. Early success in one area may encourage settlement discussions. However, client and attorney should not rely on one successful limited investigation to predict potential recovery from other issues not investigated.

The high emotions in divorce cases can be a plus for the forensic accountant because if emotion rules, the likelihood is higher that the angry party is acting more out of spite than stealth. Mistakes—often the by-product of greed—are more likely. And now to find them . . .

Expectations of a Forensic Expert

Before the forensic accountant begins a study of the fine art of forensic financial foraging, it is helpful to have an understanding of his or her role in the overall matrimonial proceeding and the factors that determine whether to join the fray in a particular case. Forensic investigators play three very important roles in a divorce proceeding.

1. They are the primary financial investigator, with an important responsibility for uncovering unreported income and assets.
2. They may be expected to be an “expert” witness, the strength of whose testimony will improve the case presentation or likelihood of settlement.
3. They must act as adviser, guiding the attorney in areas of finance, tax, and business practices with which the attorney is not familiar.

Accountants’ competence and credibility in these three areas are the cornerstones of a successful forensic practice.

Establishing Professional Relationships With Matrimonial Attorneys

What does an attorney look for when selecting a forensic investigator? Credentials, experience, reputation, demeanor—in short, all of those things that the forensic investigator would look for in hiring an attorney!

Few attorneys have the working knowledge of business or accounting matters that accountants do. Certainly, matrimonial specialists will, over the course of their practice, gain a significant understanding of such affairs, just as medical malpractice attorneys gain a considerable understanding of human anatomy. Experts, however, will always continue to be employed for a number of reasons.

- An accounting expert is likely to be more current on matters of business accounting and the techniques used by business people.
- Accountants may be less expensive on an hourly-fee basis than a matrimonial attorney.
- Although attorneys might be highly knowledgeable in matters affecting their practice, they are not likely to testify as an “expert” about their own findings. If the attorney’s testimony as a witness was instrumental to the client’s case, the procedural rules of most courts would require the attorney’s disqualification as counsel. Accountants as expert witnesses can be very useful because of their ability to testify on a broad range of financial and business practices.

It need not really be said that the attorney will expect the highest degree of competence from the forensic expert. There are, however, two additional requirements, neither of which is particularly difficult, but both of which are an integral part of the assignment, and both of which must be a part of the forensic expert’s commitment to the case.

Written Report and Formal Declarations

The forensic expert must have decent writing skills because the intended audience of the final product is not merely the attorney who did the hiring. Courts often require that information obtained through experts’ work be shared with opposing counsel. In addition, the expert’s written report is almost always introduced into evidence, so the judge will have the opportunity to assess the expert’s writing. It is crucial, therefore, that the report be a model of clarity, containing the least amount of “accountant-speak” possible. Even though it is true that the author-expert can always clarify what he or she meant to the client’s attorney, the expert may not have the same opportunity to explain himself or herself to the court.

Testimony in Court

The investigation and written report is only half of the assignment. A written report, in and of itself, is not admissible as evidence in a court of law. The technical term for it is *hearsay*. For the report to be accepted by the court, the forensic accountant must testify about the work that went into producing it and, specifically, about the findings of the investigation.

Even though it may be true that the vast majority of divorce cases are settled out of court, no expert should ever perform his or her assignment in anticipation that this will occur. If opposing counsel, in reviewing the report, is convinced that it was hastily or sloppily prepared and that its shortcomings—and the expert's—can be exploited on cross-examination, opposing counsel will not hesitate to try the case. Once a judge begins to question the expert's skills, the client cannot help but be hurt. Excellent preparation can convince opponents to sue for peace; poor preparation will motivate them to continue vigorous cross-examination.

Note: Clarity and thoroughness in both the written report and trial preparation are critical. Judges are often remarkably astute, but they are not experts in forensic accounting. The accountant should not assume that they are. In fact, it is a prudent course never to assume anything! Even a judge who seems to understand accounting basics may labor under a cloud of misinformation that, unless clarified, may lead to an unintended (and undesirable) result.

For instance, a judge may know what a balance sheet looks like, but may not realize the importance of any particular item the forensic expert believes should be adjusted to reflect the true picture. A case in point would be the claim that an otherwise legitimate tax deduction should be adjusted; for instance, the expensing of equipment with a true life span of longer than one year. A judge might reason: If the IRS permits the write-off, does that not reflect the true value of that particular asset to the business? The forensic expert must be able to articulate clearly, both in the report and in testimony, why it does not. Jurists appreciate and respect expert witnesses who communicate clearly, and cases are won or lost on the basis of communication.

Engagement Considerations

Before accepting a case, the forensic investigator should determine if he or she possesses the required skills, the attorney's expectations can be met, and the client has the resources to allow completion of the assignment. Among the factors to be considered are the following.

Conflicts of Interest and Bias

Forensic accountants must determine whether there would be a conflict of interest. They should consider whether they have rendered prior nondivorce-related services to one spouse in this divorce proceeding. If so, special rules of the AICPA Code of Conduct apply to representing the other spouse. Failure to follow these rules may be grounds for disqualification.

The forensic accountant should also consider whether he or she has performed services for anyone associated with a party. For instance, accountants who have been the tax preparer for the subject's partners or coshareholders need to consider a request carefully. If they have had access to the financial records of the subject or a company in which they are a principal, this might be reason to reject the case.

Another issue is whether the forensic accountant has rendered services for the opposing counsel. This might include personal tax or accounting services, or it might include acting as an expert for that attorney. A big consideration here, of course, is that if the accountant is seen working for the opposition, he or she may be viewed as disloyal. And even if counsel recognizes that the accountant is only doing the assignment, will the forensic accountant recognize that opposing counsel is only doing his or her job when he or she

mercilessly questions the forensic accountant's credentials and competence at trial? The accountant must be sure to understand how taking on this current assignment will affect future employment, not only with current counsel but with others in the case.

Forensic accountants must recognize that the legal system's ethics are based on advocacy and responsibility to represent the client. CPAs' ethics are based on responsibility to the public. Differences in these two ethical approaches may present challenges to the accountant in court proceedings.

Bias

Bias is an inclination or prejudice. It can include a preconceived opinion formed without analysis or facts. Bias can undermine or negate expert testimony. If the expert always works for the wife or husband in divorce cases, the expert may appear to be biased in favor of one side. If an expert chooses one method to arrive at a conclusion and adamantly rejects other widely used alternatives, this may indicate a bias for his or her method. While we all have our preferences in professional matters, keep an open mind to avoid bias.

Cooperation of the Parties

A certain lack of cooperation on the part of the investigation's subject is to be expected. After all, the forensic accountant is trying to expose that party's finances. If after discussing with counsel the progress of the case to date, the forensic accountant learns that each step has been met with resistance or hostility from both the opposing client and opposing counsel, the accountant may wish to consider whether he or she has the time or resources to complete the assignment.

Lack of cooperation is not limited to the opposing side, however. There are many clients who are less than fully cooperative. (Although retained by an attorney, forensic accountants are likely to bill the clients directly for their services.) Uncooperative clients' reasons are many. They might feel that they are paying a considerable amount of money to "hired guns" such as the accountant and counsel, and they simply have no tolerance for anything that would draw them into the details of the case; or perhaps they are naturally slow to respond to requests for documentation, even when cooperation is in their own best interest; or they have little helpful knowledge or experience. Forensic accountants should consider these factors before accepting the engagement.

Location

If the financial investigation will require physical appearance at the subject's location—whether for an inspection of the books and records or to investigate the equipment and inventory on the premises—the forensic accountant should consider whether it will be convenient to do so. If the location is too far from the office, the accountant might consider passing on this case unless adequately compensated for travel time.

Appropriate Skills and Experience

It goes without saying that as CPAs we should not accept assignments for which we do not have the appropriate skills and/or experience. However, forensic skills may be complimentary to other skills by industry, geographic location, culture, subject (tax, audit, etc.), or any number of different skills which may be required to bring a case to trial or settlement. It is not unusual for a forensic CPA to be retained before the full scope and nature of a case can be defined. An understanding of the continual flux and changing focus of a forensic assignment should be discussed initially with the client and attorney when defining roles in an engagement. As an assignment changes, new skills may be required that the original forensic CPA does not possess.

Timing and Due Dates

Salespeople are taught not to make sales calls on accountants between January 1 and April 15 because during this period accountants focus on completing income tax returns and may have little time to consider any purchases. The forensic accountant should inquire during the initial call if there are any court dates, as well as the due dates for completion of the assignment and production of a report.

If other commitments—for example, the general craziness of tax season—would interfere with the accountant's ability to conduct a thorough investigation, he or she should decline the case. There may be only a relatively short window of opportunity to conduct an investigation, and if it is promised for a time when other commitments will, in reality, push it aside, the forensic accountant may prejudice his or her client's case. The court may have imposed a deadline on the parties for completion of their "discovery" (process of obtaining documents and information). If the forensic accountant does not complete the assignment timely, the court can preclude his or her report—or testimony—from being given at trial. (Although time extensions are available from the court, they are not given automatically as they are by the IRS.)

Even though few matrimonial cases ever make it to trial, the absence of a key piece of testimony is very likely to give opposing counsel a newfound bravado. After all, even a poorly armed person will take on an unarmed one. An expert's chances of getting additional work from an attorney whose case is blown by other commitments are, naturally, nil. The ability to deliver a report in a timely fashion is as crucial as the ability to complete the investigation. If the forensic expert does not reasonably anticipate that he or she will be able to complete the task, he or she should not undertake it.

Note: It is crucial to understand the relevant deadlines, so this matter should be discussed up-front between the forensic accountant and counsel who has approached him or her. In addition, if the expert finds that he or she cannot complete the task in the time promised, he or she should always ask counsel immediately for an extension. Because forensic accountants are expensive, attorneys sometimes wait until late in a case to retain one. The candidate accountant should be certain to receive clear answers regarding impending deadlines.

Definition of Services

Forensic assignments are interesting in the ways they quickly change and evolve. It is helpful to define the forensic accountant's services carefully at the beginning of an engagement to serve as a benchmark to measure future changes. For example, a business valuation assignment can quickly turn into a fraud examination as a result of information discovered during the analysis of business records. Discuss changes in the assignment as or, if possible, before you accept a modification of the original assignment. Issues you should discuss include (1) whether you are the best person for this additional task; (2) its cost, or whether the cost can be estimated with any accuracy; (3) the expected benefits to the client; and (4) whether the client and attorney agree that the new service will be necessary.

Available Financial Resources

At the start of an assignment, CPAs are often asked to estimate the total fees for their services. Fee estimates are difficult, if not impossible, to predict with any accuracy. Fees are a function of the assignment, cooperation of the parties, condition of available records, conduct of attorneys, and myriad other factors. If a fee range is discussed, clients often hear only the low end of the estimate. The original assignment often expands with a corresponding expansion in fees and other costs.

To manage fees, consider billing more frequently than monthly. At the beginning of a case, discuss cash resources available to pay fees on an ongoing basis. Consider limiting services to those which the client can afford to pay with current cash resources.

Fee Structure

Setting an hourly fee is difficult. Obviously, the more experience the forensic accountant has, the greater the fee should be. Setting the initial one, however, is as much a function of marketing as it is of expertise. If the accountant is attempting to break into the field, the fee might be lower. He or she might also consider a multilevel fee structure, with one charge for work performed in his or her office and another for work performed in the field.

When in doubt, the best place to check is with the attorney. A matrimonial specialist knows what the going rate is, even if the accountant does not. If the forensic accountant has a good relationship with a lawyer, the lawyer will not only tell the accountant when the fee is too high, but he or she will also mention if the fee should be more. There is no right or wrong, just trial and error.

Note: One should never undertake matrimonial investigative work as an expert witness on a contingent fee basis, that is, getting paid according to how much is uncovered or how high the opposing party's holding is valued. Never mind the fact that the forensic investigator may uncover less than he or she thought (and be compensated minimally for tremendous efforts). The entire matter will irreversibly affect the forensic investigator's credibility and render his or her entire report and testimony useless.

An effective opposing attorney will always ask how the forensic accountant is being compensated. Telling a judge that the testimony is linked to the ultimate reward is the kiss of death in any trial of this sort. The forensic accountant's testimony will be discounted to practically zero, his or her client will likely end up with less, and the hiring attorney will never again return phone calls.

The forensic accountant is entitled to be compensated for his or her services, but he or she is not entitled to benefit personally (in the form of a larger fee) from his or her testimony.

Who's the Client

Accountants may participate in family law in three capacities: as consultant to the attorney, an expert for one party, or a neutral expert.

- As consultant to the attorney, the accountant is retained by the attorney and not the client. A consulting arrangement is used to cloak the accountant with a privilege—usually the attorney-client or attorney-work-product privilege. The attorney can explain the privileges and how to maintain them. They are used to prevent the opposing party from gaining access to the consultant.
- As a party's expert, the accountant is retained to render an opinion in court or to assist in settling an issue.
- Neutral experts serve as a court's expert, mediator's expert, or joint expert for the parties. When serving as a court's expert, familiarize yourself with the local statutes regarding these appointments. Caution should be observed when serving as the parties' expert. A waiver of a conflict of interest may be wise or necessary in some cases.

Engagement Letter

Once the forensic accountant has decided to accept the case, he or she should prepare an engagement (retainer).

Engagement Letter and Retainer Agreement

The engagement letter should be clear about who is retaining the forensic accountant and who has the obligation to pay him or her. (See appendix A for a sample engagement letter.) If the accountant has been recommended by the attorney and retained by the litigant, the accountant will have to seek payment

directly from the client and not the lawyer. Conversely, if the forensic accountant enters into a fee arrangement with the lawyer directly, the lawyer will be obligated to pay the accountant regardless of whether he or she is paid by the client. For obvious reasons, not many attorneys would enter into such an agreement. By and large, however, in a long-standing professional relationship, the lawyer will do all that is possible to convince the client to pay the forensic accountant's fee.

Whatever the arrangement, the forensic accountant should have an engagement or retainer letter clearly outlining the terms of employment. At the very least, it should address the following.

- *Nature of the relationship.* Is the forensic accountant being retained as a consultant or an expert witness?
- *Parties to the agreement.* Who is the client—the attorney or the spouse? The forensic accountant should consider having both attorney and spouse sign the agreement, even though the attorney will generally not be responsible for the fees.
- *Party responsible for payment.*
- *The limitations on the number of hours or fees the forensic accountant may incur in the assignment.* It is generally unwise to accept a forensic investigation assignment for a specified number of hours or dollars (fixed fee). Due to the nature of these assignments, it is not possible to estimate the total hours or fees necessary to complete the assignment.
- *The forensic accountant's exact duties, for example, to conduct a business investigation or a personal lifestyle analysis, or both.* The description of the forensic accountant's duties should include provisions governing what happens in the event that he or she will be unable to complete the assignment. The forensic accountant may be involved in a case where the mistrust between the parties causes one of the parties to wrongfully accuse the other of concealment or other bad acts. The forensic accountant needs a mechanism for withdrawing from a case in the event that unsavory behavior becomes evident. Such a provision should be included in the engagement letter.
- *Allow for withdrawal from the case if any of the following conditions occur.*
 - Failure to pay fees as billed
 - Change of attorneys
 - Disagreement with attorney or client over scope of services or opinion
 - If unreasonable time demands (as you may define them) are made for completion of assignment
 - Additional services requested which the accountant does not agree to perform
 - Add a clause stating that expert fees are payable in full if the expert withdraws or is terminated

Note: An understanding of the forensic accountant's "exact duties" should take into consideration a number of factors, including the type of property requiring valuation and the particular difficulties of arriving at this valuation. For instance, a business valuation as of the date of the investigation will not be difficult to prepare (all things being equal) because all of the records should be available or easily obtained. However, there may be situations in which it may be necessary to have two valuations, one from before the marriage, and the other a current valuation. The forensic accountant should know if this is the case because it will certainly affect the amount of work he or she must do. For instance, the law in some states (primarily the so-called "community property" states, which are covered in chapter 2) says that the "separate property" of one spouse—property brought into the marriage—remains the separate property of that spouse throughout the marriage. That may not seem like much of a problem, but as is true of so much of the law, it is the exceptions to the rule that may create a problem.

For example, some states hold that even though property may be the separate property of one spouse, if this property required active management during the marriage (as might certainly be the case if the property was rental real estate), the labors of the spouse performing the management function may be considered in determining whether any increase in the property's value should be counted as a marital asset.

Example 1–1. Fred owned a 10-unit apartment building before he married Wilma. Fred and Wilma live in a state that considers this building to be Fred's separate property. During the marriage the building appreciated in value from \$300,000 to \$500,000. Normally, the inclination might be to ignore this increase because, as Fred's separate property, the appreciation should not be allocated between Fred and Wilma upon their divorce. Unfortunately for Fred, they live in a state that evaluates the labors that went into managing the building.

After committing to the engagement during tax season, the forensic accountant learns that Fred actively managed the building for a few hours per week and that he made several improvements to the building—partially using money earned from his job and partially with money he inherited from his mother. Wilma now wants a piece of the appreciation and instructs her attorney accordingly.

If, as in the above example, the forensic accountant had failed to recognize that the valuation of Fred's building involved more than a mere examination of the income and expenses but, instead, involved sophisticated calculations based upon facts from before and during the marriage, then the accountant might be stuck, at the busiest time of year, trying to figure out whether and to what extent Fred's "few hours" of active management caused the value of the property to appreciate, and the legal impact on the property valuation of Fred's using earnings from his other job to fix up the place. This is going to be the forensic accountant's worst nightmare, one that might have been avoided either by declining the job or by realistically predicting that he or she could not accomplish the task until several months later than promised.

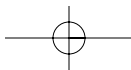
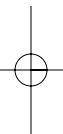
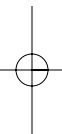
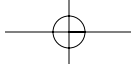
Case Coordination With Attorney and Client

Forensic assignments often involve substantial amounts of business or financial records and information. CPAs are accustomed to organizing, evaluating, and storage of voluminous records and information. Consider who will be responsible for physical possession of documents and who will organize information. Instead of creating multiple copies of records at increased expense, consider scanning and providing information on CDs or some other media.

Accountants can be helpful in preparing document requests, interrogatories, and deposition questions. Periodic meetings with the attorney and/or client can assist in dividing the case preparation between the accountant, attorney, and client and keep all focused and on schedule to timely prepare the case for settlement or trial.

Summary

- The forensic accountant's role is to uncover assets or income secreted or otherwise hidden by one party to a divorce proceeding.
- The forensic expert will be expected not only to conduct a thorough investigation, but to reduce the results to a written report and, perhaps, to testify in court.
- Before undertaking a forensic assignment, the forensic accountant should consider carefully the time available to devote to it, the potential conflicts of interest, and the cooperation (or lack of cooperation) expected from the parties.
- The retainer agreement should clearly spell out the terms of the engagement.
- The forensic accountant should not accept employment as an expert witness on a contingent-fee basis.



2

Matrimonial Actions and Property Characterization and Division: Understanding the Process

Introduction

In many 1940s film noir classics, the only way for the adulterous spouse and his or her lover to be together was to murder the unsuspecting spouse. James M. Cain's *The Postman Always Rings Twice* comes to mind, as does his *Double Indemnity*. In pre-World War II America, divorce was out of the question because of the stigma attached and the limited legal grounds available for such a dissolution.

Today, it is a frequently quoted statistic that half of marriages end in divorce. The advent of the no-fault marital dissolution—one not based on the grounds of abandonment, cruel and inhuman treatment, or adultery—has destigmatized the parting of ways between husband and wife. The battle over assets, however, still reaches a fevered pitch on many occasions.

It is safe to say that not everybody embarking on the marital journey knows their financial rights upon its dissolution. In those cases in which the parties have executed a prenuptial agreement, they likely have some understanding of their respective rights, but even then prenuptial agreements have certain requirements, among them full and accurate disclosure. In many, if not most, jurisdictions, prenuptial agreements will not be enforced if a court finds them to be overreaching, which means different things to different judges.

Now throw in some relatively new concepts of property division. For example, some states require an equal division of community property and others an equitable (fair) division. Then there are questions such as who gets the pension and what is a professional degree or license worth? The forensic accountant should be familiar with these concepts because they may affect the investigation. In fact, it is helpful for the accountant to understand the basics of matrimonial actions and property division rights if for no other reason than to be conversant with counsel and to truly appear as an expert to the court.

In states with spousal support, and all states with child support, income available for support is a significant issue. Accountants are important for help in understanding complex financial income activities leading to determining a spouse's or both spouses' income.

Property Rules Differ in Various States

The forensic accountant should also be familiar with the methods used in his or her state to determine asset distribution. Two general bodies of state laws govern the distribution of property upon marital dissolution: community property and equitable distribution.

Community, Marital, and Separate Property

In eight States,¹ the distribution of property upon dissolution of marriage is a fairly simple and straightforward matter in most cases: all assets and income acquired during the marriage, regardless of which spouse's labors (personal efforts but not capital) went into producing or acquiring them, are divided equally between the spouses. These community property states (mostly historically influenced by the Spanish) view a married couple as being one economic unit, with each fulfilling a role in essence equal to the other. So there is no question that the fruits of the labors of each spouse belong equally to the unit.

There are exceptions, however, notably for assets acquired by inheritance or gift or brought into the marriage. These are all considered to be nonmarital (also known as separate) assets. As was touched on in chapter 1, though nonmarital assets might not be counted in determining a party's property rights, there may be an exception, particularly involving small businesses or rental property, when separate assets have appreciated as the result of work (personal efforts) performed by one party during the marriage, which would require that some part of the appreciation be considered a marital (community) asset.

Example 2-1. X owns 100 percent of a rental property that he acquired before his marriage. X continues to actively manage this building after the marriage. In fact, most of the married couple's income has come from the rentals generated by this building. During the course of the marriage, the building appreciates by 50 percent, almost exclusively as a result of X's property management and marketing skills. Because X acts as an active manager, some part of the appreciation caused by X's labors might be considered marital (community) property, and his wife will be entitled to a share. Or the court could determine that the compensation received by the marital unit from the rental property reasonably compensated the personal efforts of X during marriage. Therefore, there may not be any marital (community) interest in the rental property.

And, again, the outcome will depend upon the facts of the case.

Example 2-2. Y owns 25 percent of a building rented out to various tenants. She inherited the building before her marriage. During the marriage, the building appreciates by 50 percent, largely as a result of the efforts of Y's brother, who manages the property. Y receives only her share of the net rents which, because of increased rental charges, have also increased over time. This may still be considered as separate property because Y does not have an active role in managing the property. As a passive beneficiary, her interest might be treated no differently than if she owned exchange-traded stock that appreciated in value over the same period.

There is also the question of what happens if a couple who were married in a community property state subsequently moves to a noncommunity property state, or vice versa. Or what about the case where a couple living in a community property state also owns property, such as real estate, in a noncommunity property state, or vice versa? Local law governs these scenarios, and the forensic accountant must ask the attorney for guidance on the legal issues before assuming that one type of property is countable while another is not. And, as discussed in chapter 1, the presence of community property issues may affect any decision to accept the case.

Equal or Equitable Distribution

In the remainder of the states, there is no automatic 50-50 division of property acquired during the marriage. It is the court's job to determine what constitutes an equitable division of the assets. In determining this, a judge normally weighs many factors, including the following.

- *The length of the marriage.* A marriage of short duration would not normally entitle the less well-off spouse to as large a division as a long-term marriage would.

¹ These states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. In addition, Wisconsin has enacted a statutory scheme similar to community property laws.

- *The education and relative earning ability of the spouses.* Obviously, if the spouses are of equal education and earning ability, the division would be different than if one spouse (particularly in a long-term marriage) were forced to enter the workplace for the first time.
- *The relative contribution of each spouse to the marriage.* Being the breadwinner in this day and age does not necessarily entitle that spouse to the lion's share of a distribution. The contribution of the homemaker spouse, particularly in raising children, is a very important factor.
- *The standard of living a spouse has become accustomed to.* Courts are not anxious to reduce one spouse's socioeconomic status merely because the other spouse was the primary or sole breadwinner. This is particularly true in long-standing marriages where the less well-off spouse was a child-raising homemaker.
- *What each party brought into the marriage.* Often, one spouse will bring separate property into the marriage (that is, property acquired by gift or inheritance) and then make those assets joint property. Upon dissolution, this is a factor to be weighed as well, so as not to unfairly benefit the spouse who did not own that property to begin with.
- *Prenuptial agreements.* The court will also examine any agreements made between the spouses, although this is not a guarantee that they will be completely enforced.

When family law courts make property distribution decisions based on equity (essentially, fairness), there may be significant variances from court to court, as well as state to state.

Basic Matrimonial Litigation Procedure

The Preliminary Phase of the Lawsuit

Although every jurisdiction has slightly different rules and procedures, one thing is constant: a divorce action is begun, as any litigation is, with the service by one party (called the *plaintiff* or *petitioner*) of a summons upon the other (the *defendant* or *respondent*). The summons is a very simple document, often only half a page, which simply advises the defendant that a suit has been commenced against him or her and states that unless the defendant appears in the action, a judgment of divorce may be granted on default to the party requesting it.

Along with (or, in some jurisdictions, after) the summons comes the complaint. This document spells out the details of the action and, specifically, the grounds on which the divorce is sought: abandonment, adultery, cruel and inhuman treatment, or any of the various other grounds available, depending on the jurisdiction. In many states, a person who has been legally separated from a spouse for a specified period of time may commence a divorce action on the grounds of that separation. Most states also permit divorce in the case of a felony conviction and imprisonment of one of the spouses.

In some jurisdictions, along with the summons and complaint, automatic restraining orders come into place. These orders may affect the transfer of property and income. The forensic accountant should inquire of the attorney if any, and what, restraining orders are in place. Additionally, there may be local rules of court that affect the accountant's assignment. The forensic accountant should ask counsel for copies of such local rules.

Assuming that the defendant does not merely wish to default, but, instead, wishes to contest the action (or, let's face it, to make the plaintiff's life just a bit more miserable), he or she appears in the action, usually represented by counsel, and serves an answer to the complaint on the plaintiff's attorney. The answer is precisely that: an answer to the various allegations made by the plaintiff in the complaint. The defendant will admit an allegation, deny it, or state that he or she has insufficient information to either admit or deny the allegation.

Any allegation that is denied must be proven to the court's satisfaction at trial by the plaintiff because it is the party making the allegation who has that burden of proof. So, for example, if the plaintiff claims that the defendant was cruel and inhuman, the plaintiff must show specific examples of such treatment. Naturally, the defendant can offer a reason why the particular treatment, even if true, was not cruel and inhuman. For instance, it would be madness to permit the plaintiff to claim that the defendant shoved her down to the sidewalk, fracturing her wrist, without permitting the defendant to explain that there was a truck bearing down on her at the time and he did so to save her life!

Anything admitted is no longer an issue and is considered by the court to be a fact. Admissions merely speed things along a bit and are useful when they are harmless. So, for example, if the plaintiff alleges that she and the defendant-husband are, indeed, husband and wife, it serves no useful purpose to deny this. Similarly, if the allegation is made that they reside together at 123 Main Street and this is true, it, too, will normally be admitted. However, where an admission may cause possible harm in the future—for example, the effect of an admission of cruel treatment on a later attempt to adopt a child—it may be hotly contested.

As part of the defendant's answer, he or she may make certain counterclaims or assert defenses to the action. A *counterclaim*, as the word implies, is simply a claim made by the defendant against the plaintiff. Normally a counterclaim is asserted as an offset to the main claim. So, for instance, if X owes Y \$100,000 and Y owes X \$250,000, when X sues Y for \$250,000, then Y might counterclaim for \$100,000 in an effort to reduce what Y owes to X. In a matrimonial case, a counterclaim would likely be the defendant's request that the court grant the judgment of divorce in favor of him or her.

Example 2-3. Martha sues George for divorce, claiming he abandoned her for a period exceeding one year. George then counterclaims against Martha for adultery in the hope that he will be granted the divorce from Martha.

The logical question would seem to be, who cares who divorces whom, as long as they go their separate ways? The answer has to do with money, usually, or who gets custody of the children. The facts may play a crucial role in either case; if one party can prove adultery, for instance, the court might be swayed to award custody of the children to the other party.

A defense, unlike a counterclaim, is the defendant's assertion that the plaintiff is not entitled to be granted a divorce on the grounds claimed, for a reason based either in fact or in law. A reason based in law is one that can be determined by the court without reference to any specific contested allegation. The best example is one of jurisdiction over the case.

Example 2-4. Bill and Theodora were married in New Jersey and spent their entire married lives in that state. The couple has not been getting along lately and, in fact, Bill decides to move out of the marital home. Hearing that Pennsylvania's divorce laws were more favorable to men, Bill moves across the border and, three days later, files for divorce from Theodora. In Theodora's answer she asserts the defense of lack of jurisdiction—that because she has never been a resident of Pennsylvania, the court of that state has no legal right to determine the marital rights of a couple who has spent their entire marriage in New Jersey. Theodora's defense would likely succeed in this case.

In contrast, a defense based upon facts would require that the court hear both sides before rendering its judgment.

Example 2-5. Pam, suing for divorce, claims that Sam treated her in a cruel and inhuman fashion on three occasions: First, he shoved her down to the ground and beat her. Second, that in front of dozens of witnesses, he punched her in the stomach so forcefully that she coughed up her food. Finally, he took away her car keys so that she was stuck in their home with no way to leave.

Sam admits that all three events took place but asserts the following defenses: that on the first occasion he only did so because her blouse had caught fire in the kitchen and he was smothering the flames; that on the second occasion she was choking in a restaurant and he was administering the Heimlich maneuver; and finally, on the third occasion she was drunk but insisted on driving, so he took away her ability to do so.

As you can see, even though Sam admits that each of these events occurred, his defense is that they had nothing to do with being cruel. A court would carefully weigh the testimony of both parties and, if the court believed Sam, it would be forced to dismiss Pam's case.

So much for the basics of the initial stages of a divorce action. The next step is for each side to gather up the evidence necessary to win its case or, at the very least, to place that side in a stronger position for a favorable financial settlement.

Discovery

Contrary to the public perception that all trials end with some third party admitting guilt under a grueling and skillful cross-examination by Perry Mason (in one hour, including commercials), very seldom is there that element of surprise in any litigated matter. In the overwhelming majority of cases, all the facts and information—the evidence for trial—are exchanged between the parties well in advance of trial. (I would like to say “voluntarily,” but only in the same way that most people have a root canal done “voluntarily.”) This is called the *discovery phase* of the litigation.

Discovery is the process by which each party obtains information and documents from the other party. There are several types of discovery devices. The most common are the demand for documents, interrogatories, oral depositions, and third-party subpoenas.

Demand for Documents

Each party in litigation is entitled to demand and receive all documents and other items that are relevant to proving his or her case. Documents include papers and any other physical item, such as a photograph or computer disk.

Interrogatories

One party may furnish another with a list of questions, called *interrogatories*, which must be answered by the recipient. Interrogatories may combine questions with a demand that documents supporting the answer be produced, too. Many attorneys do not like to use interrogatories because they give the opposing party time to think about their answers and, perhaps, even to formulate an answer that is brilliantly vague.

Depositions

Depositions are the oral statements of one party taken down under oath in the presence of a stenographer. Most attorneys prefer these because they offer the deponent (the person being questioned) little opportunity to reflect before giving his or her answer. Those answers become a part of the record and, if changed at the trial, can be used to impeach the witness's credibility.

Third-Party Subpoenas

Often, information and records are in the hands of a third party (not the parties to the lawsuit). In this case, either attorney may issue a subpoena to obtain records, documents, and information. In forensic investigations, these third parties are commonly banks, brokerage firms, or a corporation owned by one of the spouses. If the family business is a corporation, it may be necessary to join the corporation to the divorce lawsuit (make it a party) or to issue a subpoena to the “most knowledgeable person” to give a deposition or answer questions relevant to the case.

What happens if the other side refuses to turn documents over? Very simple: The court can order them turned over, with refusal to do so punished as contempt of court. Or, the court can penalize the refusing litigant in a variety of other ways, including preventing a party from using the documents in support of its own case. The court can even go as far as to dismiss the plaintiff's complaint or strike the defendant's answer and enter judgment for the other party. The same holds true for the refusal to answer interrogatories or to appear at a deposition. What if a litigant claims that records are simply not available? Often they may be subpoenaed from their source. So, for example, a spouse who believes that the destruction of a checkbook and canceled checks will forever hide his or her actions will be shocked to find that the bank's own microfilm copies may be subject to subpoena.

Note: In many jurisdictions, certain mandatory financial disclosure is available; the parties must exchange asset and income data, often in the form of an affidavit made under oath. The forensic expert's role begins at this point if counsel for one party believes that the other side is not being completely forthright or believes that the financial affidavit tells only half the story.


Request for Admissions

A request for admission may be sent by one party to the other. They state certain facts and ask the other party to agree to the facts. Although not normally used in small family law cases, they can be helpful in large complex cases if permitted in your jurisdiction.

Local Rules

Most courts have local rules of court. These rules may deal with discovery and the obligation of experts to provide or produce certain reports or information. Ask counsel for advise on the local rules that may apply to your case.

Now armed with an understanding of the attorney's arsenal, the forensic accountant will be better prepared to advise counsel which records should be requested or subpoenaed, and what information should be obtained either at a deposition of the adverse party or through interrogatories. (Appendix B contains an example of interrogatories.)

 **Tip:** The key to any successful forensic investigation is to get copies of all documents as soon as possible. Unfortunately, if the forensic accountant does not ask for documents early and for all he or she thinks will be needed, he or she may find that some of the more important papers have disappeared—become lost or misplaced by the other side. It is wise, therefore, to have a master list of items and to furnish it to the attorney for use in all cases in which the forensic accountant will be retained. The more the investigator asks for, the more he or she will receive. More documents require more fees. If the budget is very limited, the forensic investigator may need to limit discovery requests with the attendant risk of missing something.

Expert Witness Disclosure

Your client may be obligated to formally disclose you in pleadings. Disclosure is done by the attorney and notifies the opposing party that you will be called as an expert and the scope of your testimony.

Deposition

Prior to trial, the opposing attorney may take your deposition. You will be questioned while under oath while a court reporter records the questions and your answers.

Pretrial and Trial

Before trial the attorney is usually required to prepare a statement setting forth your client's positions and arguments therefore. Accountants are usually involved in preparing trial exhibits which will be used at trial and may be attached to trial statements.

Post-divorce Proceedings

After the initial divorce, there may be other legal proceedings. Modification of spousal and/or child support because of changes in either party's financial circumstances is the most common.

A Forensic Accountant's Role in the Courtroom

The expert's role extends well beyond conducting an investigation and preparing a written report. Reports, in and of themselves, are inadmissible at trial—they are what the law calls “hearsay.” In order for the forensic expert's findings to become a part of the trial record, he or she must actually testify at trial. Thus, if the parties cannot settle their case, your testimony will be an integral part of the case. Naturally, every attorney has different litigation techniques, and no two will prepare you for trial in exactly the same manner. For now, you should have some familiarity with the basics of what awaits.

The expert will be asked to testify as to the facts that the investigation unearthed, the conclusions that the expert has drawn from those facts, and the methodology and rationale that underlie those conclusions.

General Provisions

Your role as an expert is twofold: to educate the judge and jury and to act as their guide in evaluating the specific evidence that you bring to their attention in the case now before them. They will rely on you, so not only is how you present your case important, how you present yourself is equally important. The overwhelming odds are that your jury will consist of lay people who have absolutely no knowledge of accounting. (Although it is possible that an accountant might find his or her way onto a jury, most attorneys would not want anyone on their jury who could contradict an expert witness based upon their own professional experience. Lawyers may challenge potential jurors and have them eliminated from the jury. It is likely they would use such challenges against anyone who has accounting prowess.)

When testifying, you should explain clearly to jurors and to the court (the judge) the basic principles of what you do. In essence, you should give your testimony in “everyman's” language. It is easy to fall into the habit of using profession-specific jargon; instead, pause and explain a particular term's meaning if it is not often used outside your particular field.

More than anything, you must make yourself likeable to a jury. Even the most renowned expert will fail to impress a jury if he or she comes across as too arrogant, pompous, or flashy. Be aware that a jury does not have to accept your expertise. This is particularly true when the other side has also engaged a forensic accountant. If you come across as rude or evasive or angry and their accountant is more personable than you are, you can guess whose analysis the jury is more likely to adapt.

Dress Code

Judges expect certain decorum in their courtrooms. They take breaches of that decorum as personal affronts. Chief among the reasons that judges get upset, believe it or not, is the failure of those appearing in their courtrooms to dress with the proper level of respect. A certain amount of latitude is given to jurors, although it is not rare for a judge to ask a juror to dress more appropriately the following day. But less latitude is accorded attorneys and their witnesses. The way you dress makes your first impression. Therefore, always dress as if you were attending a job interview for the position you have been waiting for your entire life (assuming, of course, that that position is *not* as centerfielder for the New York Yankees). Suit and tie

are near-mandatory for men. Absent that, not wearing a jacket and tie is unforgiveable. For women, suits or well-suited outfits are the way to go. Leave the flashy jewelry at home. You want the jurors focusing on your 24-karat testimony, not your 4-carat diamond.

Addressing the Court, Other Counsel, and the Jury

Always address the judge as “your Honor,” not as “sir” or “ma’am.” Address opposing counsel respectfully at all times, no matter how much they try to rattle you (or at the very least, when within hearing of the judge or jury). All kidding aside, during breaks in testimony it is inappropriate to speak with opposing counsel, and you should certainly never let him or her know what you think of them. Anger, cathartic though it might be, may inadvertently reveal something that you do not want to spill. It is also unprofessional and potentially costly. (Consider this: what if your adversary was impressed by the way you handled your testimony and wanted to hire you for his next case—but you called him all kinds of nasty things to his face? Goodbye new client.) As for jurors, the judge will instruct them not to speak with anyone associated with the case. Until it is over, in the rather unlikely event that a juror approaches you with a question, you may not answer it; rather, merely state that you are prohibited by court rules from speaking to them about the case.

Testimony Demeanor

The witness stand is almost always to one side of the judge. After taking your oath or affirmation, counsel will begin questioning you. Look at the attorney during the question, then make eye contact with the jury while answering. Jurors gauge credibility of a witness more favorably when the witness—expert or otherwise—addresses them.

Papers and Organization

When you appear to testify, you should have a well organized file, extra copies of your report, and copies of your curriculum vitae or resume. Since you’re the expert, have a thorough command of your file. You should have reviewed it several times prior to testimony, not only by yourself but with counsel, and you should have marked (Post It-type tabs work great, but you knew that) pages that you expect to refer to—not only on direct examination but, if at all possible, in anticipation of cross-examination. Ideally, it will take you only a few seconds to locate any material or item of information; this gives the jury confidence that you have command of your materials. Nothing impresses a judge and jury more than organization—it implies that you are thorough which, in turn, implies that you are knowledgeable and credible. Unfortunately, many attorneys are not nearly as good at keeping papers organized, so you might discuss well prior to trial whether the attorney would like you to prepare additional copies of materials and annotate them for your hiring counsel, for opposing counsel, and/or for the judge.

Notwithstanding that you may have a very thorough report to refer to, it is not good practice to read from it verbatim for long periods of time. Doing so will bore the judge and the jury, and they may not listen attentively after a while.

Testifying

Preliminary Qualification as an Expert

Because you are an expert witness, you will likely be asked to go through your credentials prior to giving testimony. It is wise to have a current curriculum vitae or resume available in the courtroom. In fact, bring several copies so that, if asked, you can provide a copy to the judge and to opposing counsel. Most likely counsel who hired you will go over prior to trial what he or she wants you to say relative to your credentials.

In some cases, opposing counsel may actually offer to waive the testimony as to your credentials and volunteer to have the court recognize you as an expert. This may seem like a tremendous honor because, after all, it indicates that opposing counsel recognizes your credentials. In turn, your own attorney may *insist* that

you recite your credentials for the record. In case you're wondering why this reverse duel may take place, both sides are playing for the benefit of the jury. Waiving testimony as to an expert's credentials is not so much an honor as it is a litigation technique. It prevents the jury from hearing them so that later, the counsel who waved them may argue to the jury that you're just some "Joe accountant" who gave testimony for the other side. Your own counsel, in turn, wants to make sure the jury knows how long you've been working in your field, what publications you've written, where you've taught, and so forth, making it clear that your expertise is derived not from a few years of practicing accounting but from 20 years of speaking, writing, living, and breathing forensic accounting. Specifics stick in the minds of the jurors. (But note: reciting too many credentials may backfire as the jury may consider you to be pompous. Generally stick to the more impressive ones and don't pile on.)

Direct, Cross, and Redirect Examinations

As any viewer of courtroom television knows, witnesses give testimony (known as *direct testimony*) and are then cross-examined by the opposing party. Assuming that the attorney who hired you is experienced, you will be extraordinarily prepared for the direct examination—in fact, you will know almost every question in advance. Direct examination is almost like performing a play in which you memorize your lines and deliver them in the most convincing manner possible. This does not mean that the attorney will put words in your mouth; he or she will merely go over with you in advance the questions he or she intends to ask you in order to gauge what your response will be. You should never memorize answers; invariably, you will begin answering before the full question is asked and it will become immediately apparent to the entire courtroom that you are on a script. Say goodbye to your credibility. The attorney may explain to you the information that you should bring out, and may "help" you a bit as to what the "perfect" answer is, but no attorney worth his salt will ask you to parrot his answers. Most likely, he may suggest small changes such as the following.

Question: What materials did you review?

Your answer: I reviewed the defendant's bank accounts.

"Coached" answer: I reviewed the defendant's Bank of America checking account number 123456 for the period of June 1 2006 through August 31, 2008.

Objections

Very often one attorney will object to a question being asked. Most often, the objection will be made immediately following a question, before you have had the chance to answer it. When you hear the word "objection," do not answer the question, no matter which side asked it. Occasionally, the objection may be late in coming, so it will not be your fault if you begin or even complete your answer. Still, as soon as you hear the word "objection," stop and wait for the judge's direction. If the judge "sustains" an objection it means that the question is improper and you cannot answer it. Sometimes the judge will sustain the objection because the form of the question is incorrect, in which case the attorney will have the opportunity to correct it. At other times, the question is simply improper and will not be allowed. If the court "overrules" the objection, this means it has determined that the question is proper and may be answered. You should do so. If you have forgotten the exact question, you may ask that it be repeated.

Listen carefully to a question before you respond. Answer too quickly for your own attorney and you will sound too rehearsed. Answer too quickly on cross-examination and you may have prevented your own counsel from objecting. (Once a question is answered, the court may overrule an otherwise valid objection.) If you don't fully understand a question, ask the attorney to repeat or rephrase it. Answer the question completely, but don't elaborate unless asked.

Always wait for counsel to ask the complete question, especially when the questioner is opposing counsel. Take a second or two, if necessary, to fully understand counsel's precise question. Then answer that question only. To use an extremely absurd but instructive example:

Question: Do you know what time it is?

Answer: It's 9:30 a.m.

This is the incorrect answer. Let's try again:

Question: Do you know what time it is?

Answer: Yes I do.

Question: Can you tell me what time it is?

Answer: Yes I can.

Question: OK, what time do you have?

Answer: 9:30 a.m.

That is the testimony of a well-prepared expert.

If you don't know the answer to a question, answer: "I don't know." Simple as that.

A good attorney will also advise you of the judge's demeanor, specific rules, and pet peeves, as well as clue you in on opposing counsel's good and bad qualities. Don't be afraid to ask if there is anything you need to know about either of these courtroom participants.

An unfortunate side effect of good preparation is that you might be lulled into a false sense of security. After all, what could be more protectively womb-like than to know in advance the questions and answers. Cross-examination, however, is designed to turn grown-up experts into blubbing babies. If direct examination is the womb, cross-examination is labor. The most significant difference is that whereas on direct examination the attorney cannot ask you "leading" questions (generally, those that are possible to answer with a "yes" or "no"), on cross-examination the other attorney can lead you like a championship ballroom dance partner, as in the following example.

Adversary's attorney: Ms. Expert, would you agree with me that it is a vital part of a forensic examination to review each of the subject's bank records, yes or no?

Expert: Yes, of course.

Adversary's attorney: And you visited my client at his house, correct?

Expert: Yes.

Adversary's attorney: And his bank records were present at that time, correct?

Expert: Yes.

Adversary's attorney: And did you ask my client for them?

Expert: Yes, I did.

Adversary's attorney: And did he offer them to you?

Expert: Well, strictly speaking . . .

Adversary's attorney: Just yes or no, please! Did he offer them to you?

Expert: Yes.

Adversary's attorney: Now, Ms. Expert. I show you the report you prepared on behalf of the plaintiff in this case. Do you recognize it as your report?

Expert: Yes.

Adversary's attorney: And does your report contain any findings relative to my client's bank account?

Expert: No, but . . .

Adversary's attorney: Just yes or no will do.

Expert: No.

Adversary's attorney: By your own testimony, in answer to my first question, you agreed that such information was vital, correct?

Expert: Yes, I did, but . . .

Adversary's attorney: Yes or no, please. That's all I asked. Do you agree that such information is vital, yes or no?

Expert: Yes.

Adversary's attorney: Then your report—your “expert” report—is missing something that you, yourself, consider to be vital, yes or no?

Expert: Well I can't answer that the way you put it.

Adversary's attorney: Oh really? I'll withdraw my question then. I think the jury can draw its own conclusions.

See why they call it a “leading” question? It's because you have been lead down a particular path, unable to offer explanations of why a particular event did not occur. Opposing counsel has made you seem incompetent, even if you have a very good explanation.

Of course, following cross-examination comes the re-direct examination. Although it is impossible to prepare a witness for re-direct because you don't know what the cross-examination will be like, this is where your own attorney tries to control the damage. For example, the re-direct to the above cross-examination might be as follows:

Hiring attorney: Ms. Expert, you testified on cross-examination that the defendant offered you his bank records while you were in his house, is that correct?

Expert: That's correct.

Hiring attorney: And where exactly were these records when he offered them to you?

Expert: In the mouth of his Rottweiler.

Hiring attorney: And what was this Rottweiler doing at the time?

Expert: Baring its teeth and growling rather loudly.

Hiring attorney: And did the defendant say anything to you at that time?

Expert: Yes, he said that I was free to have any financial record he possessed; all I needed to do was wrestle it from the dog's mouth.

Hiring attorney: And did he mention the dog's name?

Expert: I believe he called the dog "Assassin."

One of the common tactics used by defense attorneys to discredit the credibility of a witness is to ask a very simple question: "Did you go over your testimony with anyone prior to trial?" Many unprepared witnesses will act defensively and will protest that they did not discuss their testimony with anyone. Of course, you've just fallen into a trap; counsel will invariably bring out that you spoke to *someone*—the attorney, your spouse, the party in whose behalf you testified—about the case. Then, at summation, when it is too late for your side to do anything about it, counsel will claim that you were untruthful when asked that simple, innocuous question, so aren't you capable of lying about the more important things?

Naturally, experts go over their testimony with counsel. No self-respecting attorney would allow an expert to testify *without* reviewing the testimony. The correct answer would be to state that you did, in fact, discuss the case with your attorney and treat this action as if it were the most normal thing in the world—which it is. If you answer the question "yes," opposing counsel will likely quickly move on to other areas. If you try to defend your impartiality by claiming that you had no contact with anyone, expect some embarrassing punishment to follow.

Another common question that opposing counsel may ask is: "Have you been paid for your testimony today?" The question is phrased very carefully to make it appear to a jury that your compensation is contingent upon the content of your testimony. Many attorneys will tell you that the appropriate answer is to admit that you have been "compensated for your time and services" but that such compensation is not contingent upon your testimony. Some courts may allow the question as to how much you are being paid; the purpose here may be to get the jury to view you as interested in only your own compensation. The larger the amount, the more likely a jury may believe that you are a gun-for-hire expert. Ask your attorney for guidance prior to testifying; he or she may suggest that you work into your testimony the number of hours represented by the total fee or the number of team members involved. There is no need to shy away from revealing your fee; if you're confident, the jury may feel that you are worth it. If you mumble or fumble, they may believe that you are not and, perhaps, that your analysis and testimony are not worth it either.

This is as good a time as any to stress that you should *never* lie on the witness stand. If you make a mistake, or if you misspoke, or if you simply became confused by a question and thought that you were being asked something else, 'fess up. People make mistakes, and juries are not interested in punishing honest ones. But if you get caught in a lie, the jury is free to ignore your *entire* testimony, and it may be a long time before this particular attorney engages your services again.

Of utmost importance is the consistency of your testimony with relation to your report and to any testimony you may have previously given if you were deposed prior to the trial. This does not mean that new facts or information you received or developed subsequent to your report or deposition must be ignored—in fact, under the rules of legal discovery, any changes must be disclosed to opposing counsel—but merely that there is no excuse for not being familiar with your own work product. Inconsistencies are the rocket fuel that powers the missile of cross-examination.

Consistency is not the same as concession. If opposing counsel makes a point with which you agree but which you think harms your client's case, answer it truthfully nonetheless. It's counsel's job, as illustrated previously, to fix the harm on re-direct. Conceding a point makes you look impartial in addition to knowledgeable; combatively refusing to deliver a truthful answer—and make no mistake about it, skillful opposing counsel will get it out of you one way or another—marks you as partisan and confrontational and may actually cause more harm than good. Trust your own side's attorney to make it right.

Visual Aids

Juries love these. If you think they would be helpful, ask your attorney-client. They might not be favored by a particular judge or may require prior permission under local court rules. It is always best to have them prepared in advance; writing things out on a blackboard in front of the jury may not work out the way you want it to.

Depositions

Local rules may permit opposing counsel to take your deposition before trial. Everything that applies to trial applies to depositions as well:

- Dress professionally.
- Be polite and treat opposing counsel with respect; expect the same respect in return.
- Answer just the question you have been asked. Do not elaborate.
- If you do not understand a question, ask that it be repeated.
- Depositions, most likely, will not consist of merely yes or no answers. Opposing counsel is trying to get facts and probe weaknesses. The theatrics are usually left for the jury. Consequently, if you cannot answer a question as posed, state so. Let counsel rephrase it until you can answer it but, again, try not to elaborate if at all avoidable.
- Have extra copies of your report or of the materials upon which you based your report handy.
- Ask whether your counsel wants you to bring along the actual financial documents upon which you based your report. If the material was furnished by opposing counsel, they should be expected to have it; in that case, it is likely not your responsibility. But always check with your own counsel about what additional materials you should furnish.
- Ask your counsel if there is anything you need to know about how opposing counsel operates or if there are any local deposition rules that you should be aware of.

Note: Unlike at trial, where lack of preparation will cast you in a bad light with the jury, the deposition process is slightly more forgiving as to lack of preparation. Since deposition is a “discovery” tool designed to uncover facts, any information or documentation not provided at the deposition itself can be provided to opposing counsel later. This is not to suggest that you come unprepared, merely that if you are asked for something that you did not anticipate, your counsel may provide it later.

Valuation, Characterization, and Division of Marital Property

Division of marital property requires valuation and characterization as separate, community, or marital property. This resembles a personal financial statement. However, the values are stated at current value as defined by local statute. Also, unlike a normal balance sheet presentation, individual assets or debts may be valued on different dates. This can result in omission of transactions transit between two different assets or liabilities valued on two different valuation dates.

Tracing is generally the analysis of separate or marital cash to determine if separate or marital assets were used to acquire property. Apportionment may refer to determining the separate interest in property which has separate property cash invested and appreciated during marriage.


Marital Agreements

It has been said that a second marriage is the triumph of hope over experience. Second and later marriages commonly involve marital agreements. These may be designed to protect children of a prior marriage or the financial consequences of a short marriage. They delve into the core of the extended family finances.

Prenuptial Agreements

Contrary to what is surely popular belief, the mere existence of a prenuptial agreement does not mean that it will be enforced by a court. The rules are likely to vary slightly from jurisdiction to jurisdiction, and the practitioner should become familiar with his or her state's rules (something that can be discussed with the matrimonial attorney).

Among the factors that a court might consider in upholding or striking down a prenuptial agreement is whether there has been full and accurate disclosure by the party seeking to enforce it, and if both parties had competent legal advice before entering into the agreement. Courts have generally taken the position that although a prenuptial agreement is binding, it is subject to the same rules as any contract and, most importantly, it must be free from fraud. If one party induced the other to sign the agreement based upon a misrepresentation of his or her assets, the agreement might be struck down. This makes it all the more important, if the forensic accountant is retained to represent the party seeking to challenge such a prenuptial agreement, to be diligent and vigilant in uncovering assets that may have been concealed years earlier.

 **Tip:** Because of the requirement of full disclosure, it is wise to request a copy of the prenuptial agreement for inspection. This document was likely drawn up at a time when the spouse with the greater property interest was not terribly concerned about disclosing that property. As a result, it may offer a fuller picture than any financial disclosure created for the purpose of the matrimonial litigation. The prenuptial agreement could also be a road map to discovering any later transactions that are not otherwise disclosed. The forensic accountant simply “follows the money.”

Standard of Conduct Between Spouses

The standard of conduct owed by one spouse to another may have a significant impact on all phases of a case. If the standard is fiduciary, sharing of information and documents may be obligatory, and the professionals' conduct will be attributable to the parties. If the standard is good faith and fair dealing, the obligations during marriage and dissolution may be lower. Consider the standard of conduct in your state and the effect it has on the case both during marriage and after separation.

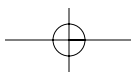
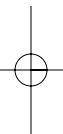
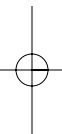
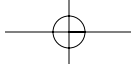
It behooves the forensic accountant to learn as much as possible about his or her state's matrimonial laws. They say that the best medical malpractice attorneys know as much medicine as the doctors they sue. So, too, should the forensic accountant know as much matrimonial law as possible. Not only will this impress the attorney, but extra knowledge never hurts. As for the sources of such information, many topical newsletters, magazines, and legal treatises are available to matrimonial practitioners. Ask the lawyer to borrow some or review them at a local law library. The Internet is also an excellent source for information on local statutes, cases, and customs.

Trusts and Estates

The common use of trusts creates complex issues in divorce. Trusts are as complicated as the mixed families that produce them. Trusts created before marriage for parties who enter into marriage later in life can be particularly complicated. They also offer opportunities for fraud.

Summary

- The matrimonial lawsuit is commenced by the service of a summons and complaint by the plaintiff (spouse who is seeking the divorce). The defendant spouse then appears and serves an answer, which may or may not contain counterclaims.
- After the preliminary phase, discovery is conducted. Each side must furnish certain information and documents to the other side. In addition, interrogatories or depositions serve to produce answers to specific questions.
- Two types of property distribution schemes divide property in a matrimonial action: community property and equitable distribution. Community property states treat many assets and most income acquired by a couple during their marriage as belonging to each in equal shares. Equitable distribution states do not have such automatic rules but attempt to treat each spouse in a fair fashion.



3

Introduction to Marital Fraud

Introduction

A common definition of *fraud* is

An intentional misrepresentation of a material existing fact made by one person to another with knowledge of its falsity and for the purpose of inducing the other person to act, and upon which the other person relies with resulting injury or damage. Fraud may also result from an omission or purposeful failure to state material facts, which nondisclosure makes other statements misleading.

Marital Fraud

Marital fraud involves liberal amounts of both false statements and nondisclosure. Many spouses who control the marital property conceal property under the theory that, in the worst case, if caught they will surrender half the concealed property with little or no consequences. Many states discourage this with statutes designed to provide consequences for fraud. For example, California discourages intentional concealment by allowing the court to apply exemplary damages. These are similar to punitive damages in that the guilty party has to surrender 100 percent of the property to the innocent spouse. Or a court may award a larger amount of property to the victimized spouse. Or the court may simply assess attorney and expert fees plus costs against the guilty party.

However, assessing penalties for fraud is the exception rather than the rule. Proving fraud cases is expensive and time consuming. Even when caught, perpetrators usually put forth any of three explanations for the fraud scheme. First, they deny that the evidence indicates anyone was deprived of property or rights. When that becomes obvious, they then argue that the fraud was an error or mistake and not intentional on their part. Finally, when confronted with overwhelming proof of intentional deceit, they argue they did it for the greater good. These rationalizations range from “protecting the community,” “pledges to church,” “for the children,” “I deserve more,” and “I earned the money so I should not give him or her any.”

Why Spouses Commit Fraud

Spouses commit fraud for the age-old reason—greed. What makes marital fraud so easy to rationalize is hostility and perception of their spouse as the enemy. A division of labor with one spouse handling cash, investments, and property with little or no internal controls makes marital fraud simple and lucrative, until the divorce. Spouses also may be committing fraud on others, and this fraud coincidentally may apply to their spouse. These instances include fraud schemes to hide or conceal income tax or sales tax; lender fraud; cheating business partners, investors, or customers, and myriad other fraud schemes.

Standard of Conduct Between Spouses

The standard or duty between spouses is defined by statute and case law in each state. If the duty is high, such as fiduciary duty, a high standard of conduct may be assumed by the accountant. This assists in determining if the alleged behavior by the fraudulent spouse is intentional because it defines the conduct a defrauded spouse can expect during marriage and until the divorce is final. Certain transactions during marriage may be subject to the statute of frauds in individual states.

Badges of Fraud

Badges of fraud are behaviors, conditions, or evidence of the possible existence of fraud. During interviews of clients or depositions of suspected fraudsters, the following badges of marital fraud may be useful to the accountant and attorney. They are short descriptions segregated in topical groups, and some are discussed in detail in other parts of this book. The existence of one of them may not indicate fraud, but several may direct the accountant and attorney to specific inquiries.

Behavior Indicators

1. Spouse is secretive about finances.
2. Spouse has exclusive control of password for online brokerage and bank accounts.
3. Spouse receives unfamiliar bank account mail.
4. Spouse redirects financial mail, such as credit card statements, from home to his or her office or a newly opened P.O. box.
5. Spouse does not leave a traditional audit trail, such as canceled checks, bank statements, statements, invoices, and so on.
6. Spouse exhibits a change in payment pattern of outstanding bills, such as prepaying credit card balances or paying in excess of the balance due, which are methods to park cash in credit balances during divorce.
7. Spouse is controlling with money.
8. All of a sudden everyone is on a budget—except for the spouse in control of the budget.
9. Spouse pays for family and big ticket expenses in cash.
10. Spouse pays personal living expenses in cash or from an account other than his or her personal account.
11. Spouse keeps cash in a safe in the home.
12. Spouse lies on loan applications.
13. Spouse asks for quitclaim deeds for real estate purchases, provides missing or incomplete records for refinancing, or performs overly complex transactions, all of which are designed to confuse and conceal economic reality.
14. Spouse exhibits a willingness to cheat on income taxes.
15. Spouse asks for tax returns to be signed late at night on April 14 and makes every effort to discourage questions and explanations, which could be a sign of fraud meant to deceive the IRS that melds perfectly into divorce planning.
16. Spouse uses a questionable tax preparer or regularly changes tax preparation providers.
17. Spouse does not file tax returns.
18. Spouse fails to share or disclose community opportunity.

19. Spouse parks money that does not belong to the community with parents and then receives consistent “gifts” until it comes time to pay support, at which time the gifts stop.
20. Spouse exhibits a tolerance for risk, which is suggested by credit reports, type of investments, or lifestyle.
21. Spouse establishes elaborate trusts without obvious estate planning objectives.
22. Spouse has a rapid, unexplained increase or decrease in net worth, which could be due to significant gambling winnings or wagers.
23. One of the spouses has a criminal record of any type.
24. Evidence of any spousal or child abuse or anger management issues on the part of one spouse.
25. Spouse makes allegations about his or her spouse.
26. Spouse files false charges against his or her spouse or adult child in order to intimidate them.
27. Spouse is frequently absent with no explanation, allegedly for business purposes.
28. Spouse changes work schedule.
29. Spouse can never be reached at work or business.
30. Spouse changes telephone or fax numbers.
31. Spouse’s accountant fails to respond to parties’ expert, attorney, or either spouse.
32. Spouse makes use of the diversionary tactic of filing motions, which keep the expert busy responding to the motions instead of examining the records.
33. Spouse makes threats against the expert.
34. Spouse tries to bully his or her spouse into firing his or her expert.
35. Spouse intentionally provides incomplete responses to discovery requests and misleading declarations and testimony.
36. Spouse resists complying with stipulations and other court orders.
37. Spouse takes advantage of the passive spouse’s lack of business experience.
38. Spouse receives telephone calls at home, to which he or she quickly or nervously responds, “I’ll call you back later.”
39. Spouse exhibits a “world owes me” personality.

Lifestyle Issues

1. Spouse lives a lifestyle in excess of reported income by making investments (art, jewelry, stamps, coins, gold, and so on) not supported with banking transactions.
2. Spouse purchases new “toys” (cars, boats, planes, and so on), which are above the standard of living indicated by income.
3. Spouse’s travel is inconsistent with other lifestyle activities.
4. Spouse exhibits significant flash and style, as compared to the passive spouse.
5. Spouse abuses drugs or pharmaceuticals.

Diverted or Hidden Income

1. Spouse’s income declines with the onset of marital difficulties (not necessarily at separation).
2. Spouse’s income declines dramatically when preparing an income-type marital standard of living, but his or her actual living expenses do not change, which may indicate that there is money in an undisclosed account which the spouse uses when cash flow is down.

3. Spouse conducts financial dealings with parents, siblings, adult children, or close friends (such as a gift of ownership interest in the family business).
4. Spouse is unable to explain the appearance of unknown accounts or invoices.
5. Spouse has multiple bank or savings accounts, or both, in or out of state, or both.
6. Spouse spends a great deal of time in a foreign country where he or she owns property (for example, Mexico) and never brings the foreign funds back to the U.S.
7. Spouse begins trips to the Cayman Islands, or other offshore haven, without his or her spouse.
8. Spouse has offshore and tax shelters.
9. Spouse has nonregistered assets such as gold coins or money “leaving the system” that cannot be found when tracing funds, which could indicate offshore accounts, unidentified accounts, or an undisclosed safe deposit box.
10. Spouse makes use of corporate cloaking in order to create a number of business entities that hold assets and money. (For example, Delaware and Nevada corporations require very little recorded information about the officers, directors, and stockholders. All they require is the name of one corporate officer, namely the registered agent, who may be an attorney or CPA.)
11. Spouse is inconsistent by saying he or she is broke or business is bad and then going out and buying an expensive car, expensive clothes, etc.
12. Spouse takes out large new loans without being worried about repayment.
13. Spouse provides cash to pay bills instead of using credit cards or checks.
14. Spouse’s net worth exceeds the amount that the parties could have reasonably accumulated based on their incomes during marriage, and this net worth is not explained by inheritance (also known as perquisite).
15. Spouse is the subject of multiple IRS audits.
16. Spouse receives excessive mail from the IRS.

Inappropriate Transfers

1. Spouse pays large legal fees to divorce attorney from business account.
2. Spouse has unusual loan or note transactions, such as loans to a losing business from nontraditional sources.
3. Spouse banks without a paper or electronic trail (parallel banking).
4. Spouse has multiple bank accounts with many transfers and large deposits and withdrawals.
5. Spouse conducts multiple transactions involving currency levels falling just below the \$10,000 currency transaction reporting requirement in order to evade enforcement scrutiny.
6. Spouse conducts convoluted financial transactions involving numerous entities with a high volume of transfers among them.
7. Spouse conducts related-party transactions.
8. Spouse frequently refinances his or her mortgage.

Business

1. Spouse has a declining “Z” score, which measures the probability of bankruptcy. (A low “Z” score with no apparent change in lifestyle may indicate hidden income.)
2. Spouse has complicated multiple entity business investments.
3. Spouse starts a new business entity with a “partner” in or out of state or outside the country.

4. Spouse employs “independent contractor” cash employees who give kickbacks to spouse.
5. Spouse has nonworkers (minor children or paramour, or both) on business payroll.
6. Spouse shuts his or her business down, if licensed, and starts employment with friendly competitor until divorce is final.
7. Spouse conducts stock transactions of his or her business with friendly third parties.
8. Spouse sells company to a third party during the divorce proceedings.
9. Spouse increases accounts receivable adjustments to cover money being taken from business.
10. Spouse is reimbursed by the business for entertainment that does not match his or her diary or calendar.
11. Spouse’s business constantly reimburses him or her for payments paid in cash.
12. Spouse takes loans from the company.
13. Spouse creates liabilities that are not real.
14. Spouse’s business creates fictitious invoices at year-end in accounts payable department.
15. Spouse’s business spreads large disbursements over several accounts in order to even out expenses.
16. Spouse’s business expenses are significantly above industry norms.
17. Spouse’s business invoices supporting purchases or expenses are similar to those generated by word processing and spreadsheet software.
18. Spouse’s business expense categories fluctuate significantly when a horizontal or vertical analysis is performed.
19. Spouse’s nonbusiness debt is carried and serviced by his or her business.
20. Spouse has nonbusiness leases (autos, paramour’s apartment, and toys) on business books.
21. Spouse’s business postpones income.
22. Spouse’s business gross profit is significantly below industry norms.
23. Spouse owns his or her own business, takes large salary with no withholding, and leaves community with large tax liability.
24. Spouse’s business compensation packages are restructured at separation.
25. Spouse offers unusual compensation packages for key employees.
26. Spouse gives bonus to employee, such as a new girlfriend or boyfriend.
27. Spouse offers unequal compensation in a two-person business with no explanation to his or her coworker as to why he or she is being paid less money.
28. Spouse changes professionals (attorneys, CPAs, and so on) at certain parts of the case.
29. Spouse has a very low level of sophistication with respect to record keeping, such as sloppy book-keeping and accounting and commingling of personal and family finances and accounts, which make tracing that much more difficult.
30. Spouse has known or alleged business disputes.
31. Spouse relocates his or her business or changes staff, personal assistants, administrative assistants, managers, and so on.
32. Spouse makes a drastic change in vendors (such as making use of an unfamiliar vendor) for the business or customer base, which may indicate sales are being diverted to another company.
33. Spouse’s business vendors are paid by a company that does not exist in the phone book.
34. Spouse’s business reports less net income than the spouse can earn working for another company.

35. Spouse's business fixed asset acquisitions are expensed as repairs and capitalized for depreciation.
36. Spouse's business creates low ending inventories, which reduces the cash used to purchase inventory and expenses through cost of goods sold.
37. Spouse's business has a substantial increase in repair and maintenance for assets that should have been capitalized or part of ending inventory.
38. Spouse's business secures a loan without the usual paperwork or meeting the terms for repayment.
39. Spouse's business either lacks loans or lacks fees and costs on existing loans.
40. Spouse's business lacks inventory records.
41. Spouse's business lacks an appointment book.
42. Spouse's business customers' accounts receivable balance is written off even though the company continues to do business with the customer.
43. Spouse's business has cash registers that do not have "total tapes" or spouse's business does not keep cash register "total tapes."
44. Spouse's business has been losing money for several years.
45. Spouse's business uses a single entry accounting system.
46. Spouse's business does not use an outside accountant.
47. Spouse's business makes use of the barter system.
48. Spouse's business makes use of a secondary endorsee on checks paid to spouse.
49. Spouse's duplicate deposit slips for his or her business do not show cash dollars when the business receives cash.
50. Spouse's business gross rents do not match the rent roll or leases.
51. Spouse's business tax returns do not match books and records.

Others

1. An attorney should analyze trust accounts in order to see if settlements are current.
2. A spouse's passport should be examined (places, dates, and so on) if he or she spends a great deal of time in foreign countries.
3. The cultural backgrounds and business practices of the parties should be considered when the divorce case is being prepared and potential fraudulent transactions are being reviewed.

The Wild Goose Chase

Occasionally, due to the emotional content of divorce, one spouse accuses the other of fraud that does not exist. A wild goose chase ensues, which can represent substantial fees and costs. The problem with the wild goose chase is you can prove the goose exists if there is one, but it is difficult to prove one does not exist. If it is possible, consider asking the client or attorney to put a fee limit on the chase. When it is reached, further pursuit will be reevaluated.

4

How to Investigate Business Assets

Introduction

Valuation of the business assets and income of the respective spouses is crucial in a matrimonial action, particularly if the marriage has been a fairly lengthy one or young children are involved.

The extent of the business's assets is important in determining an equitable distribution of the marital property or in establishing the spouse's statutory share in a community property state. The income is important in setting maintenance (alimony) payments and child support. In a hotly disputed divorce, a spouse who owns a business may seek to conceal as much as possible—and to minimize the value of the rest. Understatement of business income often results in understatement of the business's value and the income available for support.

Business assets and income may be concealed in a variety of ways.

- The business owner might take inappropriate write-offs or receive excessive perks.
- In a cash business, receipts might simply not be reported.
- The business can be made to appear less profitable in a variety of ways, including siphoning off profits or artificially raising costs through dummy middlemen.

This and succeeding chapters will focus on identifying and quantifying the inappropriate or illegal actions of the subject of the investigation.

The Role of the Forensic Accountant in Evaluation the Business

In preparing for the task, several basic rules exist that forensic accountants need to know.

First, the fact that the IRS might accept the character of a transaction does not mean the forensic accountant has to for purposes of the investigation. As anyone who has ever prepared a tax return for a business knows, it is not unheard of for a business owner, particularly a small business owner, to take liberties with expense accounts and to write off things that barely pass IRS muster. Even compliance with the Internal Revenue Code is not the standard of the forensic accountant's investigation. Broad categories of write-offs, such as depreciation and § 179 expensing, automobile use, or health and life insurance payments, may pass muster with the IRS and yet need to be reevaluated for purposes of fairly allocating assets in a divorce proceeding.

Second, just because the other owners of the business consent to a transaction—or, more appropriately in the case of perks, just because everyone receives an equivalent amount of “nontaxable” benefits—does not mean that the forensic accountant has to accept these transactions as legitimate write-offs for purposes of valuing the business for matrimonial distribution.

Third, forensic accountants should take nothing for granted. They must turn over every stone. Creative new ways of concealing assets or of writing off expenses, emerge every day. It does not take a particularly clever person to conceal business assets, but all it takes is an unskilled investigator to fail to uncover them. Investigators must be sure to have sufficient resources and time for the assignment.

Sometimes the investigation involves no more than an overview of the business books to determine whether expenses have been allocated to incorrect categories. For example, has business equipment, which typically has a life span of more than one year and is, in reality, an asset, been lumped together into the same category with such office expenses as stationery and paper clips?

At other times, the investigator will need to delve a bit more deeply. For example, has that employee who appears on the payroll ever been seen at the office, or is he or she merely the boyfriend or girlfriend of the owner? The availability of computer bookkeeping programs has made manipulation of financial records easier. On the other hand, the Internet has made discovering fraud-related information faster and less expensive. It is unclear which side is winning this digital war.

In light of these issues, the following sections discuss the job of analyzing a business's true worth.

Overview of Different Types of Business Entities

Before beginning, it is important to understand how each type of business entity may lend itself to a slightly different investigative approach.

Corporation

A corporation is an entity that exists by the grace of the state. This means simply that only a state may charter a corporation,¹ and certain formalities must be followed in forming it, including filing the articles of incorporation. In addition, some type of annual franchise tax or information return may be required.

Because of certain required formalities, the attorney can, through the subpoena process if necessary, often obtain information about a corporation's internal dealings. From the perspective of the investigating accountant, several things may be unique to a corporation that are "must haves" as far as the investigation is concerned.

- Corporations issue stock to their shareholders. An examination of the stock records will reveal the percentage of the company owned by the subject of the investigation if he or she is not the sole owner. It may also reveal recent transfer of ownership or the sale or gifts of shares.

In small, closely held corporations with more than one owner, there may be a buy-sell agreement, often combined with life insurance. This agreement should be investigated.

Corporations may enter into partnerships and joint ventures with other businesses, or they may own (except in some cases of subchapter S corporations) an interest in another corporation. Corporations may also have subsidiaries that must be investigated independently of the parent corporation. Investigating these offshoots is important, particularly for fairness as that term applies to matrimonial property division.

The tax code provides greater benefits in pension planning to corporations, so these plans must be reviewed carefully.

Hybrids of typical corporations that have come into popularity in recent years include limited liability corporations and limited liability partnerships. These, too, are chartered by following specific requirements of state law. For purposes of this chapter, however, they are all treated as corporations.

¹ Strictly speaking, this is not true, because Congress has chartered several. But these are a different type of corporation and are not important for purposes of this book.

Partnership

A partnership is, in its simplest definition, an agreement between two or more people to carry on business together. What is unique about partnerships is that they may exist without any agreement in writing between or among the partners. In other words, partnership agreements may be verbal.

Unless a written agreement exists, both profits and losses are shared equally among the partners. This is good to know because in the absence of a written agreement, the partners' tax documents (particularly their K-1s) should be identical. This is not a legal requirement, however, because there could potentially be a verbal agreement to split profits and losses unequally. Therefore, the caveat here is to investigate as many of the past tax documents as possible because they will identify the interests of the parties and any changes.

Partnerships may own corporate stock and enter into joint ventures. In addition, the partners may have a buy-sell agreement similar to that of a corporation. Copies of any written partnership agreements, buy-sell agreements, and tax returns are a must.

Sole Proprietorship

A person wakes up one morning and decides to be in business by himself or herself. This, in essence, is the sum total of the legal requirements for the creation of a sole proprietorship. Although admittedly an oversimplification, it is not far off the mark. Sole proprietors may or may not be doing business under an assumed (business) name, and they may or may not keep a set of books and accounts separate from their personal ones. Unfortunately, this may make the accountant's job a bit more difficult. Trying to discern from a single checking account which charges are appropriately attributable to the business and which to the personal spending of the sole proprietor or his or her family may be a nightmare. But if a separate set of books is kept, the business investigation will be no different from any other.

Professional Practice

Professional practices—doctors and lawyers, for example—have their own unique peculiarities. The professional relationship among practitioners can be either a partnership or a professional corporation. A professional also may practice solo without the protection afforded by professional incorporation.

In many regards, a professional practice is no different from any other business. Professional corporations are, indeed, corporations and should be investigated as such; partnerships can be investigated as any partnership would be. There are some unique considerations in professional services, however.

- It is more difficult to measure the productivity of professionals. Unlike a business that produces and sells a product, and for which the cost of goods sold can be measured and a gross figure extrapolated, the contributions of people who furnish services can be hard to value.
- Many professional practices use computerized billing and accounting systems. These may contain a wealth of information. However, often attorneys and medical doctors object successfully to producing any records that include their clients' or patients' names. This may limit access to information. Other records, such as appointment books, may prove helpful in gauging the productivity of a professional. Unless every client is contacted—something that the attorney will likely dread undertaking—how does the forensic investigator know whether the dentist's appointment was for a routine examination or a more expensive root canal? Can tongue depressors in a doctor's office be counted? How can the investigator tell that an appointment was not a free initial consultation, as many attorneys advertise?
- Complicating matters, some associations of professionals consist of individual practitioners incorporated as professional corporations and then further associated within a larger umbrella of another partnership. As a result, the investigation of a partnership consisting of professional corporations may require two levels of digging by the forensic sleuth.

- One additional point needs to be made, particularly in the case of attorneys. The law in every state requires that separate escrow or trust accounts must be kept for funds on deposit that belong to the client and not to the attorney. This is particularly important in personal injury and real estate practices. The IRS knows that trust accounts are a favorite place for attorneys to park money that has been earned but not yet booked as income. These escrow or trust accounts must be investigated carefully.

There are abundant studies and other resources that present an average professional's income, expenses, billing rates, and other practice data. These may serve as a benchmark to evaluate the instant practice.

Although this is certainly not an absolute and inflexible rule, it is also true that the larger and more organized a business is, the less likely it is that unreported income will be a factor. For instance, if required to be divided among too many principals, the legal penalties of underreporting begin to outweigh the monetary benefits of "pocket change." Larger, more centrally organized companies also tend to have internal controls that make it more difficult to fail to report income. The larger the organization, the more likely it is that the principals of the business will find ways of compensating themselves with "perks" that they will argue are deductible business expenses.

Beginning the Investigation

Two important factors underlying the investigation will be the forensic accountant's access to documents and to the physical plant of the business. Documentation, of course, forms the foundation of the investigator's analysis. Merely pouring over the paperwork, however, is only half of a thorough job. Visiting the business premises itself, either personally or by using an investigator, may also prove critical in determining whether the paperwork tells the whole story.

Obtaining the Necessary Documentation

Obtaining the documentation is the attorney's job. It will be accomplished either through the discovery process (discussed in chapter 2) or through a court order, if necessary.

Telling the attorney what documentation is required is the forensic accountant's job. Although any experienced matrimonial attorney will know the basic documentation required (in fact, the standard discovery request is likely to be on the attorney's computer), it is always helpful to have a list (see the appendixes). If the attorney is not successful in obtaining the requested records and information in a useful format within a reasonable period of time, the forensic accountant should consider withdrawing from the case. Delays in pursuing discovery will put undue pressure on the accountant to compress too much work into too short a period of time. Waiting too long because of delayed discovery makes it more difficult to withdraw from a case.

Obtaining the documentation may not be an easy task. Few business owners with something to hide will voluntarily provide ammunition against themselves. Without a subpoena or court order, the forensic accountant may have to wait forever for the requested items. Once the forensic accountant requests a document, he or she must not take no for an answer. The legal process of discovery is an ongoing one in that a party obligated to produce a document is under a continuing obligation to do so. Merely because a document cannot be produced immediately on request does not mean that its later discovery requires a new demand. The "Sorry, but you asked for it when we didn't have it and didn't ask for it when we did," argument just doesn't wash in a court of law. In addition, the law requires that a party produce documents that are either in that party's possession or in the possession of any "agents, employees, and other persons under the control" of the party from which the discovery is sought.

Conversely, if the subjects of the investigation claim not to have a particular document, they cannot be compelled to produce it. Or can they?

An important tip to the forensic accountant is to keep track of documents that he or she has been denied (or the very existence of which is denied) and to seek evidence of their existence in the documentation that has been furnished. For example, one way to cause a change of heart when you are told that a document does not exist is to investigate the billing invoices of the professionals who have rendered services for the company. Proof of the existence of the document may be found there, and the business owner may not have thought to remove the invoice from the file.

To illustrate, if the forensic accountant is looking for particular financial statements that ordinarily would be prepared by the company's accountant but was told that none exist, the forensic accountant should check the accountant's bill to see whether it mentions such an item in its details. Similarly, if the response is that no loan papers, buy-sell agreements, or other legal documents exist, a check of the bill submitted by the corporation's attorney might prove that such services were, in fact, performed. Few professionals submit bills without at least some itemization. Once the forensic accountant finds proof that a document was, in fact, prepared, he or she should immediately bring this to the attorney's attention. The attorney may prepare a subpoena directed to the professional or might seek a court order to compel the production of the document. It is also possible that the subject, caught in the lie, will now voluntarily produce the document needed.

Discovery of the existence of documents and information that may be helpful is greatly aided by access to credit granting agencies, state agencies with public information, and professional business information providers.

What Documents Should You Begin With?

The following are basic documents that should be reviewed as part of the investigation.

Business Tax Returns

One of the most important pieces of information, of course, is the tax return filed by the business being investigated. As is true of almost anything concerning the investigation, the longer a period the forensic accountant can obtain records for, the better a picture he or she will have.

If the business owner claims that the records are not in his or her possession, the forensic accountant should ask for the name of the business accountant. This may require a subpoena or court order, but it can be accomplished. If no business accountant exists, or the records are still unavailable, then records can be obtained directly from the IRS by completing Form 4506. Some state tax authorities are actually faster at producing copies of tax returns. It is highly unlikely that the availability of tax returns will be challenged (unless the scope of your request exceeds reasonableness) because a court will not look kindly upon a party who fails to make even such basic information available for inspection.

The examination of business tax returns, particularly over a period of several years, may be revealing. The forensic accountant should consider the following.

- Are there any purchases of equipment that have been expensed? Computers, in particular, are a favorite property for expensing even though such purchases are not routinely upgraded each year. Or, even more common these days, a specialty software product may have been expensed despite the fact that it is expected to be used for many years to come.
- Do depreciable assets exist? If so, the forensic accountant will need to investigate whether the depreciation exceeds the current value of the depreciated asset. Depreciation may have been taken per applicable IRS regulations, but again, this does not bind the forensic investigator or appraiser in establishing a value for matrimonial purposes. The clearest example has to be rental real estate: Just because it has been fully depreciated does not mean that the real estate has no value. In addition,

most property has at least a salvage value or, in the case of real estate, a nondepreciable base for the value of the land.

- Has there been a noticeable increase in expenses or decrease in income that cannot be explained purely in economic terms? Simply put, it is rare for marital troubles to develop overnight. The forensic accountant should ask the client when the marital discord surfaced. More often than not, problems have been apparent to one or both parties years before the decision to divorce. This is more than adequate time for a business-owning spouse to make alternate arrangements for the “profitability” of the business. This is covered in greater detail in chapter 5.
- Has one of the parties’ ownership interest in the business decreased? In the case of a partnership, Schedule K-1 of Form 1065 reveals the value of a party’s capital account and whether it has changed, either through withdrawals or through a reallocation of the percentage of profits and losses to be shared by the party under investigation. In the case of a subchapter S corporation, information on the shareholders’ percentage of stock ownership can be found on Schedule K-1 of Form 1120S.
- Has there been a decrease in a partner’s compensation? If so, where did it go and why? It may be legitimate—a true decline in business, for instance. However, further inquiry may also uncover a temporary (that is, until the divorce is concluded) decrease in compensation or bonus. Or perhaps the compensation method for the subject of the investigation has been temporarily changed to a commission-based one.
- Are there huge differences in perks from one year to the next? These may appear as a discrepancy in a variety of places, including on the lines for the deduction of employee benefits or on the “other deductions” schedule. The forensic accountant should investigate whether the subject’s compensation is, in fact, being furnished in other ways, such as in deductible expenses.
- What has the cash flow of the company been over time? Sometimes cash has been withdrawn by loans to the spouse or dividends from a corporation, particularly an S-type corporation.
- What are the value and profit drivers? The forensic accountant should determine if they have changed recently.

The foregoing are just some of the broad areas of abuse that an examination of the tax return might uncover. Specific investigative pointers will be given in the following sections and chapters.

Business Agreements and Contracts

A wealth of information can also be contained in business agreements and contracts. The object of the investigation may be linked with other business ventures.

For instance, there may be a contract with another company wholly owned by the party under investigation or by family members or friends. Because not all companies pay salary or dividends to every shareholder, the company might be a convenient place to park profits or to shift them to others temporarily.


Example 4–1. John (the subject of the investigation) and his father each own a 50 percent interest in Moe Co., Inc. In addition, John owns 100 percent of Larry Co., from which he claims (at least to his wife) to derive his income. A contract exists between Moe Co. and Larry Co. to supply unfinished widgets to the latter at the price of \$2.00 per widget.

Although widgets are readily obtainable on the open market for \$1.00 each (and, in fact, this is the price at which Moe Co. obtains them), Larry Co. is contractually obligated to pay twice that. Larry Co. sells its finished widgets at \$2.10 per piece.

Larry Co. deducts this inflated price as a cost of doing business. Naturally, with its profits being only \$.10 per widget instead of \$1.10, it appears that Larry Co. is not doing tremendously well. John claims that the company should be valued accordingly.

To take it a step further, Moe Co. has virtually no costs, only profits. John's father, who owns the other 50 percent of the shares, receives a salary (not coincidentally) equaling the total profit of Moe Co. Because Dad is a retiree, he is not too concerned about the income tax implications. John benefits, however, because his interest in Moe Co. has some value that he has not reported to his wife during their many years of marriage.

There is more than meets the eye in this contractual arrangement. It helps, of course, to know what widgets do sell for. This is information that comes with experience, or that can be researched by the forensic investigator.

 **Tip:** The forensic accountant should not neglect to conduct an investigation (or ask the attorney to do so) to determine whether contract partners are in any way inter-related and, if so, the subject's interest in those other companies. This investigation may take the form of deposing the other business owner or serving subpoenas for relevant records.

Assuming for a moment an absence of deception, legitimate agreements should also be investigated to determine their value. A long-term contract to supply a product to Company X may add tremendous value to the supplier company's worth.

Example 4-2. Jennifer owns a company that has had unsteady earnings over the past few years. Earnings have ranged from \$100,000 per year to \$300,000 per year with no discernible pattern. Such a company might be valued by the court at an average of the earnings or, if Jennifer can make a compelling argument that the high years were flukes, even toward the low end.

However, if Jennifer signs a five-year contract with a new customer, Company Y, to supply it with a stipulated quantity of her product (producing \$150,000 of annual profits), her earnings base now becomes predictable and, at the very least, her company's earnings should be assumed to be no less than \$250,000 (the least she has earned over the past few years plus the value of the new contract). Clearly the value of her company has now jumped even though she may be in only the first year of the contract.

True, Company Y might breach the contract, or the contract might contain a cancellation clause that is later invoked, or she may not have the capacity to operate continuously at this increased level of sales, but these are issues to identify and leave for the lawyers to hash out. Alternatively, the appraiser's valuation of the company might take these factors into consideration.

Books and Records of Corporate Ownership

An examination by the forensic accountant or by the attorney of the corporate record book might also yield information, not the least of which is whether the percentage of stock ownership has changed recently. Or, it could be that stock was issued in one percentage, but the tax returns reflect another. Because legal ownership of the stock (as recorded on the books of the corporation) is virtually open-and-shut proof of such ownership, a contradiction with tax records could yield a handsome payoff. In some states legal title to the stock is important. Is it in one party's name or in joint title?

Example 4-3. Half Corp. is owned in equal shares by Harry Half and by his two sons, Hugo and Henry Half, all of whom work in the business. Harry Half decides to leave the business and sells his interest to his boys. Now each Half owns half. However, for reasons known only to them (well, actually, Harry does not really want to pay any stock transfer or capital gains costs) the Halfs continue to file their corporate tax returns as they always have, indicating that the ownership belongs to them in equal shares. Any adjustments between family members are carried on informally.

If Hugo is involved in a matrimonial action, his interest is based on the 50 percent actual ownership rather than on the tax return showing that each party is receiving 33.3 percent of the profits.


The company's books may reveal other things about its owners, for example, whether the corporation is a subsidiary of a larger company. The forensic accountant may then explore the ownership interest in that parent company, if any, of the party under investigation.

Note: Any recent change in stock ownership should be reviewed very carefully for its economic reality. In other words, is there a legitimate reason, or is the party under investigation merely attempting to reduce his or her ownership on paper?

Company Financial Statement

The comparison of several years' financial statements for the company may tell an interesting story as well. Any significant changes in the balance sheet and income statement are of interest. Also to be considered are the more difficult circumstances in which no observable change is evident in the financial statements when a significant (usually positive) change would be expected in this company's industry or geographic region.

Of course, not all such increases or decreases will be the result of bad intent. For example, the sudden appearance of loans payable by the corporation might indicate a legitimate expense for expansion of the business, but it could also be a convenient way to create a fictitious liability for the company that, naturally, is intended to deflate its value. Similarly, a sudden decrease in business might indicate any number of things (remember, even the most successful typewriter manufacturer took a financial nose-dive with the advent of word processing programs), but it might also indicate that the owner is turning away business temporarily.

 **Tip:** Most companies produce an annual financial statement. The forensic accountant should not overlook the possibility of interim financial statements as well. Some company accountants prepare them quarterly or semiannually as a matter of course. The annual statement may be the one that the company wishes to present in support of its tax return, but that does not mean that interim statements will reflect the same categorization. For instance, it is not unheard of for a business accountant to reclassify some expenses at tax return preparation time to avoid deductions that the IRS red flags for further examination.

Example 4-4. Andrew is in the business of conducting computer training seminars, after which (and although unnecessary to the training session), he takes customers out for dinner. In reality, Andrew hates to cook and uses this as an excuse to eat in restaurants.

For the first nine months of the year, Andrew's accountant dutifully enters these expenses under the heading "Meals" in his interim financial statements to Andrew. At the end of the year, however, the accountant believes that there is too much deducted in this category. Not only might the IRS flag his return for audit, but even if it does not, the most he might be entitled to deduct is 50 percent of his meals. So Andrew's accountant reclassifies this spending as "Seminar-Related Expenses" and deducts the entire amount.

The reclassification illustrated in the previous example certainly would not show up on the annual financial statement, but would show up on the quarterly ones. Other popular reclassifications might include changing a capital purchase (such as a computer) to the "Office Supplies" heading. The objective is to identify as many inconsistencies as possible. The more evidence of manipulation of the books uncovered, the more leverage the client will have in settlement negotiations or at trial.

Appointment Book

Appointment books, whether manual or computerized, are particularly important in the investigation of traditionally cash businesses that operate on the basis of appointments; masseuses, hairstylists, and the

like are good examples. The appointment book is likely to give a good idea of how good or bad business really is, perhaps in contrast with the claim of the party under investigation. It may also point out some interesting inconsistencies.

Example 4–5. A masseuse has a steady weekly customer who sometimes pays in cash and sometimes by check. Interestingly, every time the payment was by check, the amount was \$85, and that amount was deposited. When payment was by cash, the cash receipts ledger reflected payment of only \$25. Such a pattern is, if nothing else, embarrassing and difficult to explain. More than likely, some of the cash is not being reported.

The same holds true for any profession that involves appointments and whose practitioners might expect to receive at least some payments in cash, for example, accountants, attorneys, doctors, dentists, or veterinarians. Their appointment books may tell a different tale than their checkbooks.

In determining whether substantial cash payments should be suspected—and explored—it is important to understand the inner workings of a particular business. Busy hair salons operate almost exclusively on the basis of appointments and largely take in cash payments.

There really is nothing much to know: Claims of declining receipts while the appointment book remains full are likely to be bogus. The same, however, may not be true of professions. What the forensic accountant must be able to identify and how to interpret it goes well beyond this simple explanation.

For example, a dentist's appointment book shows many appointments but also what seem to be too many cancellations. Is the dentist withholding information about cash payments, or are the cancellations real? How can anyone tell?

The answer may depend upon the nature of the practice. If the cancellations are of appointments of short duration for seemingly routine procedures—cleanings, fillings—the dentist may actually be collecting his or her fee in cash. The forensic investigator might suspect that something was amiss if the cancelled appointments were consistently short blocks of time, such as half an hour. Medical professionals frequently book patients in short spurts—that is, they try to pack as many as possible into the work day, even if it means a slight wait for each patient. If the investigator knew that dentists do not usually schedule a patient for filling eight cavities in one sitting, he or she also recognizes that this makes it easier for a cash-paying patient to slip through the cracks. If the investigator sees too many of these (something that comes from experience), he or she might flag the cancelled appointments for further investigation.

One question, of course, is how can anyone really know whether the dentist actually saw the patient? The answer depends on the emerging patterns of the investigation, upon the investigator's "feel" for the potential unreported income, and the nature of the other evidence that might not have been so cleverly concealed.

If the forensic accountant develops evidence of the diversion of cash, it may be possible to petition the court to appoint a receiver or independent cashier for the business. An independent receiver or cashier will provide a clear indication of the current cash collections of the business.

Documentation Duality

The theory of locating undisclosed items is quite simple: One finds the corresponding item that relates to it but that has not been tampered with. It might be called the theory of "documentation duality." Simply put, this theory holds that most, if not all, transactions are somehow, somewhere recorded twice—and this does not refer to the possibility of a second set of books being kept, though finding this is certainly a feather in the investigator's cap.

This duplicate recording can take many forms, such as the following.

- Clients are entered in the database and on ledger cards.
- Payments are entered both in the computer and on the client file, or on the client file and on a deposit slip.

- Client or patient appointments are entered in the appointment book and in their files or charts.
- Bill payments are supported by an invoice and a check, or by the physical inventory and an invoice.
- Contractual payments are evidenced by a payment as well as by the contract itself.

These examples are actually some of the simpler ones. If the forensic investigator thinks creatively and places himself or herself in the shoes of the subject (“How would I conceal payment at the same time recording all the necessary work?”), the investigator might discover how the business owner has done it. A diligent investigator will be able to uncover at least some of the discrepancies, if only because any web, no matter how intricate or elaborate, is easier to destroy than it was to create.

Creative, logical thinking is the key. For instance, in the case of a dentist, doctor, veterinarian, or any other professional who keeps patient records, the patient chart itself would indicate the visit even if the appointment book and check deposit slips do not. Medical professionals do not routinely keep two sets of patient charts even if they do keep two sets of books. Investigating a number of these files and comparing them to payments received might lead to the discovery of unreported income.

Note: In the case of medical charts and files, or any other case or business where there are patient or client confidentiality issues, the attorney may need to obtain a court order or subpoena for access to the records, and the forensic accountant may not be able to simply pick several files at random during an office visit. The forensic accountant should check with the attorney for the appropriate procedure in their state.

Other ways to determine whether there is a true fall-off in business are available. One possible answer is to investigate supply invoices. Investigate the number of supplies ordered, calculate the waste, determine the available inventory, and see whether an inexplicable discrepancy exists.

Example 4-6. Dr. Molar performed, on average, 200 oral surgery procedures in the year prior to the divorce proceeding being filed. In addition, during the course of the investigation, the forensic accountant discovered that such a procedure requires the use of a certain amount of a professional commodity or commodities, such as Novocain for numbing the patient or zinc oxide for temporary fillings.

In examining last year’s supply purchase invoices, the forensic investigator finds that Dr. Molar has purchased enough supplies for—lo and behold—approximately 200 procedures. This year, however, although the invoices show roughly the same purchases, the appointment book and deposit receipts show a decrease in business of nearly 25 percent. So what’s going on? Has the dentist suddenly started losing his skill with the result that one-quarter of the supplies are being wasted? How likely is this? Probably not very.

A better answer might be that the dentist has convinced a substantial percentage of his patients to pay in cash in return, perhaps, for a discount. Or the doctor is simply depositing his patient checks into another, undisclosed bank account.

If the forensic accountant is concerned that Dr. Molar may be stockpiling supplies, the accountant can take inventory. Or he or she might ask a dental consultant whether stockpiling is routinely done or whether, because dental supply houses can deliver needed materials within a few hours or days, a huge inventory is merely a waste of capital.

Is there another way to check for the missing patients? Of course. If the dentist runs a busy practice, perhaps he hires independent contractors to handle the overflow. They see and treat the patients, but the billing is done by the boss, of course. If these independent contractors are paid a percentage of the amount collected (not unusual in a professional relationship), such payment may be reflected in the form of a check. Just because the boss received cash does not mean the independent contractor was paid in a similar fashion. Finding a payment to an independent contractor and matching it to a patient who is not found in the billing records or appointment book (or who is listed as a cancellation) may pay handsome dividends.

Yet another way to determine the true billings of our dentist’s business might be to investigate the dentist’s malpractice insurance application. Many professional liability insurance carriers require, as a

condition of establishing rates and coverage limitations, an estimate of the different types and numbers of procedures performed yearly. This application may hold some clue about the true number of procedures performed and of the amounts billed. However, if the dishonesty predates the divorce, the dentist may understate the number of procedures to save on malpractice insurance. At the very least, any inconsistency may form the basis for further inquiry and a more favorable settlement.

Before embarking on the assumption that all large blocks of time are the result of greed and stealth, compare the dentist's story in example 4-6 with the one in example 4-7.

Example 4-7. The dentist under investigation is an oral surgeon whose practice requires that larger blocks of time (such as two hours) be allotted for the complicated procedures that he or she performs. The forensic investigator notices that there appear to be too many cancellations. Is this an indication of cash payment? And if so, how to find out? Would the answers to this example be the same as the answers for example 4-6? Or can some differences be spotted?

The answer to the cash payment questions posed in the above examples may hinge on the difference between the two dentists' practices and may have something to do with the fees that are likely to be charged. A general practitioner may have many patients, each of whom might be charged \$50.00 for a filling or a cleaning. That is not a large sum of money, and many people might pay it in cash. The oral surgeon, on the other hand, may charge several thousand dollars. Few people walk around with that much cash. Therefore, the investigator might consider that a specialist who charges larger fees would be less likely to receive them in cash. In fact, the specialist is very likely to receive fees in installments, with the patient paying by check to establish proof of the payment.

Thinking creatively, the forensic accountant might have come up with another consideration: Few people requiring serious health-care treatment schedule it and then cancel without rescheduling. If the surgeon's fees were too high, the patient probably would have learned this at the initial examination—in a block of 15 or 30 minutes—and would never have scheduled the surgery to begin with. If the forensic accountant spots a cancellation, he or she can always check the appointment book to see whether the appointment was rescheduled. If so, the mystery may be solved. If not, perhaps cash was paid.

Here's another example: Has the broken appointment been filled by another patient? The oral surgeon whose patient cancelled on short notice may not have been able to fill a two-hour block of time, but the general practitioner should have been able to fill at least a few of the shorter cancellations. If the appointment book shows many erasures and not one appointment filling the same slot, perhaps there is reason to investigate further.

Here's the opposite approach: What if there are no cancellations in the scheduling calendar? Perhaps, in 12 months, there might have been few. If there are none, the forensic accountant should suspect that there are two appointment books being kept and that he or she is being shown only the one that has been prepared for the accountant's benefit. The forensic accountant should bring this to the attention of the attorney.

Note: Veterinary practices are similar to those of general dental or medical practitioners: many patients, not too terribly high fees, lots of opportunity for cash.

What was just discussed in the case of dentists applies equally to nonmedical professionals.

Example 4-8. An accountant who prepares sophisticated financial statements and business tax returns for medium-sized corporations reports no cash payments. Is this possible?

Sure. Medium-sized businesses will most often pay their bills by check. There is nothing strange about this.

Example 4-9. An accountant who prepares primarily inexpensive personal income tax returns for a blue-collar clientele reports no cash payments. Is this likely?

No.

As you can see, it is important to know the inner workings of the professional's practice, the type of clientele, and the preferred method of payment—not merely the type of profession.

Here's another example: Attorneys who handle criminal matters are sometimes paid in cash. (An attorney might hesitate before, say, representing someone on a charge of forgery and accepting a check!) On the other hand, an attorney who represents large corporations in matters involving intellectual property (copyrights, for example) might not be expected to have a large cash practice.

An understanding of the general operation of an industry itself may be of help as well. Take, for example, the family doctor. Today, most people visiting a family physician have some form of insurance coverage to pay for the bulk of the cost. Many insurance companies require that the patient make a small copayment. If the doctor is a participant in a health maintenance organization (HMO) or preferred provider organization, these, too, usually have a patient copayment requirement.

In most cases the copayment is likely to be insignificant—\$10 to \$30—and is small enough to be paid in cash. Depending upon the office's traffic, sums could add up quickly. Even 10 patients per day, at \$10 each, multiplied by four days a week, adds up to \$20,000 per year!

This is where the appointment book comes in handy. A consistent pattern of appointments with few payments recorded in the cash record may lead to the conclusion that cash has not been reported or has been underreported.


Having now discussed all of the things that the appointment book can reveal, here is a caution: Appointment books do not give the complete story. Just as the forensic accountant must have an understanding of the nature of the specific practice (criminal law versus intellectual property), he or she must also appreciate that not all appointments result in a payment, let alone in an unreported cash payment.

Even though few people go to doctors if they are not sick (except, perhaps, for their annual check-up) and doctors seldom offer free examinations, other professionals do offer freebies that must be taken into consideration. Dentists and optometrists often offer free initial check-ups to generate new business. Attorneys also offer free consultations—particularly in the personal injury and malpractice fields—and many also offer free initial consultations for will preparation, bankruptcy, and . . . divorce.

Appointment book examination is not an exact science.

This is why the “documentation duality” theory comes in handy. For example, if the doctor is a member of an HMO and the forensic accountant knew that such organizations provide weekly or monthly summaries of fees paid to doctors based upon the number of patients investigated, the accountant would certainly be wise to investigate the summary accompanying the payment by the HMO to the doctor. A pattern of payments by the insurer for services rendered with no corresponding pattern of copayments by the patient may indicate one of three things: that the doctor does not bother collecting the copayment (highly unlikely); that the patient was treated but the cash copayment not reported; or that there was no patient treated and the doctor simply claimed that there was.

As another example, in the case of appointments suspected of being freebies, the forensic accountant might compare the appointment book with a list of new cases opened by the professional to determine whether that claimed free appointment actually became a paying client at the time.

 **Tip:** The forensic accountant must be sure that the attorney obtains the original appointment book for review or, at the very least, that the accountant or the attorney has had the opportunity to investigate the original. The forensic accountant may work off a duplicate, of course, but a copy supplied by the subject may have been carefully doctored, and the accountant will not be able to tell this from the copy.

Loan Documents

Often when a company applies for a loan, it will put its best financial foot forward. This is a nice way of saying that to show creditworthiness, the company will normally want to show its assets at their highest


values and also show as much income as possible. The reason is obvious: The lender wants to know that the company has the wherewithal to pay back the loan.


Loan applications themselves are important in that they will provide prior representations of such information as the owners of the business, their ownership percentage, and perhaps even the existence of related companies. Just as importantly, they will clue the forensic accountant in on the use of the money, a subject that may be of some importance in valuing the company.

Example 4–10. Andrew owns a small but successful baking operation. He sells his chocolate chip cookies (the recipe is a well-guarded secret) at three locations. He began with only one shop, but business has been very good. To fund additional expansion, he applies for a loan. The loan papers disclose to the bank that Andrew plans to use the proceeds to open an additional three shops during the coming year, as well as to construct a factory to support the expected demand for his cookies once he franchises his brand—something that he is currently working on with interested parties.

If the forensic accountant had relied only upon the company's books to value its worth, he or she would probably have missed the fact that plans for expansion were already under way—plans that may be evidence of an increase in the company's value. (This example presupposes that state rules allow consideration of post-divorce events.)

The financial statements provided in support of a loan can be enlightening as well, in that they may paint a more accurate or complete picture of the company's current financial health. This book discussed previously how certain expenditures may be mischaracterized for tax reporting purposes. The financial statement may characterize them correctly—and to the client's advantage.

 **Tip:** If nothing else, financial statements given in support of a loan may provide the attorney with some settlement-negotiating leverage, because the production of a false financial statement in connection with a loan application may constitute a fraud, if not a crime. Sometimes the recognition that one's position is compromised is all the leverage² required to secure a fair settlement.

 **Tip:** The appearance on the company books of a loan payable will usually indicate that the loan was preceded by a formal application. In other words, it is a tip-off that the documents may exist, and the forensic accountant should ask for them.

Insurance Papers

A veritable gold mine of information may be found in insurance documents.

In the case of life insurance, the forensic accountant might learn the following.

- The policy has a cash surrender value that can be counted as an asset of the corporation.
- Life insurance exists on the life of another person—a child from a previous marriage, for example—and that policy has a cash value.
- The life insurance is part of a buy-sell agreement between the owners of the company, and the amount of insurance is representative of the fair market value of the company. However, the policy amount may comprise two elements. The first is the buyout value of the spouse's interest in the business. The second is the “key person” portion, which provides cash to compensate for the absence of the owner and to transition the company to new ownership. The key person portion may not indicate a marital value.


² In most jurisdictions, threatening to disclose illegal activities of another may itself be illegal and should not be used in negotiations.

In the case of property insurance, the forensic accountant might learn the following.

- There are assets not listed on the tax return because they have been fully depreciated.
- The assets listed on the tax return or financial statement are worth more than their depreciated value. The policy should be reviewed for a coinsurance clause or other clauses that would modify the face amount of coverage.
- The assets are not listed anywhere, but there must be some reason they are being insured. So where are they?


Example 4–11. Company A shows premium payments of \$5,000 per year for property/casualty insurance. The forensic accountant asks to see all the policies. In reviewing the policy insuring the plant and equipment, the forensic accountant notices that a piece of machinery is insured for \$50,000, but neither the tax return nor the balance sheet seems to make reference to it.

On closer examination, the accountant finds that the machine has been fully depreciated. Nevertheless, he or she can now support a valuation of \$50,000 because this is the replacement cost³ of the item.

 **Tip:** The forensic accountant should investigate insurance policies very carefully and match the policy numbers to the checks used to pay the premiums. Make sure that the premium payments total up to the premiums shown on the policies (documentation duality). If they differ, perhaps the forensic accountant is not being shown all the insurance policies (or perhaps he or she is being shown some insurance policies covering the owner's personal possessions).

Bank Records

The forensic accountant should, of course, obtain the bank statements of the business as well as all checks and records of deposits. When he or she requests bank statements (or has the attorney subpoena them), the forensic accountant should be sure to specifically ask for all bank accounts. If the accountant asks merely for the company's operating account, he or she might miss the fact that it has a separate payroll account, tax account, or money market fund, for example (see chapter 5 for some of the abuses of multiple accounts). If the forensic accountant asks for copies of cancelled checks, he or she should request both sides of the check. This will assist in identifying the payee and banks that the check passed through.

 **Tip:** If the forensic accountant has a question or suspicion about the payee of a check (that is, that there might be some intrafamily or friendly dealings—a topic to be covered in greater detail later in this book), he or she should note the name of the bank into which the check was deposited. It could be that this bank will be the source of much more information in the investigation. It is human nature to use a bank that is convenient and use that bank for many transactions.

³ Replacement value is not the standard of marital value in every state. Another value used in policies is "actual cash value." This may not be representative of marital value either.

Example 4–12. The forensic investigator notices checks for large amounts being paid to a new supplier. No checks had been written to this supplier before the divorce was initiated. The investigator suspects that perhaps the business owner is channeling funds to a dummy corporation (see chapter 5).

If that suspicion turns out to be correct, it may also be that the business owner has used the same bank for other “hidden” accounts and may also have a safe deposit box there. It might turn out that the business owner thought he or she was being very clever in forming the dummy corporation and, figuring that the ploy would never be discovered, also used the opportunity to conduct the remainder of his or her stealth banking at the same bank.

Another method to disclose bank accounts is to review business or personal expenditures to identify missing expenses. For example, what if no payments for leasehold improvements are found and the forensic accountant knows some were installed during the year? Maybe they were paid by the landlord, but possibly they were paid by cash or from an undisclosed account. Missing expenses may be travel and entertainment, jewelry for the paramour, or personal toys (for example, cars, boats, and planes).

The forensic accountant will not necessarily have the means of finding out more information at this juncture, but any suspicion should be brought to the attorney’s attention. The attorney, in turn, might subpoena bank records or request information on the suspicious dealings in this particular bank.

The attorney may also be very interested in learning whether any bank charges are for safe deposit boxes. In conducting discovery, the lawyer can then ask if any regular visits have been paid to that box.

As unlikely as this may seem, there may be a possibility that the spouse the forensic accountant represents is the deputy on the other spouse’s safe deposit box. This designation might have dated from early in the marriage, but the business-owner spouse may have forgotten to cancel the client’s authorization. The forensic accountant should ask (or have the attorney ask) the spouse whether he or she knows of any safe deposit boxes and believes that he or she has access to them.

Financial Statement Manipulation

Some financial manipulations occur during divorce; others are tax related and have been ongoing for a number of years. The more mundane variety include delaying the deposit of revenue checks until the next year, prepaying next year’s expenses, and delaying the invoice mailing at year end. Mundane as these are, they can be effective at pushing net income from the current year into the next.

More sophisticated manipulations include the following.

- Direct entries to equity, particularly involving liabilities and equity.
- Overaccruals of payables. Supporting documents should be requested because they may contain proof of later payment.
- Inventory valuation errors. Inventory valuation may be understated by delays in recording invoices and deliveries, pricing errors, and undercounting physical quantities.
- Overstatement of allowance for bad debts.
- Directly expensing capital leases.
- Advancing bonus payments to owners or key friendly employees. These bonuses are paid for future periods.
- Additional manipulations are limited only by the perpetrator’s creativity.

Summary

- Just because the IRS might accept the validity of a transaction for tax purposes, or partners might consent to certain transactions, that does not mean that the forensic accountant is bound by these determinations for purposes of property division.
- Corporations, partnerships, sole proprietorships, and professional practices all may have unique aspects that require special consideration.
- Among the important documents that the forensic accountant should review in the investigation are business tax returns, agreements and contracts, the corporate books and company financial statements, appointment books, loan documents, insurance policies and, of course, all checks and bank statements.

5

Undisclosed Income from Personal Lifestyles Investigation

Introduction

An interesting thing about marriage: When all is going well, many things are just not questioned. One spouse might spend \$1,000 on a new camcorder and, with the possible exception of a comment such as, “How can we afford this?” or “Why didn’t you ask me first?” the purchase—and the issue of how it was paid for—may quickly fade. More so is the case if the expensive purchase was a gift for the unknowing spouse.

When one spouse is the owner of a business, the other might ask even fewer questions, reasoning, perhaps, that the luxury has somehow been deducted as a business expense—as if such write-offs cost absolutely nothing. The luxury need not even be a tangible possession. Dinners, weekend getaways, vacations in the guise of a convention, or even the appearance in the driveway of a new automobile may all come to be expected, or at least accepted, as part of this couple’s marital union. Until that union hits the skids, that is. Oh, the money for the perks may still be rolling in, but now it may be spent by the breadwinner-spouse in another fashion—on someone else or on illicit pleasures, or simply by squirreling it away for the future.

This chapter concentrates on how to conduct a study of the personal spending habits of one spouse—a lifestyle analysis—to determine whether there is undisclosed income. It also discusses some techniques for identifying property that may not previously have been known to the other spouse.

Purpose of a Lifestyle Analysis

The purpose of the personal lifestyle analysis is to determine whether a spouse is concealing assets or income that should be counted in arriving at a fair property settlement. It also may be used by a court for evaluating support. Some states establish or later modify spousal support by reference to the “marital standard of living.”

In most respects, the personal lifestyle analysis is very similar to the business investigation—a careful comparison of books and records is required—but in some respects it is a challenge of a different sort. Whereas much of an investigation of business dealings is designed to reclassify items that should not have been written off—items that are readily apparent from the company’s books or easily discovered by pouring over the company’s checkbook—the personal lifestyle analysis can involve more of an *inquisitive* investigation.

What the forensic accountant is trying to find in the personal lifestyle analysis is the hidden life that the party under investigation is leading. Very often, the accountant is trying to do so by proving that the spouse under investigation could not possibly be living at the level at which he or she is living without a little help


from some undisclosed sources of income or resources. In other words, what the forensic accountant is trying to establish is proof positive that a party is living well above his or her means without any visible means of doing so. In this regard, the accountant is seeking to uncover the same things the IRS tries to uncover in a personal income tax audit.

The first step, of course, is to obtain documentation to assist in your analysis. The time period covered by the documentation request should be at least as far back as the known beginning point of the marital disharmony and, if possible, a reasonable period before that.

Personal Lifestyle Analysis Concepts

The analysis is designed to discover expenses, and possibly income, through the following techniques.

- Conflicts in known documents, statements, and information. Surprisingly, this may often occur in documents filed with the court.
- Comparison and identification of conflicting information from interviews.
- Known expenditures made from unknown sources of cash. For example, the costs of food, a gardener, and eating out are paid in cash, but there is no explanation that would account for the source of this amount of cash.
- Inadvertent disclosure of hidden cash or investments. A spouse has a secret account and does not report it on the joint income tax return. However, when the IRS notice from a 1099 match-up arrives at the house, the other spouse opens the notice and discovers the undisclosed account.
- Participation in the deceptive conduct by both spouses before the divorce.

 **Tip:** For the cost of the lifestyle, use a simple budget such as those available in most personal financial planning work papers. Interview the parties, asking what they spent on the various budget items. Most spouses with undisclosed income have very convenient memories. So if they claim they do not remember the actual individual expenses, ask them to do the following. 1. Confirm the expense (for example, auto insurance). 2. Describe the nature and extent of the expense. 3. Identify who was paid for the expense. Ask for the amount. If the spouse is unable to say, ask for a range of the expense.

The Broad Overview—Tax Returns

The beginning point of any investigation might very well be the personal tax return of the couple or, in the event the couple has opted for the “Married Filing Separate” category, the individual tax return of the spouse under investigation. It may be helpful to spread the income tax returns into columns over a several-year period. This comparison may disclose subtle changes in income or deductions over time. Of particular interest are changes after the onset of marital discord.

The authenticity of the tax returns provided by the client or through the discovery process should be considered. Fraudulent returns are easy to produce with popular tax preparation software. The forensic accountant should consider obtaining copies of original tax returns filed with the tax agencies.

Income Tax Returns: Form 1040 (Personal), Form 1041 (Trust), and Forms 706 and 709 (Estate and Gift)

The investigation should begin at the top of the form and proceed in an orderly way to the end. Many of the entries may alert the investigator to areas warranting further consideration, even if the information listed on the individual line is strictly legitimate.

Note: In discussing the following entries, it does not matter whether the 1040s being reviewed were filed as joint or separate returns. The reader should use the following as guidance, paying careful attention to those areas affecting the specific investigation.

Wages, Salaries, Tips, and Other Income

Reported wages and income should be matched to W-2s and 1099s. These should also be matched to deposits to determine whether all wages were used for the benefit of the couple or whether there are funds in another account. This chapter examines a spreadsheet designed to assist in visualizing a couple's income and expenses. Even consistency in deposits can be misleading.

Example 5-1. Fred is an employee of XYZ Corp., which pays him biweekly. An examination indicates that for each of the past 12 months, Fred has deposited identical \$2,473.97 amounts, twice a month, into the couple's checking account. Because these numbers look about right (when deductions for taxes, benefits, and other items are considered), and because Fred receives a W-2 form at the end of the year, the forensic accountant has concluded that no further investigation is warranted because there is really no room for Fred to have concealed any income. The accountant proceeds on to the next area of his or her investigation.

In giving the preceding information merely a cursory examination simply because monthly deposits are consistent and the forensic accountant believes that a W-2 would discourage cheating, one very easily missed fact has been overlooked: Biweekly pay does not mean that Fred gets two paychecks per month. It means that he gets a paycheck every two weeks. What's the difference? Two checks per month equal 24 checks per year. Biweekly payment results in 26 pay periods annually. Twice a year, Fred receives three paychecks in a single month. This means that twice a year there should have been three deposits—a fact missed by not comparing the deposits to the actual net salary and deductions reported on the W-2 form. The forensic accountant also needs to look at pay stubs.

Interest Income and Dividend Income

The interest category reveals not only the existence of bank accounts, money market accounts, and bonds and debentures, it also will permit the accountant, in some cases (by ascertaining the yield of the underlying investment), to estimate the principal's value. This category will also disclose tax-exempt interest (if it is reported, as it should be) and, thus, the existence of such holdings. In addition, the existence of dividend income will disclose the existence of the stock producing it.

Tax Refunds

Although not all tax refunds are necessarily reportable as income, a figure on this line will indicate that taxes have been overpaid. If it is a small amount, it may be unworthy of further consideration. It should, however, trigger a further inquiry on the forensic accountant's part. For instance, the tax refund line should prompt a request for information about the current year's tax payments. Monthly income may be found to be smaller than it should otherwise be because an employee (or an employer/owner) has increased withholding in the hope that this fact will be missed. The result is a large refund delayed until after the divorce. The forensic accountant should also look for a record of deposit for the refund.

Example 5–2. Tom, a self-employed businessman, begins increasing his withholding and additional tax payments by about \$1,000 per month effective January 2008, when he first thinks about divorcing his wife. This amount, although large, is not so large that it raises anyone’s suspicions. The official explanation, if asked, is that Tom anticipates having a more profitable year in 2008. Lo and behold, he files for divorce in April and, not surprisingly (for reasons discussed previously in this book), his income falls off for the remainder of the year.

The divorce proceeding drags on, so by the following April, with neither spouse now speaking to the other, they decide to file their taxes using the status “Married Filing Separately.” Tom, however, instead of filing his return for 2008, requests an automatic extension. His extension form, a copy of which is dutifully furnished to his spouse’s attorney, shows that he anticipates paying more in taxes, and this reported tax liability is not closely scrutinized precisely because it is listed as a liability to the IRS—and, after all, who in their right mind would pay the IRS more than they had to?

In reality, however, Tom has intentionally understated his business deductions, with the result that he is overpaying his estimated tax.

In August, Tom requests an additional extension of time to file until October. In September 2009—almost two years after he first thought of divorce—the marriage is finally dissolved. Although in October he files his return for 2008 using “Married Filing Separately” status (he will not be “Single” until his 2009 return is required), he still receives quite a hefty refund because, though his income was on target, his expenses—what a shock—were higher than he initially believed. Of course, with his divorce now behind him, there is no requirement that he share this windfall.

Even barring Tom’s scenario, in the case of a two-income couple, the forensic accountant should also check to see whether each spouse has paid his or her fair share of taxes. It could be that one of the spouses has intentionally boosted exemptions knowing that end-of-year taxes would be paid for with spousal assets.

Example 5–3. Jack and Jill are a married couple earning approximately the same amount of money. Each claims one exemption, resulting in the withholding of \$100 per week of federal and \$25 per week of state income tax from each of their paychecks. At the end of the year, they usually receive tax refunds of \$2,500 and \$1,500 from the IRS and the state, respectively.

Jack decided to increase his exemptions to three, resulting in federal withholding of only \$25 and no state withholding. He has effectively boosted his weekly income by \$100 (\$5,200 per year), which he deposits into a separate account or uses to boost his current lifestyle. At the end of the year, the couple now owes \$1,400 and \$700 to the respective taxing authorities. Jack writes the required checks from the couple’s joint account. Jack’s “cost” is only \$1,050 (one-half of the \$2,100 due) for a “net gain” of \$4,150 (his added take-home pay less his share of the tax due at year’s end).

Also, there is the possibility of a reimbursement in community property states for taxes paid by the community on one spouse’s separate property. The obligation of the separate estate to reimburse the community may exist for the entire marriage. These are often substantial sums added to the value of the community estate.

Alimony or Child Support Received or Paid

This portion of the tax return discloses the existence of alimony obligations to or from a prior spouse, both of which are likely already to be known by the other spouse. Just because they are known, however, does not mean these entries may simply be glanced over. It is important to confirm the source of these funds.

For instance, has the money paid as alimony come from the business operation of one of the divorcing spouses? If so, then might the business owner be attempting to deduct it twice—once as a business expense and again as a personal adjustment to income? Ignoring for a moment the obvious impropriety of this action, a reduction of business income may, as discussed in a prior chapter, adversely affect the value of a business and, therefore, the share to which the nonowner spouse may be entitled in the marital dissolution.

The same holds true for child support. In fact, it holds truer for child support. Alimony is deductible, whereas child support payments are not. If a business owner were so inclined, he or she might attempt to put children “on the books” of the company in order to deduct a nondeductible expense.

The point to consider here is the following: If it has not been determined whether either of the parties is supporting children from a prior marriage, the tax return’s alimony line ought to trigger those questions—about alimony, child support, and other related issues.

The “Exemptions” portion of the tax return also asks whether the taxpayer claims as a dependent a child who is not living with the parent. This information should be examined as well.

In some jurisdictions, if support of a prior marriage is paid from community funds while separate property of the paying spouse is available, the separate property must repay the community. The source of prior support payments may be discovered by analyzing the source of funds used to pay the support.

Pensions and Annuities

The subject of pension valuation is highly complex and beyond the scope of this work, but the nature and extent of such assets need to be determined. The advantage in this area is that qualified retirement plans are highly regulated, and at least annual accountings and tax reporting are required. Loans from retirement plans may be the source of unexplained funds and later be considered a reduction in the value of the pension or annuity.

Annuities are more difficult.

Example 5-4. Jim Smyth, a personal injury lawyer, is contemplating divorce. He is 55 years old and is concerned about his retirement after the divorce. He is also concerned about a large contingent fee case that is going to trial in 30 days. At the settlement conference in the contingent fee case, the parties are able to reach a settlement of three million dollars. Jim’s firm would be entitled to a fee of \$900,000. When Jim is talking with the insurance company attorney about a structured settlement, he suddenly has a bright idea. He has a way to deprive both his law firm partners and his soon-to-be ex-wife from sharing in the full contingent fee. He agrees with the insurance company in the contingent fee case that \$400,000 of the \$900,000 fee will be paid to the law firm. The remaining \$500,000 will be paid by the insurance company to purchase an annuity in Jim’s name. The terms of the annuity is a single pay in 10 years when Jim turns 65. Jim hopes that neither his partners nor his wife will discover the diversion of \$500,000 into the annuity.¹

Other Income

There are as many possibilities in this category as there are possibilities for entering figures into this category. Naturally, any money reported as miscellaneous income should be reviewed.

IRAs and Other Retirement Contributions

Deductions for individual retirement arrangements (IRAs) and Keoghs should be confirmed. It may be that the money claimed to have been placed into a retirement account was not. Just because the tax return says it is so does not make it so. Conversely, it may also be that more was contributed to the retirement fund than was reported. Just because it is not tax deductible does not mean the taxpayer has not attempted to bury money in this account.

Finally, it may be that the numbers match, but the contribution made was excessive, notwithstanding the penalty for excess contributions. As for any penalty, the potential mindset of the contributing spouse is, “It is better to pay a 10 percent penalty to the government than 50 percent to the divorcing spouse.”

¹ Although this example would be an unusual occurrence, it is included to illustrate that fraudsters do not seem to follow the rules, and that you should watch for these types of events.

Other Adjustments to Income

The space on a 1040 tax return for adjustments to income may also contain a treasure trove of information. IRA deductions and alimony have already been discussed. This heading also contains reference to deductions for the following.

- Self-employment tax.
- Health insurance deduction.
- Penalty for early withdrawal on savings.

The self-employment tax category should be compared to any records maintained by the sole proprietor. Discrepancies between what was written off against business income (on Schedule C, for instance) and what appears on the face of the Form 1040 should be examined.

If a deduction is taken for health insurance, this will indicate that health insurance exists. Not only should the deduction be confirmed, but, armed with the knowledge that there is insurance, the policy and premium statements may need to be examined to determine whether anyone else—a parent, prior spouse, children from a prior marriage, current lover—is also on the policy. In addition, any reimbursements received should show up as bank deposits.

The penalty for early withdrawal of funds will be an alert to the existence of such funds, if they have not previously been disclosed.

Tax Credits


Because credits reduce tax liability dollar for dollar, they are ordinarily far too beneficial to ignore, so they usually are not. The forensic accountant should be vigilant: Where there is a credit against income, there is also income!

For instance, a foreign tax credit may indicate the ownership of foreign stocks or a mutual fund specializing in such stocks. The tax return will disclose this if the forensic accountant has not previously received this information.

Tax Payments

All payments reported—whether estimated or withheld—should be accounted for. The source of the funds for the payment and the correct application of those funds must be examined, including the following.

- Were the payments improperly made from a company account, with the result that the net earnings are depressed?
- Were the payments made as shown in examples 5-2 or 5-3?
- Were they made from a previously undisclosed account?
- If the couple is filing separate returns, have payments from joint accounts been properly credited?

 **Tip:** The forensic accountant should examine cancelled checks and copies of Form 1040-ES (and the state equivalents) to determine whose Social Security number appears on the checks and forms. This will indicate to whose account the payment was applied. If the payment was made from a joint account but applied to the separate tax return of one of the spouses, an adjustment will be needed.

Schedules to Form 1040

It is not just Form 1040 that needs to be scrutinized. The attached schedules will often contain a wealth of information to assist in the investigation.

Schedule A—Itemized Deductions

Home Mortgage Interest Deduction

This should be matched to any 1098 form furnished by the lender. If more is being deducted than is supported by the 1098, it could be that one spouse was deducting mortgage interest on another piece of property. Naturally, strict scrutiny must be employed if the lender is related to one of the parties; if any home mortgage interest is being paid to someone other than a financial institution, the forensic accountant needs to determine who, why, and how much.

Deductible Mortgage Points

Unless this couple refinanced their jointly owned real estate during the last year of their marriage, it could be that mortgage points were deducted as a result of a refinancing or purchase by one spouse of real property that either has not been disclosed to the other or that may otherwise have an impact on the marital property division. Because points are amortized over the life of a refinanced loan, the forensic accountant should find out if the client knows of a refinancing.

State and Local Income Taxes

The scenario discussed in example 5–3 may come to light by the examination and matching of the figures reported on this line.

Real Estate Taxes

What was previously discussed in the case of interest and deductible points applies to real estate taxes as well. A greater deduction than is supported by the documentation for the reported real estate might indicate that one spouse owns undisclosed real property.


Casualty Loss

Because of the high threshold for claiming a casualty deduction (generally, only that part of a loss exceeding 10 percent of adjusted gross income is deductible), fewer people have claimed it in recent years. The importance of this category, if a deduction is claimed, however, is that it may disclose the existence of property that has not been disclosed previously.


Miscellaneous Deductions

Fewer people are taking miscellaneous deductions these days because of the two percent floor on deductibility. If applicable, however, the forensic accountant should consider the following.

- *Safe deposit box.* The deduction of this expense will reveal its existence. Now all that needs to be done is to verify its whereabouts and contents.

 **Tip:** The size of the safe deposit box should always be identified. (This may be confirmed by obtaining the receipt for it.) Safe deposits come in a variety of sizes, and the subject's rental of a large box may indicate the existence of numerous (or sizable) assets requiring such added protection. For instance, an expensive stamp or coin collection may take up a large space. The forensic accountant should tell the attorney what he or she has learned and leave it for the subject of the investigations to explain the need for a large box.


- *Investment expenses.* Whether it is the cost of subscriptions or the interest on a margin account, the deduction of such items should be traced to the property to which it relates, if any.

 **Tip:** Increasing numbers of people are preparing their own income tax returns with the help of computer programs created for this purpose. It's possible that all information has been entered into the program, regardless of whether it is useful or not, and it might not have been purged. If a tax return was prepared by computer, request copies of all reports and worksheets generated by the program. A copy of the computer file should also be examined if possible.

Example 5-5. Tommy and Twaila Turbo are a married couple. Tommy has been using a computer program to prepare the couple's tax returns for several years. He enters all information into the program and then lets it prepare the final return. Among the data entered into the program are potential deductions for Tommy's safe deposit box. Although the computer program cannot make use of this information in lowering the couple's taxes (because of the two percent floor on deductions), it nevertheless stores it, and can generate a report or worksheet showing all Schedule A miscellaneous deductions. Just such a report will contain the desired information, even if the miscellaneous deductions portion of the final computer-generated tax return shows no information.

Schedule B—Interest and Dividends

The forensic accountant should match all interest and dividends to statements showing their existence. Naturally, if anything does not match, it should be explored further to determine whether any assets have been omitted, or income is not being reported.

 **Tip:** Schedule B, although most notable for interest and dividend information, can also be a tip-off to the existence of other financial instruments. For instance, one of the questions refers to interest claimed as excludable from Series EE U.S. Savings Bonds. If an exemption is claimed, it is obvious that the bonds existed—somewhere, sometime. Similarly, Schedule B contains a question about capital gains distributions. An entry here indicates that there are likely to be mutual funds somewhere. Finally, the IRS specifically inquires about foreign trusts and accounts. This, too, is a potential tip-off for the investigator.

Schedule C—Business Income and Schedule F—Farm Income

Businesses have been discussed in earlier chapters. Additional analysis might include cash flow actually withdrawn from the business or farm. Reconciling tax return income to income from the company's records is recommended.

Schedule D—Capital Gains and Losses

Investment and property sales are reported as capital gains or losses. Among the information disclosed by this schedule is the date a capital asset was purchased, its original cost, the date it was sold, and the proceeds received from the sale. It may be that a stock from an unreported brokerage account was sold. Or it may be that the subject's mutual fund distributed capital gains that needed to be reported. Either way, the forensic accountant should follow this road until its end.

The forensic accountant should also obtain explanations of the source of cash used to purchase the investments and the disposition of cash from the sale of investments. To hide cash, the first step is to convert property into cash. This may be disclosed on the tax returns as a capital gain or loss.

In addition, an entry on the line for a capital loss carryover is important because it may also indicate the existence of undisclosed assets.

Example 5–6. Murray and Mary have been married for 10 years. During this time, Murray has handled most of the finances. Mary does not know the nature of the couple's holdings. When the couple becomes enmeshed in a divorce, Mary calls in a forensic accountant.

One of the accountant's requests is for information about stock and bond holdings. Murray says there are no current holdings. The forensic accountant examines Schedule D for the past five years and, although she sees no activity during the past two years, notices a capital loss carryover three years ago. Tracking back a year, the accountant sees that the loss is again carried over. Going back a few more years, she discovers that there was a sale reported (at a huge loss, thus the carryover) six years ago. The carryover was finally used up three years ago. That's why no activity showed for the past two years.

The sale itself six years ago is not, in and of itself, a concern, but Murray didn't disclose in his current net worth statement the whereabouts of the six-year-old proceeds. This carryover loss clue uncovered through a diligent search will lead the accountant to investigate further and, hopefully, to recover some part of the proceeds for Mary.

One other thing to be aware of is that Schedule D requests separate disclosure for capital gains or losses realized through partnerships, S corporations, estates, and other entities. An entry on the relevant line will be a tip-off to the existence of such capital gains or losses being passed through to the taxpayer from another (presumably unreported) source.

Schedule E—Rental Properties, Partnerships, and Other Arrangements

Almost all partnerships and trusts are required to provide the IRS and taxpayers a K-1 annually. If the K-1 information on the personal income tax return, as filed, does not report the K-1 income, correspondence and possibly an audit will result. To report the K-1 on the actual filed return and not disclose it on the return seen by the spouse, two returns are prepared, one with the K-1 income and one without. The return presented to the spouse for signature is the "without" return, but the signature page of the "with" return is inserted for signature. After filing the "with" return, the file copy of the "without" return is left for the spouse. The actual final check due or refund should be compared to the return presented as the actual filed copy. Alternatively, copies can be obtained from both the IRS and state taxing authorities.

Other Schedules

The forensic accountant should examine all other schedules attached to the return. For example, if the taxpayer fills out Form 2106 (Employee Business Expenses), the accountant might be prompted to inquire about the reason for the expense and the source of the original payment.

Example 5–7. Perry and Petunia's joint return includes a Form 2106 which Perry completes. Among the items found are a deduction for lodging and meals during a selling trip. The forensic accountant attempts to match the claimed expenses to credit card charges or canceled checks but cannot locate any supporting documentation.

As when examining business records, the dates of the trip, its purpose, and the people involved ought to be determined. In addition, if the expense is claimed and a receipt produced in support, but the source of payment cannot be confirmed, it may very well be that cash was used. Further exploration would clearly be warranted in such a situation.

Amended Returns

The forensic accountant must ensure his or her access to all tax returns. If given an amended return, the accountant should always request the original return that it purports to amend. It may be that the

amended return was filed to conceal certain items that would become apparent from viewing the original. All changes should be reviewed. The accountant should also get access to IRS matching notices or other changes made by the IRS to previously filed returns.

Estate Returns

If either party receives an inheritance, the decedent's estate tax return (Form 706) provides a wealth of information about the amount and nature of the inheritance. Probate records may provide additional useful information.

Trust Income Tax Returns

Property, investments, or cash can be diverted to a trust and concealed from the other spouse. If the trust pays tax on the trust income, there may not be any income to pass through on a K-1 to the party's personal return, thus effectively concealing the trust property. This is especially problematic for foreign trusts.

Other Documentation

In addition to the tax return, clues about the nature and extent of one spouse's personal assets and income can be found in a variety of other documentation. In essence, the examination is very similar to the business investigation, and will include the following.

Bank Records

Bank statements are among the first things to be reviewed in a personal lifestyle investigation, and spousal joint bank accounts should be available from the client. Naturally, accounts belonging only to the spouse under investigation might be more difficult to obtain (certainly without a discovery demand or a subpoena), but the best information would be found in the latter statements.

Personal bank accounts might disclose several things, including the following.

- *Sources of income that may have been missed or undiscoverable from a business investigation.* For instance, the business owner might have been clever enough to have formed a dummy middleman to capture some of the company's profits, but believing himself or herself quite clever, might have tripped up by depositing the profits from this dummy business into a personal account, believing that this account would never be discovered.
- *Sources of income that cannot be explained by any other records previously furnished.* So far, discussion has considered a business owner—one in some control of the way the company functions—attempting to deprive a spouse of his or her fair share. Employees of a large company can also do this, depending upon their compensation structure. For instance, a salesperson might receive two checks per pay period, one for commissions and one for something else such as minimum draw or reimbursement for expenses. One of the checks might have been deposited into the marital joint account, while the other might not have. The bank records may disclose this.

Similarly, a salesperson might receive a commission check for new business every two weeks but only deposit one check per month into the family account, while depositing the second into a personal account. Perhaps some or all of the employee's personal expenses—car payment, gas, repairs, insurance, meals—have been paid from this account, and only the household expenses from the other account, so the spouse is never suspicious because the expenses are always paid.

Note: It takes only one slip-up to set the accountant in the proper direction. The best way of finding this slip-up is by examining personal records that go back far enough.

Example 5–8. Jerome and Geraldine have been married for six years. Early in the marriage, Jerome, who is a salesman, deposited both his sales commissions and his smaller, incentive bonus checks (which because of the company’s bookkeeping are issued separately) into the marital account. During the past two years, however, as marital disharmony became more and more prevalent, Jerome began depositing every second bonus check into a separate account.

If the forensic accountant were to examine only the past two years’ records, he or she might have missed this fact. Instead, by requesting and receiving records going back five years, the accountant has spotted the anomaly. If Jerome, confronted with this information, does not come clean, at the very least, the investigation has provided your attorney with the ammunition necessary to obtain information from the employer by subpoena.

- *Undisclosed expenses leading to the discovery of significant personal facts or property.* The payment of expenses from a previously undisclosed account may lead to some interesting findings. Those expenses could be for such items as a getaway apartment, hotels, restaurants, or second automobiles. One might discover an entire alternate persona.

They might also be for payment of ordinary expenses associated with property that has not previously been disclosed. Examples of this include the ownership of real property kept hidden from the spouse.

Cancelled Checks

If bank statements are the beginning of the inquiry, copies of cancelled checks are certainly the next step. They will confirm (or not) the disposition of monies taken from the accounts. If possible, the forensic accountant should view the back side of some of the checks to determine the bank into which they were originally deposited.

Bank Deposits

Although cancelled checks will disclose where money went, the forensic accountant must also make sure that deposits constitute the total extent of the monies receivable.

Say, for example, that for quite some time now, one spouse has been depositing \$1,000 per week into a spousal joint checking account. Now the couple will be divorcing and the question arises: Has the entire amount of the spouse’s paycheck been deposited into that account? An examination of the deposited check might reveal that it has not—particularly when compared with the earner’s W-2 and 1099 forms.

It is entirely possible that a spouse has been “skimming” by first depositing money into one account and then depositing a smaller amount into the spousal joint account, effectively concealing the difference. If this has been going on for many years, the total may be significant even though each individual act skimmed off only a few dollars. The question is how to go about investigating such a situation.

If the breadwinner is also the business owner, or in control of his or her own destiny within the company, the basic principles of the investigation have already been outlined in the previous chapters. If the subject of the investigation is an employee of a company that he or she does not control, understanding the methods of reducing a paycheck being deposited is critical. (Note that our discussion does not include any of the methods of reducing the size of a paycheck through the various payroll deduction options such as 401(k) plans and the like.)

There are several different ways of accomplishing the reduced-paycheck trick.

- The earner could have cashed his or her paycheck and deposited only a given amount into the spousal account.

- The earner could have deposited the paycheck into a different account and then withdrawn cash for deposit into the spousal joint account.
- The earner could have deposited the paycheck into a previously unknown separate account, and then written a check on that account for deposit into the spousal joint account.

Each of these methods warrants its own investigative routes and may involve a subpoena of the bank's records or of the employee's payroll records. The point here, however, is simply this: a deposit by one spouse should never be assumed to be the entire deposit. This is true even if that spouse is an employee and is unlikely to be so foolish as to skim what is so obviously discoverable. The total of deposits should always be compared against 1099s, W-2s, and other third-party records.

Income Expected But Not Included

Sometimes suspicion should be aroused by what is missing rather than by what is present, as the following examples demonstrate.

- *Cash bonuses.* Although most people associate bonuses with the end of the calendar year, this should not be taken for granted. There are end-of-fiscal-year bonuses, periodic bonuses for meeting productivity or sales goals, and even profit-sharing bonuses.
- *Partial, rather than complete, bonuses.* The entire amount of the bonus should be confirmed. It is possible, using the same methods discussed previously, to deposit a \$25,000 end-of-year bonus check into a separate, intermediate account and then write out and deposit into the marital account a check for \$10,000 which, although substantially smaller, might be sufficiently large to deflect suspicion.
- *Other bonuses.* Not all bonuses are given in cash. In some companies, larger bonuses are paid out in the form of company stock that may or may not have transfer restrictions and may not be reflected anywhere (except for a 1099 form) until sold. Inquire as to whether the company gives bonuses in stock or in ways other than cash. A 1099 with no corresponding cash deposit will also be a clue.

Note: Although it may be the predominant custom, not all end-of-year bonuses are paid in December. Some bonuses are paid at different times, for example, after the close of a company's fiscal year, or twice a year as smaller bonuses. It is especially easy to miss the latter. After all, if no one is expecting to find a July bonus, no one will be suspicious when it does not show up in the marital bank account. The safest bet, again, is to ask direct questions and to compare information with tax returns and W-2s and 1099s. Also look at personal credit cards; they are often paid down from a bonus.

- *Employee expense reimbursement.* Employees are sometimes required to charge business-related expenses to their own charge cards in anticipation of reimbursement at some later time. A spouse charging a hotel room or expensive meal may, in fact, be doing so for business purposes. If so, a reimbursement check should have been received and deposited into the spousal account. If not, there may be two possible explanations. First, the charges were not business related and were, in fact, the cost of carrying on an affair. Second, they were, in fact, reimbursed business expenses, but the reimbursement check itself was diverted by the recipient. Either possibility is worth exploring.
- *Other reimbursement checks.* Reimbursement checks, generally, are candidates for depositing into hidden accounts. Whether they are reimbursement for health care or drug costs, for a wrecked automobile, or the result of some casualty such as a theft, they are easily concealed not so much because of their relatively modest amounts but because they are nonrecurring items; many people simply forget that they are due.

Example 5-9. After Bill and Mary's house is burglarized, they put in a claim with their insurer for \$2,000. Mary handles all of the paperwork and, when she receives a check for \$1,500 (taking into consideration the deductible), deposits it into her personal account. Bill never misses this money because the replacement items

(TV, stereo, and others) were purchased immediately after the theft using the couple's joint credit card account. The balance continues to be paid off monthly, and Bill does not give it a second thought until the divorce.

- *Income tax refunds.* This is another one of those items which, if not expected, will not be missed. It would be an easy matter for one spouse to redirect the payment to a separate account.

Example 5–10. Timmy and Tammy have been married for six years and have always filed a joint tax return. Tammy has routinely handled this matter. Timmy's sole task is to sign the return. In most years, Tammy indicates that overpayments should be applied toward a future year's taxes. This year, however, she indicates that a refund should be sent. When it is received, she deposits it into a separate account. Timmy, not accustomed to receiving a refund, does not have reason to think that anything is amiss.

Gifts and Inheritances

Under ordinary circumstances, gifts and inheritances received by one spouse separately remain the separate property of that spouse. This is so, despite the common misconception that such assets are somehow "reachable" by the other spouse in the case of divorce. (They are normally not; it is only in the case of the death of one spouse that the other may have a statutory claim against a portion or all of the deceased spouse's separate property.) On the other hand, the income from separate property is available for support payments.

The forensic investigator should inquire about the existence of separate accounts that house such assets. Although they may not be countable for purposes of a marital property division, that does not mean that the owner-spouse has not used the same account to park marital assets.

Example 5–11. Burt is a salesman who receives a commission check every two weeks and an expense reimbursement check at the end of each month. Several years ago, Burt inherited \$25,000 from his mother, and he has kept this money in a separate account since its initial receipt. There is no quarrel with this because the money is separate property, and his spouse has no claim to it in the case of divorce. However, for years Burt has also been depositing his reimbursement checks into this separate account. By learning from the client whether anyone close to Burt died during the marriage—and "close" means "inheritance—close"—and then reviewing the inheritance account, the forensic accountant can determine the existence of and source of any additions to the initial inheritance.

Examining Personal Expenses

Most of this subject has been covered in one way or another under the business headings, and so a reminder is all that is necessary here. Checks should be examined very carefully because they will occasionally yield information of use in determining expenditures on undisclosed assets as well as an undisclosed second lifestyle. Following are some examples.

Nonmarital Real Estate

Checks to taxing authorities, property insurers, landscapers, and other service providers should be analyzed to determine whether they are for payment of the marital property or for that owned solely by an individual spouse.

Nonmarital Personal Property

This might include items such as an undisclosed car that also can be found by tracing the payment of insurance premiums and repair bills.

Payment of Credit Card Bills

This is secondary to examining the credit card bills themselves but can disclose such things as any hotel rendezvous or weekend lodging expenses. If expenses are explained as "business related" (by an employee of a legitimate company), the employee should also have received reimbursement for these expenses. Proof

should be requested; the absence of proof may provide evidence that the hotel room was, in fact, not business related.

Payment of Second Rental or Utility Bill

It is important to match payments against the utility bills themselves. It is not impossible, of course, to make one check payable to the local gas or electric company to cover more than one account, the first covering the marital home and the second covering another residential spot. The same could be true of telephone bills, water bills, and others.

W-2 Forms and 1099s

No matter how seemingly clever—or lacking in cleverness—a scheme might appear at first blush, the only way to know for certain is to compare deposits with W-2s and 1099s. The things to ascertain include the following.

- *All jobs are being disclosed.* It is theoretically possible to be paid by several employers although working on one job site.

Example 5–12. Paula is a paralegal who works for a group of lawyers, doing work for each as needed. Her primary employment, approximately 20 hours per week, is with one firm: Dewey Cheatham & Howe (DCH). DCH also rents its suite to a bunch of solo practitioners, each of whom uses Paula for a few hours a week and pays her as an independent contractor.

Paula deposits checks from DCH into the spousal joint account but deposits the rest of her checks into her own account. At the end of the year, she receives a W-2 form from DCH and 1099s from each of the other attorneys.

- *All income is disclosed in one form or another.* In some businesses, a Christmas or end-of-year bonus (as well as other merit-based remuneration or profit sharing) is distributed by separate check. It is a simple matter for the recipient not to disclose its existence. True, this may be difficult in the case of a Christmas bonus, but if the check is cashed, how is one spouse to really know whether the full amount has been brought home by the other spouse?

The investigator should match this to reported bonuses (1099s) or even to those learned of as a result of discovery or subpoena.

Some employers may seek to bury bonuses among other categories of write-offs so that they don't have to consider such payments as compensation with the resulting tax and withholding ramifications inherent in such payments. An excessively large "reimbursement" check at the year's end (particularly if it is written out in round numbers) is a tip-off, and it might not appear on a W-2 or 1099.

Credit Card Records

When a person is carrying on an affair, it is not always possible to carry on using just the income being earned. This is particularly true for a person earning a fixed annual wage. To make the affair affordable—or at least to spread the cost over a more affordable period of time—some people will resort to the use of their credit cards. No comment is offered here on the intelligence of doing so; the only observation is that it does, indeed, happen, particularly when a cash-strapped lover does not want to appear to be cheap.

Having access to the credit card statements for a period of time can act as a road map to the affair. It might show such things as motel bills, restaurant charges, and gasoline receipts from service stations in out-of-the-way places. It might also give the investigator—and the attorney—an indication of how long this affair has been going on.

Safe Deposit Box Records

This, strictly speaking, is not an area that will be explored so much as brought to the attention of the attorney for further investigation. If a client reports his or her spouse is making regular trips to the safe deposit box, this might indicate that cash is being dropped off or received.

Brokerage Account Records

Obtaining these will, of course, give an indication of the nature and extent of the subject's holdings, as well as showing cash deposits that should be traced to other records.

Loan Applications and Financial Statements

Just as in the case of a business, personal loan applications and financial statements may indicate that there are other sources of income that, although hidden now, were disclosed at a time when the subject wanted to put his or her best financial foot forward. Small business loans often require a personal financial statement from the borrower (as well as a personal guarantee).

In addition, increasing numbers of people are using computerized financial (checkbook balancing) programs to keep track of their personal finances. Most such programs also permit users to prepare personal financial statements for themselves. These should be obtained and reviewed, if available. Consider discovery of the actual computer hard drive rather than a copy of the data on CD. This inquiry may require a forensic computer specialist.

Rental Real Estate/Separate Spousal Property

Previously in this publication, the concept of "community property" was briefly explained, as was the basic premise that certain types of property—those that are inherited, received by gift, or brought into the marriage—remain the recipient's separate property unless title is voluntarily changed.

But what if marital property, such as earnings of either spouse, is used in some way towards the maintenance or improvement of the separate property?

Example 5-13. When Fred and Betty married, Fred was the owner of a house he had inherited from his parents. Before the marriage, Fred lived there with his sister, Ethel, who is disabled and unemployed. After their marriage, Fred and Betty lived there for a while, paying the cost of upkeep from their combined earnings, but after a year, they decided to buy their own place and to let Ethel continue living there. The upkeep is paid for by Fred and Betty, with a bit of help coming from Ethel's government benefits check.

If Fred and Betty divorce a few years later, what impact will the fact that their combined incomes paid for the upkeep have?

The legal answer may vary from state to state, and the attorney should be consulted on this issue. However, the forensic accountant must be alert to inquire about the ramifications of marital payment for the maintenance and upkeep of separate property. Personal efforts during marriage that enhance the value of separate property during marriage may also create a community property interest in what would otherwise be separate property.

If bills have been paid for with joint assets, an adjustment may need to be made in the name of "equity." For instance, if the upkeep in the above example had been paid for from a joint account into which Betty contributed 40 percent and Fred 60 percent, then, depending upon their state of residence, Betty might be entitled to recoup her 40 percent of the expense or might even be entitled to some portion of the property's appreciation (assuming that it has appreciated).

The Personal Lifestyle Analysis

Having now covered the basic areas of the investigation, the question is, what is the best way to discover items that may have fallen through the cracks? After all, is it not true that people keep far fewer records of their personal spending than they do of tax-deductible business expenses? Of course it is. And it is also more likely that people operate on a cash basis at a personal level while business expenses are largely documented by check or charge records. It is precisely because cash is often the predominant “currency” of personal spending that makes it difficult to determine whether money is being spent as opposed to hoarded.

Various analytical tools are used to determine questionable trends or data that requires further investigation. For example, the following “smoking gun” analysis can be used to determine the possible existence of undisclosed income, cash, or other assets. It can be constructed over the term of the marriage in annual increments as follows.

- + Disclosed income in tax returns
- + Income disclosed other than in tax returns
- + Sales of investments
- + Other disclosed receipts (gifts, etc.)
- = Total receipts
- Itemized deductions paid per tax returns
- Income tax paid per tax returns
- Payroll and other taxes paid
- Investments purchased per tax returns
- Claimed expenses from court filings (excluding duplicates in the itemized deductions)
- Other disclosed expenditures
- = Net cash flow (annual)
- + Cash beginning of year
- = Cash end of year
- Actual disclosed cash end of year
- = Undisclosed cash (positive only)

Another analysis is the net worth method used by the IRS for discovering and disclosing unreported income. This method, however, does not always indicate undisclosed assets. These types of analyses can be used to focus the assignment and provide support to further commitment of resources in a particular area.

To determine what is going on, and whether the level of claimed spending far exceeds anything reasonable, the forensic accountant may need to conduct a detailed lifestyle analysis on a month-to-month basis. Generally, he or she will be scrutinizing several years of monthly transactions for inconsistencies that may indicate hidden income or resources. How long the period of investigation should be will depend upon how long the parties have been living unhappily together. As was true of the business records, the forensic accountant should try to acquire personal records going back at least six months to one year before the onset of the frustrations leading to the current matrimonial action.

The personal analysis is best visualized in the form of a spreadsheet, with the months taking up one axis and the typical monthly expense categories forming the other. By plotting monthly income and expenses, the forensic accountant might be able to detect some areas warranting further examination. Certainly the forensic accountant will be able to see at a glance whether the reported income supports the lifestyle described by the subject, or whether the lifestyle does not justify the types of withdrawals being observed.

For example, the spreadsheet on this page represents the last nine months of 2009 income and expenses for Ned and Stacey, a married couple. It is by no means all-inclusive (such items as clothing and toiletries and other personal items are omitted here but should be examined in a real investigation).


Among the relevant facts revealed about the couple are the following.

- All the couple's expenses shown on the spreadsheet are paid either by check or charged to a charge card. Items not shown (such as daytime meals and incidentals) are paid in cash, all of which appears to have been drawn from ATMs.
- Ned drives to work each day. Stacey commutes by railroad.
- They have no children and no other dependents to support.
- Ned is responsible for grocery shopping.
- Finally, assume that Ned began growing tired of being married to Stacey at around the beginning of the period shown in the spreadsheet.

The spreadsheet has been organized into several categories. Household expenses are mutual expenses. Personal expenses are those that each spouse incurs separately. Finally, income is recorded separately, as is each spouse's withdrawals.

	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
Household Expenses									
Mortgage	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500
Heating Fuel	300	200		100		200	600	600	600
Water			50			60			50
Gardening	100	150	150	150	150	150	100		
Telephone	100	120	110	100	120	110	120	100	120
Groceries*	350	300	350	400	450	450	450	450	475
Personal Expenses									
Wife's:									
Car Payment	300	300	300	300	300	300	300	300	300
Gasoline*	30	30	30	30	30	30	40	40	30
Repairs	200		500			125			
Husband's:									
Car Payment	350	350	350	350	350	350	350	350	350
Gasoline*	100	100	150	150	150	150	200	200	225
Repairs		450		650					
Wife's:									
Commute	125	125	125	125	125	125	125	125	125
*Some or all of these payments are in cash.									
Income									
Husband's job	\$4,800	\$4,800	\$4,800	\$4,800	\$4,800	\$4,800	\$4,800	\$4,800	\$4,800
Bonus	3,000		2,000						2,000
Wife's job	2,400	2,400	3,600	2,400	2,400	2,400	3,600	2,400	2,400
Bonus									2,400
Monthly ATM withdrawals and cashed checks									
Husband	1,000	1,200	1,300	1,400	1,500	1,750	1,600	1,600	2,000
Wife	500	500	550	500	475	500	500	600	750

The forensic accountant's job might be made easier if the subject uses a personal finance computer program (such as Quicken) to maintain records. If so, he or she may be able to produce a report that summarizes much of what would be done manually. The forensic accountant should make it a point to request all computer-generated financial documents or have them subpoenaed.

 **Tip:** Once the forensic accountant has plotted the couple's income and expenses on a month-by-month basis, he or she is in a better position to detect certain suspicious patterns and advise the attorney of any potential discrepancies or areas requiring further inquiry. For instance, some things to note in the above example include the following.

- *Mortgage.* This is consistent from month to month and appears to be legitimate. If it matches the couple's mortgage note, it is likely legitimate.
- *Heating fuel and gardening.* These are largely seasonal expenses, so it is not unusual to see larger payments during the winter months for heating oil and no expenses during some of the summer months. Conversely, a landscaping charge during the summer is not unusual.
- *Telephone and water.* Utilities are usually easily documentable, assuming that payment is not being made for more than one account by way of the marital joint bank account.
- *Groceries.* These are largely cash expenditures which Ned, the unhappy spouse, is in charge of. The question you ought to be asking is this: between April and December, were the spouses eating together at home more or less? There is a possibility, even a likelihood, that Ned, not wishing to be in Stacey's company, made excuses during that period—this is something to ask Stacey—with the result that the grocery expenses should not have risen by one-third. They probably should have fallen. It may be that Ned is claiming this expenditure while not actually making it. This is impossible to prove to the penny, but a good attorney can adequately cast doubts upon the veracity of a party making the inflated claim. And credibility is an important factor in any lawsuit.
- *Automobile costs.* The payments, whether they are purchase or lease payments, are obviously consistent and not a problem. The disparity in the gasoline expense might be explained by the fact that Ned drives his car back and forth to work whereas Stacey commutes by railroad. But there is the question of why Ned's gasoline bill increased from \$100 to \$225. Is he working harder and driving more? Is he paying for someone else's gasoline? Or is it merely a lie that he is spending more?
- *Income.* If Ned is paid monthly and Stacey is paid biweekly, then these figures may be acceptable. Stacey's income is higher in June and October, reflecting three pay periods during those months. If Ned, too, is paid biweekly, it appears that he has neglected to deposit two of his extra checks. This possibility must be explored.
- *Bonus pay.* Ned apparently received a bonus in April, June, and December. The amounts are inconsistent, so a further explanation is required. Does Ned receive a bonus based on performance? If so, how often? Could it be bimonthly? Has he neglected to deposit his bonus for August and October but included his December bonus because excluding the year-end amount would be too suspicious? These questions all require answers.
- *ATM and cash withdrawals.* The analysis of withdrawals, whether through check cashing or ATM use, is a crucial area for investigation. It is here where inconsistencies will likely become apparent.

The increase in Ned's ATM and cash withdrawals certainly raises an eyebrow in this case, as demonstrated by the following example.

	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
Cash—Groceries	\$350	\$300	\$350	\$400	\$450	\$450	\$450	\$450	\$475
Cash—Gasoline	100	100	100	150	150	150	200	200	225
Total Cash Expense	450	400	500	550	600	600	650	650	700
Total ATM withdrawals	1,000	1,200	1,300	1,400	1,500	1,750	1,600	1,600	2,000
Excess cash withdrawals	550	800	800	850	900	1,150	950	950	1,300

Groceries and gasoline are Ned's two cash expenditures. They rise from \$450 in April to \$700 in December. At the same time, Ned's total ATM withdrawals far exceeded even this purported expense. Ned withdrew \$1,000 in April and, after paying for gas and groceries, had \$550 left over. This is likely his spending money for the month and, depending upon a variety of factors (such as where he eats his meals during the day, whether he smokes, or how often he goes out for a drink with the office gang), it may very well be a reasonable sum. But notice that by December, the excess ATM withdrawal is \$1,300 and, even taking into consideration holiday spending, is probably well in excess of what he is actually spending. Notice, too, that the excess (unexplained) cash withdrawals have been rising steadily since May. Where exactly is this money going? This is something that will be the subject of serious questioning by Stacey's attorney.

The question might arise about how one goes about distinguishing which spouse withdrew which amounts from a joint account. After all, each spouse has equal access. The answer might be as simple as asking the client, or may require an analysis of patterns. If the latter, the following is of import.

People are often consistent in the range of funds that they withdraw from an ATM in any given transaction. In other words, once they have gotten used to withdrawing \$100 at a time, it becomes virtually impossible to go near one of those cash dispensing demons without pulling out a similar amount (unless, of course, the account is short on cash at the time). So, if one pattern emerges in which a series of weekly \$100 transactions shows each month and another series of \$40 withdrawals also appears, it is a good bet—although certainly not infallible—that one spouse is drawing out one amount and the second is drawing out the other amount.

In addition, most bank statements show the location of the ATM at which the withdrawal was made. This makes it easier to request verification from each spouse about his or her transactions. But even in the absence of such voluntary identification, a pattern may emerge of withdrawals from the same ATM location, and this may be a clue about who the drawing partner was. So, for instance, if a series of \$40 withdrawals occurs at an ATM two blocks from where one spouse works, and all of the withdrawals occurred between 12 noon and 1:30 P.M. (assuming that these details are offered on the monthly statement), this series of withdrawals could be assumed to have been made during the lunch hour by the spouse whose office was near to that ATM.

As an important aside: If ATM withdrawals emerge that fit another pattern—at some out-of-the-way location, for instance, this information might be subject to later investigation because, as in the case of credit card receipts containing proof of rendezvous, these withdrawals may prove helpful.

Example 5-14. The forensic accountant has identified Mr. Jones's ATM withdrawals as coming from Location A primarily, and Mrs. Jones's withdrawals as coming from Location B. But there is also a pattern of withdrawals coming from some location seemingly out of the way for both parties. Could it be that money is being withdrawn as needed by a party having an affair? It is certainly worth considering.

In conducting the personal lifestyle investigation, the forensic accountant should keep in mind the following: although one suspicious factor that is unearthed, such as an increase in the cost of groceries or gasoline, might easily be explained, the combination of factors might very well strain credibility. So, for instance, if the forensic accountant also demonstrates that Ned has underreported income and has neglected to deposit bonuses, and the accountant has established that Ned's cash withdrawals are higher than his documentable expenses, the accountant will undoubtedly make it easier for a judge to conclude that the subject has not been dealing with his or her spouse in a fair and forthright manner. This, in essence, is the forensic accountant's goal.

Uncovering Lifestyle Changes

So far, this discussion has covered how a methodical examination of a party's financial records might lead to the discovery of a hidden lifestyle, focusing primarily on discovering undisclosed assets and income, or in demonstrating how funds might be secreted or siphoned off a little at a time. But this chapter would not be complete without a few words on the role of the forensic accountant—the golden opportunity might be a better description—in assisting the attorney in establishing the approximate time period that marital deterioration began in earnest. By recognizing the clues buried within the data and by understanding human nature, the forensic accountant will also help himself or herself narrow (or broaden) the time period of the examination. The key is in interpreting the information discovered among legitimate expenditures.

Cancelled checks and credit card receipts for such run-of-the-mill personal expenditures as clothing might be glossed over by an inexperienced investigator looking only for the “juicy” expenditures such as mid-week hotel rentals or expensive gifts. But even a mundane expense can be the tip-off to an infidelity. Expenditures that might indicate a sudden change of lifestyle are important.

To be perfectly blunt, if one spouse is carrying on an affair, this behavior might be preceded by, or accompanied by, some advance “preparation.” Is it not human nature to want to be attractive to a new companion? Of course it is. As a result, the unhappy spouse might have joined a gym or health club, for example, in order to get into shape for his or her new love interest.

Preparation might also include purchasing a new wardrobe. After all, one wants to look one's best, especially in the beginning stages of any personal relationship. An unusually large investment in clothing or a sudden flurry of smaller purchases (as evidenced by charges or checks written for these items) may help fix the date when one spouse's disenchantment became, in essence, irrevocable and final.

Purchasing or leasing a new car, particularly one designed to draw attention to the driver, might also be a tip-off, as might virtually any change in habits, hygiene, interests, or appearance.

Example 5–15. Darlene has filed for divorce from her husband, David. Joseph is hired by David to conduct a personal analysis of Darlene's finances.

In reviewing her checkbook and finding a check made out to Freedomville Junior College, Joseph inquires and learns that Darlene has been taking continuing education courses at a local community college. There is nothing wrong with this, of course, and no effort has been made either to hide or to deny it. Should the entry be ignored or brought to the attention of the attorney? The latter seems to be the prudent course of action here.

Several possible explanations exist, some quite innocent, to be sure. For instance, Darlene could simply be bored and desirous of intellectual stimulation. Or she may be finishing up a degree interrupted when she chose to stay at home and concentrate on raising the couple's children.

Then again, Darlene could be smitten by the professor or by a fellow student. Or she could merely be using the course as a pretext for being out of the house on certain nights. In fact, maybe she hasn't attended a single class. Or perhaps, planning the eventual end of her marriage, she has elected to finish her studies in order to become more self sufficient.

Determining which of these scenarios is the correct one is not the forensic accountant's job; the truth will likely be brought out by the attorney during the discovery process.

The lesson here is that the accountant should not ignore transactions simply because they appear to be legitimate and fully supported by documentation. Data should be interpreted more flexibly than simply by the criteria of whether the expenditure is provable. Conversely, the forensic accountant should be vigilant for expenditures that do not exist. Using again the health club example, the following scenario is instructive.

Example 5-16. Arlene has filed for divorce from her husband, Adam. Andrew is hired by Adam to conduct a personal analysis of his wife's finances.

As part of Andrew's investigation, he specifically asks whether Arlene is a member of any health club and is told that she is. Funny, but there doesn't seem to be a check or charge slip indicating payment to the club. Was that payment made in cash from an undisclosed account?

Andrew asks Adam whether he has noticed a change in his wife's wardrobe of late. Adam acknowledges that he had indeed noticed that Arlene is paying more attention to the way she dresses and, in fact, has many new outfits. Again, Andrew is at a loss to explain how Arlene has purchased her new outfits. Certainly neither the couple's bank accounts (nor any personal ones acknowledged by Arlene) show withdrawals to explain this expenditure, and no credit card charges appear for clothing. Again, could it be that Andrew needs to look more carefully for undisclosed accounts? It certainly appears so.

The forensic accountant should ask the client about any changes he or she has noticed in his or her spouse. Use those clues as a starting point for any inquiry. Until the forensic accountant has gained enough experience, it is also advisable to get the advice of the attorney regarding what the accountant should be looking for in this particular case. After all, if there is anyone who understands the dark and devious side of human nature, it will probably be an experienced matrimonial attorney.

The forensic accountant will also want to discuss which avenues the attorney wants explored, even if the accountant is experienced. Chances are, the money for payment is limited, and the forensic accountant needs to know if the attorney and client want him or her to look for hidden assets, undisclosed cash, expenses of an affair, or other information.

Summary

- A personal lifestyle analysis will help determine whether any personal unreported assets or income exist. In this respect, it is very similar to a business analysis and, in fact, uses many of the same investigative and analytical techniques.
- Among the documents that should be obtained and scrutinized are the personal tax records of the couple—particularly if the spouses file separate returns. Tax returns may lead to discovery of previously undisclosed sources of income and assets. Amended returns should be compared to the original ones, and every schedule to the tax return should be examined.
- Deposits into marital accounts should be carefully checked against the supporting documents such as W-2s or 1099s. It is possible to deposit less than all of a spouse's earnings into an account without the other spouse ever knowing it. This can be done by depositing fewer than all payroll, bonus, and reimbursement checks. It can also be done by depositing checks into an account that exists only to siphon off funds.
- Bank or brokerage accounts housing one spouse's separate assets, as in the case of those received by gift or inheritance, may also be used to siphon off funds, so they should be checked carefully.

- A lifestyle and spending analysis, usually in the form of a spreadsheet, should be done to detect any patterns evidencing a failure to deposit funds or an excess of cash withdrawals.
- A sudden interest in physical appearance or in wardrobe, as evidenced by expenditures discovered in the lifestyle analysis, may be a tip-off about the onset of the marital problems. Conversely, a change of wardrobe or interest in appearance not supported by documented expenditures may be a tip-off about the existence of a hidden account.

6

How to Examine and Analyze Specific Transactions—and Red Flags to Watch For

What is at Stake

This chapter analyzes some of the specific areas where the financial investigation may lead. Not everything discussed here is designed to uncover dishonest behavior on the part of the business owner. Some of the red flag areas simply aid in an understanding of, and adjustment of, the business income statement. Consequently, the statement forms the basis for the expert opinion in valuing the business.

Adjustment of the income statement, where appropriate, is crucial in determining the value of the business and the forensic investigator's client's rightful share of it. If the court values the company on the basis of a multiple of net annual earnings (as is often the case), it should be obvious that the greater the bottom line, the greater the value of the business.

Example 6-1. Company B reports sales of \$400,000 and net earnings of \$50,000. If the average company in B's industry is valued at five times net annual earnings, this company is theoretically worth \$250,000. However, if the forensic accountant succeeds in proving that the \$50,000 earnings is the result of some "erroneous" accounting, and that the net earnings are actually \$70,000, then the accountant has succeeded in raising the theoretical worth of the company to \$350,000, which, if divided equally between husband and wife, means a gain of \$50,000 for the client.

With this in mind, the following sections analyze those areas of a company's financial statement requiring careful scrutiny.

Salary

One of the first examination areas ought to be the compensation of company officers and shareholders and, particularly, the compensation of the investigative target. Although it is true that salaries are "ordinary and necessary" expenditures, the forensic accountant still needs to investigate their reasonableness.


Some business owners—specifically those whose companies are subchapter S corporations—might prefer to allocate a smaller share of compensation to salary and the balance to profits. The reason is easy to appreciate: Federal Insurance Contributions Act (FICA) and Medicare taxes are collected from salary with an additional matching amount paid by the company. The result is a smaller paycheck. If the company is to be valued as a multiple of net earnings, this will not cause the forensic accountant much of a problem.

In fact, it works to the client's benefit because the greater the earnings, the greater the company's value. But what if the business owner, realizing this, switches to a higher salary? After all, it is surely better to have higher payroll deductions for a year or two than to pay the difference in a matrimonial settlement.

Example 6-2. Bill's company, a sub-S corporation, had gross sales of \$200,000 last year. There are two employees: Bill and his secretary. Bill pays himself a salary of \$30,000 and his assistant, \$20,000. All other expenses are legitimate and total \$60,000 per year. Bill's company has net earnings, therefore, of \$90,000 (\$200,000 of income less \$110,000 of expenses). If the court would value Bill's company at five times net earnings, it is theoretically worth \$450,000. Bill's wife, assuming she is entitled to one-half, would receive \$225,000.

Example 6-3. Bill is no dummy, however. He gives himself a huge raise this year to \$80,000. The company's FICA and Medicare contributions rise by about \$5,000 (in round numbers), but all other expenses remain the same, as do his gross sales. The result is that expenses rise to \$165,000 (\$80,000 plus \$5,000 for Bill, \$80,000 more for his secretary and other legitimate expenses). The net earnings of Bill's company, therefore, fall to \$35,000. Applying the same five-time multiplier, the value of Bill's company appears to be only \$175,000. His wife, still entitled to one-half, will now receive only \$87,500, or \$137,500 less than she did in Example 6-2. So, for an additional FICA and Medicare cost of less than \$5,000, Bill has saved—or at least tried to save—himself \$137,500.

Bill's clever little maneuver will have to be adjusted to bring his salary in line with those of similar business owners—something that requires some research on the forensic accountant's part to determine.

 **Tip:** An interesting contradiction presents itself for spouses able to set their own compensation. To the extent that they understate salaries and do not include profits of the company in their personal earnings, they will have lower income available for alimony and child support. This reduces their support. Overstating their salary decreases the business earnings and, therefore, its value (if not properly adjusted). So motivation is important. Is suppression of long-term support worth more than lowering the present value of the company?

So far, it has been assumed that the owner's salary has been fully tracked, but it is wise to make a notation to compare the salary checks written by the company with deposits made into the owner's household account. It might be that an interim account was established by the owner and less than the full salary was deposited into the husband-wife joint account.

Example 6-4. Arthur receives a salary, after deductions, of \$4,508.55 per month. Rather than deposit this amount into a spousal joint account—from which such household expenses as rent and food are paid—he first deposits his check into a separate account, and then deposits only \$3,508.55 into the family pool. Because he personally makes each deposit, his wife is none the wiser. She believes that the latter sum is what he earns. By matching payroll checks to family deposits, the forensic accountant will uncover this scam and discover the existence of Arthur's slush fund, which might contain more than the \$1,000 per month being parked there.

Even if it is assumed that the full after-tax salary is deposited into the family account, it might be that Arthur's periodic "draw against profits" or his bonus (or a part of it) is deposited into a separate and unknown account. The forensic accountant must match all checks against reported personal deposits and watch for year-end bonuses used to pay back owners' loans during the year.

Capital Investments and Withdrawals

At the start of a business, and from time to time thereafter, the owner may invest or retain capital in the company. The amount should be revealed by the capital account of the party under investigation. Increases

of capital, in and of themselves, may not be suspicious. Because they are such a normal part of business life, however, the forensic investigator might miss a golden opportunity to find leads to other hidden assets.

If the business being investigated is fairly new, the forensic investigator should determine how much money was contributed by the person under investigation and, more importantly, the money's origin. The investigator might find that the source of the funds is easily traced and legitimately accounted for, but he or she might also find that the source was some undisclosed asset of the owner. If so, the investigator may likely have grabbed hold of a thread that will unravel not only some other hidden assets, but perhaps even a hidden lifestyle. An example may serve to illustrate why even an innocent-looking transaction should be investigated carefully.

Example 6-5. Paul is in the antiques business. For the past five years, as he has grown less and less fond of his wife, he has been keeping a secret bank account. Into it he places cash received from the business but not reported either to the IRS or to his wife. This could be called his “entertainment money.” Its importance will become evident in a moment.

One day, Paul stumbles upon an opportunity to purchase some merchandise that he knows is terribly undervalued and that he believes he can quickly turn over for a tremendous profit—but he has insufficient funds in the company account to purchase it with. Foolishly, he draws upon his hidden stash and makes a deposit of \$10,000 by check into his business account.

True, he could have purchased the merchandise with cash from the concealed account, but that might have meant carrying a large sum of cash to the location of the merchandise—a pretty rough neighborhood—and he did not want to risk it. And the seller would not accept his personal check, only a company check. Besides, thought Paul, his wife had no clue about his unhappiness or his side-tracking of funds, and she likely never would. Of course, Paul had no intention of divorcing her—or of marrying the woman with whom he was having an affair.

Paul's temporary lapse of judgment—call it hubris—has provided the forensic investigator with an opportunity. In examining Paul's business account several years later, the investigator notices the large deposit. She also notices that his accountant has credited it to his capital account, indicating that it is not ordinary income. (She also notices that shortly before the divorce action was filed, this capital was withdrawn by Paul.) The investigator inquires about the source of this money, but Paul swears he cannot recall. After all, the transaction occurred years before.

The forensic accountant then investigates the business bank records subpoenaed at her request by the attorney. They show the source of these funds as a checking account in Paul's name at a bank on the other side of town. The investigator asks for and receives a subpoenaed set of statements, cancelled checks, and deposit slips from this account. She discovers some amazing things: Every deposit since the account's inception has been in cash! The withdrawals are even more interesting: checks written for renting an apartment—a love nest, it turns out—as well as monthly credit card payments to an account not previously disclosed.

Next, the attorney subpoenas the credit card records, and the forensic accountant's investigation shows the purchase of some expensive women's jewelry. It also shows payment for a hotel room in Palm Springs at the very time Paul has told his wife that he was on a purchasing trip in Ohio.

One slip-up has unraveled the entire tapestry, but it is a slip-up the investigator might have missed if she had merely accepted the fact that capital investments are an ordinary part of business and not worthy of closer investigation.

The above scenario has certainly been stretched for the sake of drama, but it really is not so far-fetched. Often the forensic accountant is investigating a person who might believe himself or herself stuck in a loveless relationship and, more importantly, a person who believes himself or herself to be infallibly clever. No sane person creates a secret life believing that they will be caught. But, being human, mistakes do occur.

In addition, not all such transactions are based on a love affair. It could just be greed—the unwillingness to share the full fruits of one’s labor with the person with whom he or she is no longer in love. For instance, example 6–5 might just as easily have revealed that the \$10,000 was taken from another undisclosed and unrelated business owned by Paul, rather than from a personal account created in secret. That second business might require a valuation all its own. In fact, given the tendency of valuing businesses at a multiple of earnings, this discovery would certainly benefit the forensic accountant’s client. Anything is possible.

Two other points illustrate the importance of thoroughness. First, the subject’s credibility in court will have been severely damaged by his or her stealthy action. So the investigation may provide the client with the moral high ground, leading to a bigger judgment or settlement.

Capital investments need not be from secret sources. The forensic accountant might find that the source of the capital is a person buying into the business. In such a case, the forensic accountant should request and investigate the purchase agreement, as it will most certainly establish the original purchase price. If the buyer is an arm’s-length party purchasing an interest in the business for a fair market value, the forensic accountant may have a basis for testifying about the current value of the business. Few owners will sell to an arm’s-length purchaser at a price unfair to themselves.

Conversely, the purchaser may be a family member, and the price of the purchase may be very low or high. The purpose, of course, will be to establish a low valuation, perhaps even to have the subject’s own expert attest to the fairness of that low sale price. In community property states, a business acquired before marriage or during marriage by gift or inheritance benefits from a higher value. Showing that the purchaser is a related party is important.

Just as increases should be traced, so should capital withdrawals. Where did they go? The forensic investigator may discover the existence of an undisclosed account in this manner. He or she may discover that the withdrawal of the capital account is not the only source of funds for this previously unknown account. Another source may be unreported cash, as was the case in the example of Paul’s antiques business.

Evaluating the Propriety of Otherwise Legitimate Business Write-Offs

The business expense categories afford a business owner a wide latitude for abuse. The forensic accountant is not bound by what the IRS will accept as legitimate business expenses. Just as in the case of salary, discussed previously, excessive write-offs only serve to diminish the value of the property for purposes of marital dissolution valuation. If marital standard of living is at issue, personal expenses paid from the business may be included in that analysis.

This section explores some of the possible write-off categories where hidden value may be found.

Automobiles

Clearly, one of the most abused areas of business deductions is the automobile. Business owners know it, the IRS knows it, and the forensic accountant should know it. That’s why the IRS requires that contemporaneous usage logs be kept. The forensic accountant should request the log. Often it does not exist—business owners treat it as a nuisance to be “created” if and when the IRS comes calling.

One of the first things the accountant must do is determine the number of cars being written off by the business. If one car, the business owner’s, is being written off, the tendency might be to shrug it off because “everyone does it.” However, personal use might add a bit to the bottom line of the business value.

Example 6–6. Carmela’s business, which she fully owns, leased a new car for her this year. The rationale: she needs to visit customers on a regular basis. The cost: \$500 per month. During the past year, Carmela worked 5 days a week for 50 weeks (250 days), and used the car to commute the 48 miles (round trip) back and forth to work, a total of 12,000 miles. The total mileage driven during the year was 15,000 miles. So only 3,000 miles

(if that, because this hasn't accounted for weekend use) were business-related; the remaining 12,000 were nondeductible commuting miles. But that is not what the business reported on its tax return.

For purposes of adjusting the income statement (and valuing the company), the forensic accountant might add back 80 percent ($12,000 \div 15,000$) of the \$6,000 annual lease expense. So the company income statement should be adjusted upward by \$4,800, plus 80 percent of oil, gas, and other expenses. The personal use should also be reflected on Carmela's W-2.

More important, however, is the analysis and valuation if more than one car is being written off. Multiple automobiles may simply be the result of an arrangement whereby each of the business owners receives a leased car as a perk. Even if this is "fair," for example, among the partners, this expense will have to be analyzed and possibly adjusted for purposes of valuing the business.

Example 6-7. Carmela is one of four equal partners, each of whom receives a car for "business" use. The total annual automobile lease deduction is \$25,000, of which only \$5,000 can rightly be called a legitimate business expense. Adding the excess amount back to the company in the form of an income adjustment will increase the earnings by \$20,000 which, in turn, will increase the value of the company by \$20,000 times the earnings multiplier to be applied by the court.

Adjustments to income need not be massive in any one category to make a serious impact on the company's bottom line. This is still early in the examination, and plenty of categories are left still to analyze. (The case study at the end of this chapter demonstrates how a series of small adjustments can mean the difference between a company reporting a profit and reporting an apparent loss.)

In addition to examining automobile usage, the forensic accountant should evaluate the type of vehicle being written off. Is it a Mercedes or a Dodge? Even if the forensic accountant is inclined to concede that a business owner may write off part of a vehicle's value, the accountant might be less inclined to do so if the car is an expensive import, and its owner claims to be unable to afford child support payments. An excessively costly and luxurious automobile may need to be factored into the business valuation. Naturally, this depends on a number of factors, including the nature of the business. A stockbroker might wish to convey an aura of success to potential customers. After all, who wants to entrust their money to a person who does not display some level of financial comfort? A Mercedes might be appropriate here. But does Paul, our antiques dealer, need such a car? What he really needs is a vehicle to transport large, bulky, dusty antiques. If a vehicle is more a display of the owner's status than a business necessity, the spouse and children should not be made to subsidize it.

Deductions for additional vehicles may lead to the discovery of another important bit of information: the existence or identity of the owner's boyfriend or girlfriend. It is not unheard of for a businessperson to reward an extramarital paramour with transportation paid for partially by the company and, thanks to tax deductibility, partially by the taxpayers. Finding this out is a matter of skillful probing. What type of vehicle is it? The antiques dealer's second car—a minivan—may be appropriate. A second luxury automobile or a sporty car, however, is suspicious. Where exactly is the vehicle? Who is driving it?

This is where insurance policies come in handy. Even though the car itself might be registered to the company, the insurance policy might name the mystery driver as an insured party. If nothing else, this could provide the means for the forensic accountant's attorney to learn the name of the subject's consort. Even if no proof is found of an illicit affair or of vehicular payback in exchange, the second vehicle may be of direct benefit to someone close to the business owner.

Example 6-8. Sam has two college age children from a prior marriage. Each of them needs a car to get to and from school. Rather than give them the money in the form of nondeductible child support payments, he furnishes them with an automobile and deducts the cost as a business expense. The IRS would not approve and neither should the forensic investigator. The cars' value should be added back in valuing the company.

Another way of gauging the use of an automobile is to investigate receipts from gasoline charge cards or other credit card charges paid by the company. Although this is discussed separately later in this section, it is worth noting that a credit card may often be a part of the business owner's largesse. So, for example, the business owner's boyfriend or girlfriend, or the college kids from the first marriage, might be given a company credit card with permission to use it for gasoline and repairs.

If there is a consistent pattern of gasoline purchases at one or several locations not in the business owner's home-to-work travel path, the forensic accountant might have pinpointed the approximate location of where the car spends most of its time. This is particularly true in the case of children from a prior marriage who may be using the automobile at a college campus far from home. The attorney can learn through the discovery process exactly where the owner's children are attending school.

Example 6-9. The forensic investigator notes that a vehicle registered to the company is constantly filling its gas tank in Princeton, New Jersey, although the company's offices are headquartered in Hauppauge, New York. An inquiry reveals that the owner's daughter attends Princeton University. It is easy to see the connection.

Travel and Entertainment

The forensic accountant should make it a point to check credit card charges to determine whether they are business-related or personal. Again, this information could lead to information about afternoon rendezvous. A careless spouse might have charged the hotel room. Or perhaps he or she charged some late night dinners at very expensive restaurants, when entertaining clients is not usually a part of the job.

Example 6-10. Edgar runs a small law firm out of a storefront near the local court building. His clientele is primarily of the walk-in variety, and he deals mostly with people in need of representation in traffic ticket matters or the occasional minor criminal action. It's a good bet that Edgar is not regularly entertaining his clients at Chez Tres Expensive, the local French culinary center.

Any charge that seems out of place might provide a lead either to the forensic accountant or to a private investigator, such as the following.

- A charge from a florist might be suspicious. (Then again, if the subject is a funeral director, the charge might not be suspicious.)
- A charge at a chocolate shop might raise an eyebrow.
- A lingerie purchase is certainly curious.

One particularly interesting subcategory of "travel and entertainment" is the convention-related expense category. Most professionals and trades people have the opportunity to attend at least one annual professional gathering. Most such conventions are legitimate—even though the organizers might schedule events during only part of the day so that attendees may enjoy the remainder of their time away.

Investigate the expenses associated with conventions very carefully. Did the subject leave for the convention several days early or stay several days after it ended? This could indicate that at least part of the trip was for pleasure—something that should not be subsidized by the divorcing spouse. Between the convention documentation and the credit cards records, the forensic investigator might discover a wealth of information. Did the business owner buy one or two airline tickets? Was the room reserved for one or for two people? If so, whom did the owner take along?

Personal Expenses Written Off on the Business

The types of personal expenses that might potentially be written off as business expenses are virtually limitless. In fact, one might say that their existence is influenced by only two things: the chance that the business owner is willing to take that he or she will not be selected for an IRS audit, and the other parties

(excluding the spouse) that the business person must account to—normally either the other shareholders of the company or the other partners or co-owners of the business.

Perks in addition to automobiles and travel expenses, entertainment, and conventions include the following.

- Country club memberships.
- Health club memberships.
- Personal subscriptions and books.
- “Out-of-pocket” expenses that really are not.
- Meals paid for by the company on a regular basis.
- Personal computer purchases.
- Hobby expenses, such as auto racing or airplanes.

The list could go on and on. The forensic accountant must investigate the business necessity of each item and the reasonableness of the expense. The reasonableness of country club memberships depends upon the type of business. A hair stylist seldom entertains aboard her yacht. A film producer might use any excuse to do exactly that—and perhaps big name stars expect it. The forensic accountant should have little difficulty in rejecting purely personal expenses, such as health clubs and subscriptions.

The out-of-pocket expense reimbursement may be nothing more than a sham to pull tax-free dollars out of the business. In the absence of supporting proof, reimbursements should be viewed suspiciously.

Example 6–11. Darlene runs a small dry cleaning establishment and is on the premises every day from 6:00 A.M. until 7:00 P.M. Each month she “reimburses” herself the following amounts for the given reasons.

- \$35 for gas money: “I drive around to check out what my competition is doing.”
- \$200 for meals: “It is my company policy that if an employee must be physically on the premises between the hours of 11:00 A.M. and 2:00 P.M., they are entitled to lunch, and if they work past 6:30 P.M., they are entitled to dinner.” (Darlene, conveniently, is the only employee who fits this bill.)
- \$15 for the daily newspaper: “I have to check my competitors’ ads, don’t I?”

These seemingly trivial expense reimbursements add up to \$3,000 per year. Combine that with the other perks Darlene allows herself—a leased automobile, various insurance payments, the Annual Dry Cleaners’ Convention (it’s in Hawaii this year; those grass skirts are a pain to clean!)—and this could mean some serious numbers.

Note: If the business has more than one partner or owner, the forensic accountant must investigate the other partners’ expenditures as well. The odds are that there is an unwritten understanding among the owners that each will receive, more or less, the same level of perks. This information will help the forensic accountant add back all of the hidden value of the business and give a clearer picture of what it looks like when all hanky-panky is factored out. This adds value to the divorcing spouse only if the partner spouse receives personal expenses in excess of his or her ownership interest.

Example 6–12. George is one of five equal partners of Company G. The partners are pretty savvy; they agree that each will have a “slush fund” of \$20,000 per year for personal items to be written off as business expenses. After deducting other legitimate expenses, Company G showed net earnings of \$100,000 this past year. A multiplier of five would place the value of this company at \$500,000 and George’s share at \$100,000. If his wife is entitled to one-half, her share would have a value of \$50,000.

However, by adding back George’s “slush funds” of the net earnings are effectively doubled and so is the value of the company. Mrs. George is now entitled to \$100,000.

To understand the tremendous importance of examining everyone's personal spending, the mathematical result would have been very different if the forensic accountant had only investigated transactions relating to George. The accountant would have added only \$20,000 to the \$100,000 of reported net earnings, thereby valuing the company at \$120,000. The soon-to-be-ex-Mrs. George would have received only half of this amount—\$60,000—and not the \$100,000 to which she is actually entitled.

Petty Cash

For most businesses, petty cash is exactly that: small amounts of cash kept on hand for contingencies when cutting a check is not convenient. Given a sufficiently small amount, petty cash accounts might not be worth exploring too carefully. If petty cash, however, consistently amounts to hundreds of dollars per month and receipts or legitimate explanations are not supplied, this may be a proper area to adjust for. Even \$100 per week quickly adds up to over \$5,000 per year of extra earning power (tax free, no doubt) for the business owner.

Suspense

This is an account that shows up in many businesses for items that are hard for the bookkeeper to characterize during the year. It is usually zeroed out at the end of the year, but it can be worthwhile to see what passed through it during the year before it was redistributed by someone. Unusual items could be items that the forensic accountant needs to investigate further.

Utilities and Telephone

Another area to investigate is the company's expense for utilities and telephone. Although these are usually legitimate, it is worth examining whether the business owner is writing off a telephone in the home, a cellular phone or pager, or residential utilities under the guise of a home office. Or perhaps he or she is using the pretext that the business "requires" that a telephone be available to the subject 24 hours a day.

The IRS might agree with the subject if the business return is ever audited, but the forensic accountant is not bound by its determination.

Furnishings

Most office furniture finds its way into the office. Occasionally, however, a piece of furniture happens to be "accidentally" unloaded in the living room of the subject's love nest. The forensic accountant should check whether the type of furniture is suitable only for an office, or whether it can be adopted for personal use. A couch is a good example. Some furniture could appear suspicious but may be completely legitimate: dining room furniture for the company cafeteria, for example. Expensive art work for the office may be expensed by the business. Also check out "office" decorating expenses and the source of funds used to pay for recent home improvements.

And then there are the "no-brainers": The purchase of a queen size bed is not usually an office expenditure.

Insurance

The last chapter touched on the importance of obtaining copies of insurance policies for the purpose of establishing the existence and value of tangible property and, in the case of life insurance purchased to fund a buy-sell agreement, for valuing the business in the event of death.

Property Insurance

As previously explained, the forensic accountant's examination of property insurance policies may result in a basis on which to value depreciated or expensed property. It may also reveal the very existence of property that has not been disclosed previously, because even unreported property will likely be insured against loss.

Other types of insurance also warrant close examination. (Note that some of these types of insurance may have a legitimate business purpose, but the premiums may not be legitimate expenses for valuing the business.)

Life Insurance

Aside from the fact that many businesses use life insurance to fund buy-sell agreements in the event of death, there might be a hidden value in such policies—the cash value. If the business itself owns the policy, which is very often the case, the cash value should be reflected in the books. If the business does not own the policy, the value of the company should be adjusted accordingly.

Example 6–13. Jerry and Ben have been partners for 20 years. Early in their partnership, they decided to purchase life insurance to provide funds for the widow of one partner in the event of the death of the other partner. Although they considered term insurance (which would have provided coverage without cash accumulation), they rejected this in favor a more expensive cash value policy. Their company now owns policies on both their lives, and the cash value of these policies totals \$30,000.

This cash value should be considered an asset of the company because it could be withdrawn (most likely at a nominal rate of interest) without affecting the insurance coverage. Note that in counting the cash, the forensic accountant should add back the value of all partners' policies. Otherwise, there will be an undervaluation problem similar to that discussed in example 6–12.

It may also be that the business owner is the owner of the insurance policy. Life insurance presents an interesting way of pulling money out of the company in the form of a perk. The company pays the premium, but the owner of the insurance controls the use of its cash value. A variation is the company's purchase of a single-payment life insurance policy. Even though the typical life insurance policy is paid for in installments (quarterly or annually), usually over the life of the insured, this is not the only way to purchase insurance. Insurers offer—and insurance agents lick their chops at the prospect of selling—policies that are fully paid up in return for a single, very large premium. Such a policy should not be missed because it may have a tremendous cash value.

The forensic accountant should not assume that because such a one-shot policy might not pass muster with the IRS as an ordinary business expense, it is not done. Such a policy may be difficult to find—it might not be reflected on the recent company statements—because it may have been taken out years earlier. Even if the forensic accountant misses it, the attorney might be able to subpoena it, or it might show up in the investigation of personal assets, a topic discussed in a later chapter.

Finally, the forensic accountant should not neglect to investigate whose life is being insured. It might be that the business is footing the bill for insurance on the life of a parent, child, or ex-spouse of the owner.

A term life policy with no cash surrender value may still have value. If the insured has become uninsurable because of declining health, the term policy may have substantial value. For large policies, an actuary may value the term policy, taking into account the current state of the insured's health.

Disability Insurance

Unless the policy is a substitute for a state's disability insurance, the company's payment of a disability income insurance policy for the owner—a policy that pays a fixed monthly amount if the owner cannot work—is not an "ordinary" business expense and should be added back. Again, when adjusting the income statement, the forensic accountant must be sure to include the policies of all business owners.

Medical Insurance

This type of insurance is usually a legitimate expense. The forensic accountant should determine who is covered under the policy. Is the business owner's family covered as well? Children from a prior marriage? Elderly parents? Are these coverages provided to other employees?

The forensic accountant should carefully investigate all policies. Perhaps a policy has been furnished, in addition to salary, to a phantom employee who is the owner's lover. A medical reimbursement plan that pays all medical expenses not reimbursed by insurance—but only for the owner and his or her family—might also be a questionable business expense.

Because insurance coverage can provide tips on issues that might otherwise be missed, such as the existence of unreported real and personal property, other people being supported by the business owner, or the owner's own fair market valuation of the company, they should be investigated thoroughly.

Interest Payments

Interest payments are a legitimate cost of doing business, but there is room for abuse here as well.

First, the forensic accountant must determine what the interest is being paid for. If it is a cost of carrying inventory or some other legitimate business use, the inquiry may end there. But interest payments might be for personal use as well.

Next, the forensic accountant should investigate the source of the loan. Was it a family member “lending” money to the company at an above-market rate? If so, then this must be factored into the valuation.

Example 6–14. Tammy borrows money from her mother for the purchase of inventory. She agrees to pay her mother interest at the rate of “prime plus 15.” If the prime rate is at 7 percent, she pays her mother 22 percent interest. Tammy's business has a good track record, however, and any commercial bank would be eager to lend her money at rates substantially below this level.

Tammy prefers her current arrangement, however, because it provides her mother with income and is tax deductible as a business expense. It also lowers the profitability of her business and, consequently, the share that her husband would be entitled to receive upon the dissolution of the marriage.

The forensic accountant determines that a market rate of interest would be 12 percent. The expense attributable to the remaining 10 percent should be added back in the adjustment of the income statement.

Buyouts

What if the expense is a legitimate interest payment being made to a former co-owner of the business to buy him or her out? Even in this case, the interest payment may need to be removed from the equation because the sale and principal debt have already been factored into the valuation of the business. The interest might be allowed when determining income available for support.

Example 6–15. Moe and Larry own Two Stooges, Inc., a company that manufactures gag gifts. The company is debt free and valued at \$1 million because it has \$200,000 of net profits, and the industry standard is that such companies trade hands at a ratio of five (that is, companies similar to Two Stooges sell for five times annual profits).

Larry agrees to buy out Moe's interest for \$500,000 at 10 percent payable over 5 years. The company will actually be buying Moe's stock, but the effect is that Larry will own 100 percent of the issued and outstanding shares. Assuming that Larry's wife files for divorce shortly after the purchase, consider how the transaction's structure might affect the analysis of the company's value unless adjusted for by the forensic accountant. The \$50,000 of interest paid to finance the buy-out appears to reduce the company's profits from \$200,000 to \$150,000. Since the selling ratio remains unchanged at five times net earnings, the value of the company now appears to be only \$750,000.

When computing income available for support, the court will likely allow the interest as a deduction of interest related to a bona fide business debt.

Loans to Shareholders

Loans to shareholders are assets of the corporation and, assuming that they are legitimate and fully reflected in the company's books, there might appear to be no need for deeper investigation. But there is.

Where did the funds go? By tracking them, the forensic accountant may find that they have been deposited into a previously undisclosed account. They may have also been funneled into a side business that the subject has not disclosed. What are the loan's terms? Is it at a below market rate? If so, and if the business could be putting this money to better use, it may deflate the value of the company.

Example 6-16. Bill borrows \$100,000 at 10 percent per annum from Bill Co., Inc., the company in which he and his father are the sole and equal shareholders. The company has an outstanding bank loan of \$250,000 at 14 percent. Lending the money to Bill, instead of repaying the bank, is costing the company at least \$4,000 per year in interest. This is easy to measure, but the loss from lost opportunities to use the \$100,000 for other business purposes is less easily quantified.

Family Employees

Hiring family members is not necessarily "bad," as that term might be defined in the scope of a forensic investigation. Many business owners put children on the payroll, not only to spread income over a wider band of tax brackets, but perhaps also to give a junior family member a taste of the responsibility of employment. If the family member performs a legitimate function, there is little to complain about as long as the compensation is fair.

Example 6-17. Bud Jr., 20 years old, works for his father as a customer service representative. He is paid \$25,000 per year for his services. This might be entirely fair if his dad would pay that to any similar hire and if the job is truly necessary to the business.

The forensic accountant should not forget to factor in perks for family members as well.

On the opposite end of the spectrum, it is not unheard of for a business person to have a parent on the payroll, again, to spread the income around to smaller tax brackets, but perhaps also to qualify an elderly parent for medical benefits under the company's group plan. Although admirable from a family values perspective, such employment arrangements or "consulting contracts" should be adjusted in determining the value of a company.

Example 6-18. Bud pays his mother, Flo, \$50,000 per year as the company bookkeeper. Her duties are to come in every second Friday to pay bills and make out the payroll. This salary seems excessive and should be adjusted to market rates for similar services.

Rental Payments

Rent is a difficult category to gauge. Is an above-market rent being paid for the business premises? If so, is it being paid to a relative or other closely related person? Excess rent will, of course, affect the business's bottom line. The forensic accountant should check the leases and obtain information—often available from a local real estate broker who specializes in commercial rentals—about the fair market value of similar property in the area.

If the real property is owned by the parties and rented to the business (except in the case of sole proprietors), the reasonableness of the rent is important. If the real property is appraised, that appraisal will contain the fair rental value of the property. If the total expenses paid by the company for the rental building are higher than the appraisal rental value, the difference should be added back to income. If the expenses are less than fair rental value, the company income will be adjusted downward. This is important because appraisal rental income multiples are generally higher than appraisers use in closely held business.

Repairs

Are repairs or other construction being billed to the business when they are actually being performed at the owner's personal residence or second home?

This is not unheard of. Remember Leona Helmsley?

All repair invoices should be checked carefully. They may give hints about the type of work and the location where it was done. When the forensic accountant is physically on the premises, he or she has the chance to check to see that the work has, in fact, been done. If the expense is large, the forensic accountant can retain an estimator to analyze the costs of the improvements on the business premises. If personal residence improvements are suspected, he or she can ask the appraiser of the residence to look for evidence of recent improvements to the residence.

Example 6-19. A construction invoice reads: "Re-tile and re-grout bathroom." The accountant visits the site and excuses himself to use the restroom. He immediately notices that there are no tiles in the company bathroom. This repair, therefore, may be to a personal residence. The accountant brings this to the attention of the attorney who will explore further the existence and whereabouts of the possible love nest.

Prepaid Expenses

Most of the time, prepaid expenses will be negligible. After all, there are just so many years into the future that one can renew a magazine subscription, and there are just so many magazines one can read. But the accountant should check anyway. The business owner might have engaged in some "window dressing" late in the last year that he or she anticipates his or her "profits" will be shared with the spouse.

Example 6-20. Ginger commences a divorce proceeding against her husband, Fred, in mid-2009, and the divorce is expected to be final sometime in 2010. In December 2009, Fred prepaid for two years of liability insurance and six months of 2010 rent. Naturally, this reduces his company's net income for 2009. Adjustments should be made for this attempt to devalue the company.

Miscellaneous Expenses

When a business person doesn't know how to categorize a particular expense, it often ends up in the garbage can category of "Miscellaneous" or "Other." You never know what you'll find here, but it's worth reviewing with a fine tooth comb.

Inventory

Your inquiry should include an examination of the company's inventory method, specifically, whether it uses the last-in first-out (LIFO) method or the first-in first-out (FIFO) method. LIFO tends to cause an undervaluation of the inventory in many cases.

Example 6-21. Jack P. Notnoir owns a wine shop whose stock contains, among other things, 500 bottles of vintage wines and liquors. He uses the LIFO method for recording the value of his inventory. Among his stock can be found several dozen cases of Chateau Lafite Rothschild 1978 vintage, which he carries on his books at \$20 per bottle, the purchase price at the time he bought them. Good luck trying to find a bottle of that wine today at under \$200 a bottle! A careful review would disclose that Jack's wine cellar contains many similar items whose value has appreciated tremendously. In fact, his 500 bottles, valued by LIFO at approximately \$10,000, would fetch closer to \$150,000 in today's market.

The LIFO method, therefore, clearly does not do justice to the value of the business and must be adjusted.

It should be apparent that a physical inventory and a knowledge of the current value of a business's stockpile are imperative. Any business where the product, by nature, fluctuates in value, or has traditionally risen, should be investigated carefully. Among these are the following.

- Antiques.
- Collectibles such as stamps, coins, comic books, old toys, sports cards, rare books, movie posters, post cards, and other paper ephemera.
- Art prints and paintings.
- Jewelry (particularly precious gems and gold).
- Fine wines.
- Construction contractors "Construction in Progress" and "Billings in excess of costs and estimated earnings" are easily manipulated.

Many price guides have been published for collectors. Hunting down one of these—available at most good book stores—will give you some idea of the inventory's value. But note carefully: Particularly in the case of collectibles, the condition of the items is of paramount importance, and an item shown in a catalog at \$100 may actually be worth only \$10 because of its condition. You may have to rely upon a professional appraiser to determine the true, rather than the theoretical (catalog), value.

Adjustments to inventory value are not limited to the special businesses listed above. Virtually any business that maintains an inventory on the LIFO system is a candidate for adjustment unless the price differential between the first piece in and the last piece in is negligible. In addition, you must be careful in your analysis because some inventory does, in fact, depreciate. This will be less problematic for you as an investigator, however, as the odds are that the subject's own accountant or "expert" will have made the case that the inventory is not worth its book value.

Example 6-22. Dot Maytrix owns a computer monitor distributorship. Her warehouse contains 50 black and white computer monitors that cost her \$200 each 10 years ago. She would consider herself extremely fortunate to be able to sell them for \$20 each today. (In fact, the only interest she has received came from a manufacturer of fish tanks who thought it would be a novel idea to turn these old screens into aquariums.) Although valued using the LIFO method, Dot's accountant will clearly show that the entire inventory is worth only \$500. And he will be right.

For manufacturing businesses, be sure that scrap is accounted for if the raw material has any value (and most does). Owners frequently sell scrap for cash and pocket the proceeds.

Large One-Time Purchases

The existence of certain business assets might not be readily apparent from the initial review of tax returns thanks to § 179 of the Internal Revenue Code. Identifying expensed equipment is important in valuing the company. What you must determine is the nature of the purchase, its use, its useful life, and the contribution that it makes to the company's bottom line. Is it an item whose function is to help the business remain competitive in the marketplace? Or is the product a state-of-the-art replacement for something else? In that case, your analysis must include whether this item will improve the bottom line and a projection of how much.

Other Adjustments for Purposes of Calculating Value

Nonrecurring Items

As discussed previously, not everything reflected in the company's tax return need be accepted for purposes of valuing the business in case of divorce. There are many instances—large one-time purchases, moving expenses, etc.—which may seem, at first blush, to make the company worth less, when such expenditures may actually make the company worth more. You must know how to evaluate such items.

The opposite may be true as well. For example, if a company receives a large one-time order for its product, the tendency might be for you to value the company higher. Whether or not an order is, in fact, only a one-shot deal is a proper issue for investigation which can be accomplished in part by reviewing the contracts.

What follows are some expenditures that may tip you off to an increase, or potential increase, in a company's value.

Recent Moves

As a business grows, it may find itself cramped for space. To sustain the growth, it may move to larger quarters. As anyone who has ever moved an office knows, this is not only a royal pain in the neck, but an expensive one as well. New stationery must be printed, movers paid handsomely, and utilities installed. And although certain moving expenses are properly deducted only over a period of time, others are likely to be written off in the current tax year.

Even if expensing moving costs is inappropriate, it may, nevertheless, be done.

Example 6-23. Sam's Hams, Inc. decides to move its processing plant to a new, larger location because business is booming. At the same time, Sam purchases and installs a new state-of-the-art packaging machine. The IRS permits expensing of the cost of machinery moved from one site to the other, but requires capitalization of the cost of installing or moving newly purchased machinery. Sam's accountant, not realizing this, expenses all of the cost of moving Sam's equipment.

The forensic accountant should make an adjustment to capitalize, rather than expense, the new packaging machine.

In the above example, not only should the erroneous expensing be taken into consideration, but the forensic accountant should also make an adjustment to the company's balance sheet for any expenses associated with the move simply because they are nonrecurring charges and will serve only to deflate the value of the company if left unchallenged.

An additional factor should be considered here—one which might be missed unless you think of the business's prospects resulting from the move. Ask yourself the following questions. They may help you find the true value of the company.

- Why did the company move? Was it simply a case of losing its lease? Or did it move to a better location?
- What are the business possibilities at this new location? Are they better? If so, can you extrapolate this to future years? Although the business owner might not appreciate a projection of future business prospects, it could also be that this location is the breakthrough that the company has long been waiting for—and perhaps the divorcing spouse, who has supplemented the family income for many years until the business finally “hit,” is entitled to a share of the future earnings.
- Is the rent lower? This, in and of itself, can affect the company's bottom line.

Don't forget to investigate the parties involved in this new move. Is the business owner self-dealing? In other words, is this a lease (or purchase) entered into between the company and a related or friendly party?

Example 6–24. Joe moves his business into a building owned by his mother. His “lease” calls for the payment of rent at 1.5 times the going market rate. This, too, should be adjusted for.

Things That Might Temporarily Drive a Business Into Decline

Just as a change of location or a large purchase of equipment may warrant investigation and upward adjustment of the income projection, a decline in business should be investigated carefully because it may be nothing more than a nonrecurring disruption in business.

To be clear, we must distinguish between a decline in business and a “mere” disruption. A decline can be caused by many things—from an outdated product or concept, to an economic recession, to the loss of a key customer or employee. Although declines can be reversed, it may be a highly speculative undertaking to project the business's health a year down the road. And, in fact, a court might be less inclined to accept such a projection unless it can be shown that the events leading to the decline were within the control of the business owner, who elected to artificially reduce the value of his or her business.

A disruption, on the other hand, might be the type of event which, while serious and genuine, is a singular occurrence. It is easier to adjust for this type of event—at least in theory—than for a decline occasioned by a downturn in the business cycle.

Example 6–25. Joe owns a gas station. For six months last year, the town in which his business is located was installing new sewers, closing off the street for much of the time. Naturally, with cars unable to drive on the avenue on which the gas station was located, Joe's business came to a virtual standstill. But the street has now reopened and business is back to the level it was at before the interruption.

It is very likely that this business should be valued based upon its earnings in the year(s) prior to the construction, with little or no adjustment for the disruption.

In addition, expensive criminal behavior might skew the true picture of the company's worth. Suppose there was an embezzlement or a large scale theft not covered by insurance. Although this event might cause a loss for a particular year, it should not be factored into the valuation.

Example 6–26. Mac's Computer Outlet was cleaned out by thieves a few years back. Mac had insurance coverage of \$100,000; unfortunately, the robbers managed to take \$300,000 of inventory. Naturally, Mac deducted the \$200,000 loss in the year incurred. However, barring any future thefts, this occurrence is likely to be a one-time event. The business—assuming that business itself has continued at more or less the same pace—should be valued with little or no adjustment for this crime.

But be careful in evaluating losses of this nature. Certain businesses do suffer criminal acts as a way of life. For instance, liquor store owners may endure a higher risk of armed robbery than do most stores, and retail outlets regularly report shortages resulting from theft. These are certainly a legitimate deduction from profits—a cost of doing business, if you will.

Litigation

Unless litigation is just a cost of doing business, and, therefore, already factored into the value of the business, the existence of a lawsuit might have an impact on your valuation of the company. Evaluating the merits of pending litigation is beyond the scope of this work, and few attorneys would expect a forensic accountant to undertake this task. But you still may wish to consider the cost of litigation in your study of the company.

Many times this is a judgment call, and only experience will teach you whether the litigation is merely a cost of doing business. For instance, an automobile dealer might be in court regularly as a result of customer dissatisfaction. A computer software consultant might not be. But keep in mind that the litigation sword cuts many ways. Certainly, the forensic accountant should evaluate whether litigation against the company might have a detrimental impact on its value if the litigation is successful.

Example 6-27. Company X manufactures seat belt fasteners that have failed to function properly in 50 instances over the past three years. Several people have been killed as a result, and a multitude of lawsuits are pending against the company. The problem has been traced to a design defect. According to the company's defense attorney, the lawsuits have merit. Unfortunately, insurance will cover only about 80 percent of the cost.

Is the remaining 20 percent a valid charge to the company? Probably. Is it a one-time charge? Perhaps not. It may be that the company can expect similar lawsuits to be brought for years to come. These are things which you must evaluate.

Conversely, however, perhaps the company has a lawsuit pending against a supplier or competitor. If the case has merit, it might result in a tremendous windfall to the company and, consequently, to its value. This, too, must be evaluated.

Example 6-28. E-Z Tax, Inc. writes and sells software that enables accountants to process complex tax returns in half the usual time. Last year, it was discovered that its competitor, Slee-Z Tax, Inc. has copied important parts of its program, which are copyrighted. Slee-Z Tax has racked up sales of \$10,000,000 using E-Z Tax's work. E-Z does what any red-blooded American company would do—it sues!

An evaluation of E-Z's claim shows it to be highly meritorious, and it is anticipated that Slee-Z will be made to surrender its profits. This should be taken into consideration in valuing E-Z.

Lawsuits of this nature should be discussed with the attorney who retained you before you set out to place a value on the company. You may be qualified to form an opinion as to how a successful resolution might impact the company's bottom line, but you cannot do so without all the knowledge available to the attorney. For instance, in certain cases—antitrust litigation comes to mind—treble damages might be awarded by the court. In others, punitive damages might be appropriate. So, even if you calculated that Slee-Z's profits on sales of \$10,000,000 were \$2,000,000, you might not have any way of anticipating whether additional damages might be awarded.

Reviewing legal fee and attorney invoices may also lead to the discovery that the business is looking into new directions (e.g., franchising to other locations), which may initially reduce profits but ultimately increase the business's value.

Depreciation

Depreciation is one of those areas where, clearly, the value of property reported on the balance sheet may not come close to the true value of the asset. Missing this area may result in a gross undervaluation of the company under investigation. Your examination should encompass two possibilities: that fully depreciated property no longer appears on the balance sheet, and that partially depreciated property is worth more than it appears to be worth.

Fully Depreciated Assets

Assets that have been depreciated fully for tax purposes may no longer appear as assets in the company's financial records. But that does not mean that they do not have value, even if it is only salvage value. The question, of course, is how you investigate assets that no longer appear on the balance sheet.

Example 6–29. Bill owns a book bindery. Ten years ago he purchased a heavy-duty binding system, which, by now, is fully depreciated. It does not appear on the company's balance sheet. Salvage value is similarly unaccounted for. Nevertheless, many ways of finding out about this property exist.

First, a physical inventory of the premises will probably disclose its existence, unless it has been moved off the premises prior to your visit—an unlikely scenario most of the time, either because such machinery will be too large to move, or because the business owner often will not think along such deceitful lines.

Second, you might have discovered its existence in your initial review of insurance documents. As pointed out previously, even fully depreciated assets are usually insured against casualty loss.

Third, you might have deduced its existence. A book bindery cannot operate without equipment to bind books! If such equipment is unaccounted for, chances are great that it does, nevertheless, exist.

To get an idea of what might constitute tools of the trade in any business, try to get a hold of a supply catalog for that business. It will tell you what you might expect to find. While this is not a flawless method of preparation for your investigation, it will give you a better feel for your subject.

Real Estate

If the company owns real estate, it is very likely that the value reflected on the company's books, as depreciated, is not the true market value. (Even if buildings are fully depreciated, remember that they still have value, as does the land they stand on.) Working in conjunction with a real estate appraiser, an adjustment should be made for purposes of the divorce valuation to reflect the actual value of any real estate. Often, the property will have actually increased in value since its purchase.

On-Site Inspections

This chapter has made several references to examination of the physical location of a business under investigation. A few words need to be said about this, and about how important it is to gain access to the physical plant if at all possible.

For several reasons, you may wish to conduct your examination of the books and records of the business right on site. This may help to give you a better understanding of the plant, layout, and workings of the company. As you might well appreciate, seeing numbers on a piece of paper and then comparing them with your own observations—relying upon your own senses to tell you the actual possibilities—may be like the difference between day and night.

Example 6–30. Peter Parker owns a parking lot adjacent to a very busy railroad station in a suburb of Metropolis. You have investigated the deed to the property, which lists it as half an acre but, being a city slicker, you have no clue how large that is. You have also investigated his income reports for the past year and have found that Peter reports leasing daily parking space to an average of 100 cars per day, five days per week. The numbers are fairly consistent, as you might expect of a parking lot adjacent to a railroad station.

When you visit the site, however, you are amazed to learn that one-half acre will accommodate about 150 cars, and Peter's lot is absolutely packed. It appears that he has been underreporting his income by one-third. Would you ever have known this without visiting the lot itself?

The importance of an on-site visit is apparent in countless other ways. For instance, it might disclose how many employees there really are and, particularly if you are concerned about a no-show lover, it might serve to confirm your suspicions. For instance, you might make discreet inquiries about the person. Or you might bring up the suspected no-show in passing conversation. Even if employees have been warned of your impending visit and asked not to speak with you, it is probably the rare business owner who will confide his marital difficulties to all of his employees. As a result, they might not realize that your passing pleasantries are actually a fact-finding mission.

Even seemingly innocuous questions can be fruitful to your investigation, as the following example shows.

Example 6-31. You believe that a particular individual for whom paychecks are routinely issued is, in actuality, a no-show employee (either the owner's lover or a family member whose salary is intended to remove funds from the company). So you innocently ask someone where that person's office is and are greeted with a blank stare. "Michael who?" is the answer. It is a good bet that "Michael Who" is, in fact, a no-show.

Or, rather than a blank stare, you might even get a look of amusement from the employee—who knows that the owner's lover is on the payroll and who now suspects (or even delights in the fact) that you are looking into that possibility.

Example 6-31 illustrates only the opening salvo. If you don't receive a satisfactory answer, you can broaden your query. For instance, you can ask employees directly: "When was the last time that you saw Michael?" or "How often does he show up here?"

A physical inspection is important for more reasons than finding no-show employees. If inventory is kept on the premises, you may be able, either directly or clandestinely, to make a physical count and compare it with reported inventory. Being on-site will also provide you with the opportunity to discover items that you may have missed in the shuffle of paperwork.

Example 6-32. Paulette's printing company reports owning a four-color printing press and bindery equipment, both of which appear to have been disclosed on the balance sheet and in insurance documents. While visiting the plant, however, you notice that there are actually two printing presses on the premises, both chugging away at full speed. It turns out that the second press—a black-ink-only behemoth—was fully depreciated several years ago, and you simply missed the fact that it was covered under the insurance policy, which you had investigated. You can now add the value of that press into the business.

As an aside, this discovery might lead to other answers. For instance, it might now explain why more black ink than colored ink had been ordered by the company. This fact had been a mystery to your printing expert, who swore up and down that a four-color press uses roughly equal amounts of black, cyan, magenta, and yellow inks in creating full-color printing. You begin to realize, as you analyze invoices more carefully now, that some of the jobs being run on the black-ink-only press seem not to have been paid for. Or were they, but in cash? Or were they siphoned off into another bank account? The inquiry has now taken a different turn, has it not?

A physical examination of the premises can also give you an idea of customer traffic. For instance, if a deli owner claims to serve only 100 customers per day, are there actually 200 walking in and out of the store each day? This type of investigation will be covered in greater detail in chapter 6, where the problem of cash businesses is discussed. The point is that seeing adds a whole new (and very valuable) dimension to your investigation.

The biggest obstacle to conducting an on-site examination will be the subject's objection. Most often the owner will claim that having you on the premises will cause a disruption. Usually, that is merely an excuse for not having you anywhere near the premises precisely because the business owner is wondering what it is that you might discover (or, conversely, what it is he will have to go back and temporarily conceal).

The best way to overcome this objection is to defuse it. Ask, for example, whether the business's own accountant does not come by every few months to do the quarterly books. If so, where does the company put him or her? You will not require much more room than that, you assure the owner. Even if their accountant does not make house calls, you may still stress that you will not take up much space. Try to convince the owner that it will be actually more convenient for him or her because should other material or information be needed, it will usually be at the owner's fingertips. Isn't it quicker to have the papers pulled immediately, investigated then and there, and returned to their correct place? Isn't it neater than risking that weeks later, after they have been pulled, sent to the owner's lawyer, copied, and then returned, the papers will be misfiled? And what if the originals are later requested, as is the right of the parties to do? This will require a second round of pulling, sending, copying, and filing. And, of course, there is the issue of safety. These are the owner's original documents, and he should not risk having them lost in transit, right?

With all of these benefits, isn't it logical that an on-site inspection—"and I really, really promise to bring my lunch and keep quiet and out of your way"—is preferable? What's an owner to say now?

Summary

- Certain categories of a company's expenses should be scrutinized carefully. They are subject to abuse or even innocent miscategorization. In either case, improper charges should be adjusted for so that the company's true financial health is correctly reflected.
- Make it a point to identify the parties in certain categories, such as employment (no-show or family employees), insurance (who is covered), and rental (is it a sweetheart deal with a family member). Any category that might comfortably fit a related or friendly party may be a category ripe for abuse.
- If the company uses the LIFO inventory method, consider adjusting it to FIFO to more accurately reflect the inventory's worth.
- Assets that have been fully depreciated or expensed may have value that is not reflected on the company's books. Adjustments should be made to reflect this fact as well.
- Analyze nonrecurring items (moving expenses, a one-time contract, a disruption in business) carefully whether they are in your favor or not. An adjustment for either such event is warranted as well.
- An on-site inspection is often very helpful in gaining a better understanding of the business.

Case Study

Company B manufactures brass bugles under the name of "Boogie Woogie Bugles." The company is 100 percent owned by Bill Bailey (the defendant in a matrimonial suit).

Company B reported sales of \$3,000,000 this past year and, after subtracting \$1,900,000 as the cost of goods sold, the company's gross profit is \$1,100,000. Additional expenses (including salaries, advertising and marketing, rent, utilities, shipping, etc.) are given as \$1,200,000, leaving the company with a net loss of \$100,000 for the year. Naturally, this does not bode well for the plaintiff's (your client's) marital property division.

The plaintiff's attorney has requested certain documents in the discovery phase of the litigation. Among the documents you have received in response to this request is Company B's financial statement. After reviewing the financial statement and other documents received, you discover the following.

- *Automobile expense.* The company writes off two automobiles, one for the owner and one for the owner's college age daughter from a prior marriage. The former, for which the company pays \$400 per month in leasing charges, \$200 per month in auto insurance, and \$100 of miscellaneous expenses, is used 75 percent of the time for Bill's commuting and other personal errands. His daughter's car costs the company \$500 per month.
- *Insurance.* In addition to the automobile insurance, Company B also pays the annual premium for medical insurance for Bill (\$3,000), Bill's parents (\$2,000 each), and, in addition, pays for Bill's life insurance (\$5,000 per year). His beneficiary is his daughter.
- *Bill's salary.* Bill pays himself quite handsomely—or at least he does this year. He grosses \$100,000 per year in salary and an additional \$50,000 of bonus. This is double what he has taken home in prior years and is also approximately \$50,000 greater (in total) than most similarly situated bugle manufacturers.
- *Employee salaries.* Employee salaries do not appear out of the ordinary except for one: Bill's mother is on the payroll to the tune of \$50,000 per year. Her duties are bookkeeper/filing clerk. You learn also that Bill's mother works only one day per week, and only in the morning at that.
- *Conventions.* Bill seems to have taken a trip to the National Bugle Manufacturer's Convention this past year. Although this was a legitimate business trip, the convention lasted only two days, while the hotel charges were \$200 per day for eight days.
- *Move to larger space.* Company B moved to a larger space this past year. In examining the lease, you find that Bill entered into an arrangement whereby he is paying \$10 per square foot for 10,000 square feet. Unfortunately for Bill, the average rent in that neighborhood goes for between \$5 and \$7 per square foot. You laugh at how bad a businessman Bill must be . . . until you find out that the landlord is his father.
- *Expensed and depreciated items.* Reviewing the tax returns for the past few years, you find that Company B has expensed most of its purchases. For the past two years, it has written off \$17,500 each year as IRC § 179 property, even though the combined properties still have an estimated value of \$30,000. In addition, some of the larger purchases have used accelerated depreciation methods. In fact—and excluding the property just discussed—Company B has depreciated \$200,000 of equipment down to \$50,000, even though the true value is closer to \$150,000. The estimated excess depreciation for this year is \$20,000.
- *Inventory.* You also discover that Company B uses the LIFO inventory method. The value of its inventory, therefore, is booked at \$50,000 when, in fact, it is worth \$200,000 under the FIFO method.

Given the previous information, how would you adjust Company B's income and expense statement to reflect the true value of the company?

Here are some ideas.

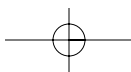
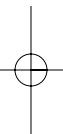
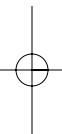
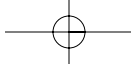
- *Automobile expense.* Absolutely no justification exists for writing off the daughter's automobile expense. This cost, \$6,000 annually, should be added back. Similarly, because 75 percent of Bill's expense is for personal use, three quarters of the cost, \$6,300 ($\$700 \text{ monthly} \times 12 \text{ months} = \$8,400 \times 75 \text{ percent}$) should be added back.
- *Insurance.* Medical insurance for Bill might be viewed as legitimate, particularly if it is a perk given to all salaried employees. However, there is no reason to include Bill's parents (\$4,000 total) in this. Technically, we might be able to justify Bill's mother because she is an employee, but given what we know about her employment—only one day per week—it is certainly arguable that she should be excluded altogether. In addition, Bill's life insurance is a personal cost, so \$5,000 should be added back.

- *Bill's salary.* Bill's salary has obviously been increased to reduce his company's bottom line. The question here is whether it should be adjusted to \$75,000 (where it had been in prior years) or whether, because \$100,000 seems to be the industry standard, it ought to be rolled back to that level. This is a judgment call and perhaps one best left up to the attorney. Counsel might feel that it is worth trying for the larger reduction. If so, then you should be prepared to support both conclusions. For purposes of completing this example, however, we will roll it back only to be in line with other similar executives—\$100,000—and therefore will adjust by only \$50,000.
- *Employee salaries.* Mom isn't worth anywhere near her salary. Assuming that she works 4 hours per week for 50 weeks, her 200 annual hours are probably worth no more than, say, \$2,000. An adjustment of \$48,000 is appropriate.
- *Conventions.* Six days (at \$200 per day) appear to be personal and should be added back.
- *Move to larger space.* We have not addressed the issue of whether the move was necessary or how the moving expenses should be handled (expensed or capitalized). Dealing only with the issue of the overpayment, we should adjust it to reflect the difference between rent paid and the market rate that might have been paid. Assuming that the average market rent is \$6 per square foot (\$60,000) and that Bill pays \$100,000 per year, an adjustment of \$40,000 is warranted.
- *Expensed and depreciated items.* The § 179 property is worth \$30,000 according to the example. This adjustment should clearly be made. In addition, the true value of the depreciated property appears understated by \$100,000 (\$150,000 actual value less \$50,000 book/depreciated value). This adjustment should also be made on the balance sheet. But the income statement will reflect only the \$20,000 of excess depreciation expense.
- *Inventory.* An adjustment from LIFO to FIFO should be made to reflect the true market value of the inventory. This will result in an income increase of \$150,000.

The total adjustment to income may be summarized as follows.

Addition of Bill's personal automobile use	\$ 6,300
Addition of daughter's auto expenses	6,000
Bill's parents' medical insurance	4,000
Bill's life insurance as a personal expense	5,000
Adjustment to change Bill's compensation to "reasonable"	50,000
Excessive salary of Bill's mother	48,000
Personal time before and/or after the convention	1,200
Excess rent costs	40,000
Adjustment for excess depreciation	20,000
Change of inventory from LIFO to FIFO	<u>150,000</u>
Total	\$330,500

Therefore, the adjusted income statement would show a profit of \$230,500, rather than a \$100,000 loss.



7

Beyond the Unallowable and Into the Land of Sham

Introduction

Although many of the categories discussed in the previous chapter are those that are ripe for concealing or “misallocating” expenses, with few exceptions, these categories can contain innocent mistakes. A business owner, for example, might have been motivated by the desire to pay less tax and by the hope that the IRS might either accept or miss the deduction.

In some states, if one spouse commits fraud or breaches his or her fiduciary duty to the other spouse, there can be severe penalties imposed on the deceitful spouse. The penalties may include forfeiture of the property. These are assignments that require the unique skills of forensic accountants.

This chapter concentrates on those areas where a business owner can be best described as “black-hearted”—where the transactions are designed specifically to make the business appear less profitable for the express purpose of depriving a spouse of his or her due. Many times, the spouse experiencing marital misery will begin such steps well before the divorce proceeding is actually commenced, and the forensic accountant should be aware of this fact in that it will affect how far back he or she must begin the investigation.

Some transactions about to be discussed may, indeed, be the result of something other than fraud, and the intent here is not to paint all business owners with the same brush of dishonesty. The purpose is to help the forensic accountant spot those areas where careful scrutiny may be required.

Self-Dealing and Inter-Family Dealings

One way that a business owner can alter the true picture of a business’s worth is through self-dealing or dealing with close family members. For purposes of our discussion, both types of transactions are called “self-dealing.”

Self-dealing involves the creation of a series of transactions that have no economic purpose except to make the company appear less profitable or reduce the apparent ownership percentage. For example, the business owner wishing to inflate the cost of his or her purchases might establish a middleman company that purchases and then resells to the company the product previously purchased directly from the supplier. Accomplishing this is simple: the middleman, owned by the subject of the investigation or by a family member, purchases the supply or product, marks it up accordingly, and then resells it to the business owner. Because the business owner sells the finished product at the same price, profits are reduced.

Example 7-1. Bradley owns an office supply store. Up until the time that the divorce papers were served on him, he purchased his inventory from a number of sources and marked his product up by 100 percent. Thus, for example, if he paid \$500 for a shipment, his customers would purchase it for \$1,000. For argument's sake, his overhead also reduced his profit by \$200, leaving a net profit of \$300 on every \$1,000 sale.

After being sued for divorce, Bradley sets up a corporation, owned by his parents, for the specific purpose of being the middleman in his purchases. The middleman corporation begins buying supplies from Bradley's former vendors, then resells the very same inventory to Bradley's company at a markup of 50 percent. This means that whereas Bradley had previously been paying \$500 for a given shipment, he is now paying—at least on paper—\$750 for the same shipment. If he resells it for \$1,000 and has the same \$200 of overhead expenses, his net profit is reduced to \$50, a substantial decline from the \$300 previously reported. The \$250 of profit will surely find its way back to Bradley after the divorce is finalized.

The same result can be achieved in the opposite way—the business owner can purchase directly from the supplier and sell to the middleman at a discount. The middleman then resells at the normal price, taking a huge chunk of the profit off the books of the subject corporation.

Example 7-2. Tammy is in the furniture-building business. She buys raw materials and turns them into beautiful and expensive items. Her customer base includes some of the biggest department stores in the country. Profits are tremendous—she marks up the finished product by 200 percent over the cost of her labor and materials. A table costing her \$300 is sold to a customer for \$900.

After being served with divorce papers, Tammy creates a dummy corporation, wholly owned by her father, and sells 50 percent of her finished product to it at a markup of only 50 percent. So, where she might previously have received \$900, she now shows income of only \$450. Her profit has fallen from \$600 to \$150 on these items. The dummy corporation, of course, resells the furniture to the usual customers at a markup that produces the same overall \$600 profit. These profits are parked in the dummy corporation until the divorce is finalized.

A particularly devious and greedy person can make this scam work both ways—with a family-controlled middleman on both ends of the equation.

Anyone who thinks that this type of transaction is unusual need only recall the many savings and loan institutions that got into trouble in past years as a result of the fraud by real estate developers that involved the constant exchange of property between related parties and dummy corporations at ever-increasing prices, making it look like property was appreciating in value—so the new owner could get progressively larger loans—when, in fact, there was no economic reality to the transactions.

Identifying such self-dealing is not difficult, but it does require a lot of digging to get to the root of the proof. This is where it is crucial to have the company's records investigated, going back a sufficient period before the divorce. Most business owners do not create such a middleman scheme until it becomes apparent that a part of the value of their business might go to their spouse. Among the things the forensic accountant should investigate are the following.

Sudden Increases in the Cost of Supplies Without a Corresponding Increase in Prices Passed on to the Customer

Sudden is a subjective term; the change could have taken place over the past year or two but will seem apparent when several years' records are laid out. The forensic accountant has to recognize how to analyze the figures, or they may not appear to be out of the ordinary.

Example 7–3. Income and expenses for Company A are as follows.

	2005	2006	2007	2008
Gross income	300,000	330,000	363,000	400,000
Cost of materials	(50,000)	(55,000)	(60,000)	(90,000)
Cost of labor	<u>(20,000)</u>	<u>(22,000)</u>	<u>(24,000)</u>	<u>(26,000)</u>
Profits	230,000	253,000	279,000	284,000

If the forensic accountant looked only at the bottom line, he or she would see only a steady increase in net profits. The accountant might not find this unusual; in fact, he or she might consider this company to be quite profitable. It certainly is that, but the question is whether it is showing the profit that it should be.

A careful study of example 7–3 will show fairly consistent numbers from 2005–2008. Gross income increases by approximately 10 percent each year. Labor costs also increase by 10 percent each year. The cost of materials also increases by 10 percent for the first few years. But in 2008, the year the divorce was filed, it mysteriously shoots up by 50 percent! Why? Certainly the numbers alone do not explain the change, but it should tip off the accountant that further investigation is warranted, particularly because the net income is no longer 77 percent of gross as it was in the previous three years. It could very well be that this business owner has formed a middleman supplier and is skimming profits.

But how does one know that supply costs did not shoot up dramatically? In many instances the forensic accountant may be able to confirm this by research (that is, by checking commodity prices, asking one of the forensic accountant's clients or some other expert familiar with the business, or calling suppliers). Intuition and an understanding of economics might provide the answer as well.

It is illogical for most business owners to suffer large, legitimate rising costs without passing on at least a part of this increase to their customers, especially because most of their competitors would likely be in a similar situation. Because the purpose of this type of middleman arrangement is to decrease profits, however, few business owners have the foresight to make the transaction look plausible by actually raising their prices. In fact, it might be counterproductive to do so. If they raise costs to give the fraud the appearance of economic reality, they may end up losing customers who might take their business to a competitor who has not raised prices.

Note: Not every increase in the cost of materials is attributable to dishonesty, and not every cost can be passed on to consumers. Take, for example, the case where a competing restaurant opens up a few blocks away and the owner of the existing business—the subject of the investigation—must cut costs or offer more for the money to remain in business. This is not an unlikely scenario; even among giants there are occasional product wars, such as McDonald's offering 99¢ Big Macs and Burger King lowering the price of its Whopper to compete. Granted, a huge underwriting by the parent corporation is likely in the previous example, but the principle is the same: There may be outside factors that affect profitability. If this is the case, the subject's accountant or attorney will bring the issue to light. The forensic accountant's goal, at least at this point, is simply to identify possible transactions designed only to decrease profitability for the purpose of depriving the spouse of his or her fair share.

Sudden Decrease in the Gross Income Without a Corresponding Decrease in the Cost of Labor or Supplies

The previous discussion works as well in reverse: If gross income decreases and cannot be explained by an unusual increase in costs, perhaps the finished product is being sold to a middleman for a smaller markup than is usual.

Example 7-4. Income and expenses for Company A are as follows.

	2005	2006	2007	2008
Gross income	300,000	330,000	363,000	370,000
Cost of materials	(50,000)	(55,000)	(60,000)	(65,000)
Cost of labor	<u>(20,000)</u>	<u>(22,000)</u>	<u>(24,000)</u>	<u>(26,000)</u>
Profits	230,000	253,000	279,000	279,000

In the example, it again appears as if everything is normal. The cost of materials and labor is rising at a steady 10 percent, and the company is profitable, even though there has been no increase in net profits from 2007–2008. Given these facts, does it not appear unusual that gross income for 2008 is not 10 percent higher than for 2007? What exactly has changed? If there has been a price war, the gross income might be expected to be higher; it is the net profits that should be lower. Why is it that, suddenly, this company is not as profitable as it was even though the cost of materials and labor is steady?

Before jumping to the conclusion that a middleman is involved, it is wise to eliminate other possible explanations. For instance, in this example there is one thing not yet considered—inventory. Perhaps the decrease in sales is a result of an economic slowdown or price-cutting to prevent loss of a large customer. In that case, the low sales might be reflected in higher than normal inventory—also a company asset. However, if they are not explained by inventory but, rather, by a decrease (or lack of increase) in the actual sale price of the product, the forensic accountant should investigate more carefully for a middleman.

Sudden Appearance of New Suppliers or New Customers

Once the forensic accountant has narrowed the possibilities and suspects that a middleman has been used to decrease profitability, how does he or she go about proving this? Perhaps the first thing is to identify new sources of supply or new customers. Second, the forensic accountant should determine whether the terms on which business is conducted with these new sources roughly duplicates the dealings with other suppliers or customers, and whether there is a rational economic business reason for this. Finally, the forensic accountant should determine whether these new vendors or customers merely replace existing ones.

Example 7-5. From at least 2005 (that is as far back as the available records go) until roughly January 2008, Yummy Cookie Co. purchased all of its baking supplies from Baker's Buddy, Inc. On average, Yummy spent \$1,000 per month for these supplies. In February 2008, approximately six weeks after the owner of Yummy was sued for divorce by his wife, the purchases from Baker's stopped, and they were replaced by purchases from Budget Buster Bakery Service. Invoices—which have been matched to checks—show that Yummy is now spending approximately \$1,500 per month for the very same supplies. The forensic accountant is suspicious.

In a case such as this, first attempt to find out a bit more about Budget Buster. Some of the investigation may be undertaken by the forensic accountant; other parts may need to be undertaken by the attorney. Among the steps that the forensic accountant might take are the following.

- Investigate the new supplier's invoice for an address and telephone number. A phone call is necessary to see whether the number is a legitimate business or only someone's personal telephone. If the caller reaches an answering machine, did he or she get a business message: "Hi . . . this is Budget Buster Bakery . . . we're not in right now?" Or was it a message likely found on home machines? "Hi. We're not home and the dog hasn't learned to answer the phone yet."

- Someone—the forensic accountant, the attorney, or an investigator—should drive by the business address. Is it a residence address? A mail drop?
- Is there a listing for the company in the telephone directory?
- The attorney may wish to investigate whether Budget Buster is incorporated. If so, who is the owner? If not incorporated, has an assumed name certificate (John Smith, doing business as “Budget Buster Bakery Supplies”) been filed with the appropriate governmental agency?
- At some point, the attorney may even wish to request (or subpoena if necessary) from Baker’s Buddy, the original supplier, information on whether it has sold any supplies directly to Budget Buster which, in turn, marked up those supplies for resale to Yummy.
- Checks from Yummy to Budget will show where Budget maintains its bank accounts. A subpoena of those records may reveal a bit about Budget’s ownership.

New Customers Immediately Replacing Nearly Identical Old Ones

Normally, when a business gains a new customer, it is a reason to be happy. When the new customer materializes shortly before or very soon after the matrimonial action is commenced, however, it may indicate something else. The forensic investigator must be ever vigilant in identifying the impact of such new customers because they may very well be entities belonging to friends or family members. (The same holds true of new vendors.)

One of the most important questions to ask when examining new customers is simply this: Are sales to this person or company in addition to those of other customers, or did they (almost immediately) replace existing sales that were nearly identical? One way to satisfy any curiosity about the economic reality of this coincidence is to contact the old customer and ask why they left. The forensic accountant may find that they were asked to purchase their product from a different company—a middleman—for a short time.

Example 7–6. From at least 1998 through the date that divorce papers were filed, Mary’s Tool & Die Co. sold its product to between 10 and 15 steady customers who used her product in their own manufacturing processes. Every few years, Mary might pick up another customer, and maybe lose one, but the customer base was fairly steady and predictable, and the net profits (except for periods of recession when nobody was buying anything) were also fairly steady at 25 percent of gross sales.

One month after the divorce was filed, Mary picked up a new customer, which now accounted for roughly 40 percent of her sales, but her net income has fallen to a mere 5 percent of sales. The forensic accountant also notices that, mysteriously, 40 percent of her existing customers are no longer placing orders. For some unexplained reason—at least Mary shrugs and claims not to be able to explain it—these loyal customers have just stopped purchasing from Mary’s Tool & Die. The forensic accountant is suspicious.

The coincidences presented by this scenario are too juicy to pass up. It seems likely that Mary has set up a middleman and has requested that her long-standing customers purchase from it rather than from her. Their price will be the same, she assures them, as she diverts the profits of Mary’s Tool & Die to this new company. But how to prove it?

The investigation is the same as previously discussed. The forensic accountant should find out all possible about this new company, by checking telephone listings, addresses, and governmental filings for ownership and assumed names. The old customers also could be a good source for determining whether they are purchasing from the new company, so the attorney may subpoena the records of this new company to aid in the investigation. Also, the forensic accountant should check the utility bills for the shop. The electrical bills should have declined if the sales have declined. Raw tool stock would be another indicator or production activity.

However, not all sales at greatly reduced profits are fraudulent, and other possibilities must, in all fairness, be eliminated. For instance, it is a fact of life in the business world that companies with great sales also wield great purchasing clout. The following example shows what such clout might mean.

Example 7-7. Wohl-Mart, one of the country's largest retail outlets, has approached Will Whatchit for the purchase of his patented, battery-operated "Whatchamacallit." Normally, Will wholesales these for \$10.00 each, and his cost is \$5.00 apiece. His wholesale customers will normally retail them for \$19.95.

The Wohl-Mart representative tells Will that he will buy 100,000 of them—but only if Will sells them at \$6.00 each. "Take it or leave it," says the Wohl-Mart representative.

To fulfill this contract, Will concludes that he will need to put his employees on overtime, further cutting into his profit margin. But even at 50¢ profit per piece, he still stands to make \$50,000 from the deal. Will agrees.

Upon investigation, the forensic accountant notices that what has previously been a \$5.00 profit item now is being sold at a "mere" 50¢ profit. He is suspicious. A further explanation—supported by documentation and the cut-throat reputation of Wohl-Mart—convinces the investigator that nothing is amiss here.

Investigation of Receivables, Payables, and the Like

Accounts Receivable

Accounts receivable are another possible area where skilled tampering may have quite an impact on the apparent profitability of a company. In the context of this section, *receivables* refers to any earned, but not yet received amounts, whether the method of accounting is cash or accrual basis.

The inquiry begins with the investigator's determination of whether receivables have increased inexplicably or whether a large number of receivables at any given time is just a fact of life for the particular business under scrutiny. If such receivables are a recent occurrence, this must be explored.

It is not unheard of for a business owner to defer customer billing, or even to make a call to customers with the suggestion that the bill not be paid just yet, and with the promise that there will be no repercussions for this. Of course, a business owner extending such an offer risks the possibility that the bill may never be paid. Perhaps that is a worthwhile risk for better customers, particularly when measured against the near certainty of loss in the divorce proceeding.

It is even easier for professionals who charge for their time or services to defer billing; in fact, in some cases, it may be nearly impossible to discover without the most thorough of investigations, and the forensic accountant may have to become a virtual attack dog to root out the owner's dishonesty.

Example 7-8. Leonard Lawless, Esq. is a sole practitioner whose clientele primarily comprises small business owners—about 30 of them—who entrust him with a wide range of corporate matters, from annual corporate filings and defending clients against citations and fines occasioned by minor violations, to litigating contract disputes and collecting their unpaid accounts receivable.

Leonard's clientele is steady, and he bills them primarily on an hourly fee basis, although some matters, notably the account collection work, he handles on a contingent fee basis. (He collects a portion of what he recovers.) On average, Leonard bills 25 hours per week at \$200 per hour. His income from collection work is about \$2,000 per month. He sends bills out on the first of every month. His billing is usually steady at about \$25,000 per month. Assuming a 20 percent rate of late payment, he still manages to collect about \$20,000 per month—until his wife serves him with divorce papers.

At this point, the forensic accountant notices that billings become slightly lower (\$20,000 per month). Amazingly, his clients are not paying their bills regularly anymore. Income falls to \$10,000 per month. Leonard can offer no explanation. He is as amazed as the forensic accountant! What to make of all this?

Leonard appears smart enough to know that if he withheld his billing, no judge would believe his explanation that business has suddenly fallen off by 50 percent. Much too coincidental. So he continues to send out his bills. But payment by his clients is out of his control, isn't it?

Then again, what are the probabilities that each of his 30 clients has fallen on hard times at the very moment of his divorce? Not very likely. It seems obvious that Leonard has called his clients and instructed them to withhold payment. Any other explanation would appear contrived. And if the forensic accountant tried to call Leonard's clients to discuss the matter, they might hide behind the shield of "attorney-client privilege" (which Leonard has asked them to invoke, but which would fail in a court of law because Leonard's actions and the investigation of them have nothing to do with matters discussed in preparation of the client's case).

Keeping in mind that Leonard's actions probably began shortly after the divorce action was filed and that an investigation of his books took place many months later, the forensic accountant should investigate the work that Leonard undertook on behalf of nonpaying clients after they began their slow payment or nonpayment. If Leonard stopped performing services for a client who did not pay his or her bill—very understandable—perhaps this is a legitimate deadbeat. If Leonard, however, continued performing services for this client—something that might be discovered when the attorney requested an accounting of Leonard's time over the past months—the forensic accountant might gather that Leonard was engaged in the deferral of his billings.

Other things could explain the lack of income, such as the following.

- The client has paid in cash.
- The client has paid a third party—perhaps another attorney, who will later forward the money to Leonard as counsel fees.
- Leonard may have parked the fees in his escrow account. This is a particularly good place to look for fees when investigating attorneys.

Each of these should be investigated and eliminated as a possibility. It may be helpful to subpoena the deposit records and compare the date on the check to the date it was deposited by the lawyer. This would disclose and quantify the delay in depositing the client's check.

In general, accounts receivable should be investigated carefully for a pattern that has emerged too conveniently parallel to the divorce proceedings and cannot be explained by a mere business decline.

Accounts Payable

Even a business category as seemingly legitimate as accounts payable must be carefully scrutinized. It does not take much effort to create a fictitious account payable. All that it requires is a family member willing to receive the payment. All accounts payable (and all accounts paid) should be investigated carefully to determine their economic reality. For example, the forensic accountant's query might focus on the following issues.

- How long has this account existed? Is it a fairly new supplier? Exactly what has payment been made for? If payment is made to a supplier, does it replace a previous supplier? Why? Was there some falling out? Did the old supplier cease doing business? Or could it be that the new supplier is a middleman, as discussed previously? Is the payment to the new supplier out of line with what the company might expect to pay for supplies or may have paid to the predecessor supplier? This, too, may indicate a middleman. Is the supplier in the phone book?
- Is payment to a family member or to a related company? If payment is for rent or services, are they at fair market value? Again, investigate the economic viability.

Example 7–9. Shortly after receiving his divorce papers, Carl hires his father as a “consultant” and pays him \$50,000 per year for a few days’ work. This is a clear area for income readjustment.

- If an account payable is to a long-time vendor, could it be that the bill has, in fact, been paid in cash but kept open on the company’s books to decrease the value of the company?

Example 7–10. Bill owns a delicatessen. Half of his invoices for cold cuts are paid in cash. Nevertheless, Bill keeps the invoices classified as “payables,” reducing the apparent profitability of his deli.

- If payment is to a legitimate vendor, does the purchased item appear on the premises, or can it be accounted for?

Example 7–11. Joe buys a dining room set, purportedly for the company cafeteria. However, the forensic accountant discovers, upon visiting the premises, that no company cafeteria exists. Where is the furniture?

- Does the quantity of finished product manufactured by the business match the inventory plus reported purchases?

Example 7–12. James owns “Don’t Tread on Me,” a tire retailer and wheel balancing operation. During the year, according to his invoices, James purchased 500 steel belted radials from a legitimate supplier. However, upon further investigation, the forensic accountant finds that James can account for sales of only 350 of those tires, although his physical inventory discloses the presence of 50 more. What happened to the remaining 100 tires?

This discrepancy might lead to an investigation of two possibilities: James either had unreported cash sales to customers, or he unloaded the spare tires (no pun intended) to another dealer for cash or other services.

Notes Receivable

A note receivable may seem simple to deal with because it is an admitted business asset. As is true of everything discussed in this book, however, looks can be deceiving. A careful investigation of notes receivable will not only help determine whether there are any dishonest dealings, but also find legitimate action that may aid in any valuation of the company or in a discovery of other secreted personal assets.


Notes receivable likely fall into three categories, including the following.

- Those given in connection with the sale of part of the business.
- Those given to evidence a loan to a shareholder.
- Those to third parties for some other reason.

In chapter 6, example 6–15 discussed the case of Two Stooges, Inc. and how the purchase by one partner of the other partner’s interest could affect the valuation of the business. Certainly if two parties acting at arm’s length value a business at a certain price, the party being investigated—assuming that he or she is the recipient of the purchase price—will have a hard time convincing a court that the value is lower than that stated in the notes and in the underlying contract for sale. In other words, determining the value of notes receivable resulting from an arm’s length transaction is not a problem. The forensic accountant’s client may not necessarily be bound by the terms of the transaction if the investigation discloses that the purchaser is a related party (parent or sibling, for instance). Arguably, the transaction was not arm’s length and may need to be reevaluated accordingly.

Example 7–13. Shortly before a divorce action is commenced, Ted, knowing that such an action was imminent, contracted to sell 50 percent of his business (which might otherwise be found to be worth \$600,000) to his brother, Ed, in return for a series of promissory notes totaling \$200,000, payable over a 20-year period at 5 percent interest.

In this case, the business has obviously been undervalued for purposes of the sale. In addition, the payment period and interest rate seem unusually generous. Obviously this transaction is ripe for challenge and would likely either be set aside or ignored by the court in determining the other spouse's rights.

 **Tip:** The forensic accountant should also determine whether the notes are, in fact, being paid. So, for instance, in the above example, if Ted's brother had not made a single payment, the forensic accountant's conclusion—and a court's conclusion—will certainly be that this transaction was a sham.

One might be amazed at the number of otherwise intelligent people who believe that if something is in writing, it is binding for all purposes. Not true. A court will determine the rights of the parties relative to each other. For instance, the contract entered into between Ted and Ed in example 7–13 would bind Ted in the event that his brother sought to enforce it (that is, Ted believed that Ed was trustworthy but, in reality, Ed is out to take advantage of him). However, as between Ted and his wife, who is not a party to this sibling transaction, a court could—and probably would—find that Ted's business was worth more and that he engaged in a sham transaction, and would make fair provisions for his wife despite his efforts to the contrary.

Regardless of the fairness issue in the valuation of the transaction, investigating the payment on the notes may also aid in uncovering undisclosed personal assets. This will often occur when the business owner, rather than the company, is the recipient of the payments. By tracking where the payments were deposited, the forensic accountant might find an undisclosed source of income.

Example 7–14. Ted deposits each of Ed's payments into an account in his own name. This account has not previously been disclosed to his wife or to her attorney. The accountant now has found another avenue to explore.

Finally, notes may be related to sales contracts. These contracts are sometimes split into sale of a business interest, intangible interest, and covenants not to compete. Allocation of value between these different agreements should be considered when valuing notes.

Loans to Shareholders

If the note is payable to the business as a result of a loan to a shareholder, clearly it is an asset of the company. Again, the loan should be evaluated for the fairness of the interest rate and other terms and, if not economically viable (that is, if the company would not have given similar terms to a stranger), the difference must be considered in valuing the company.

In addition, one must never forget to “follow the money.” As described several times now, this could lead to the discovery of assets or other facts not previously disclosed to the forensic accountant's client's side.

Loans to Others

Notes receivable can come from other parties as well. For instance, the business owner may have agreed to lend money to her sister on terms more favorable than she otherwise could have obtained in an arm's length transaction. These should be evaluated in the same way as any other transaction: How does the diminished return affect the business, both from the point of view of lost direct income (for example, the three percent loan to a sibling is less than a certificate of deposit would have yielded) and of the indirect loss caused by the inability to use the money to generate more business?

Notes Payable

As was true of accounts payable, notes payable is another area for possible abuse and, therefore, careful investigation. Notes payable, after all, are liabilities that reduce the value of the company. The forensic accountant's investigation of notes payable by the company should encompass the following inquiries.

- Is there “legal consideration” supporting the note—that is, has there been some value received by the company in return for its promise to repay the loan? After all, just as an account payable may be fabricated, so too may a note payable.
- What was the note for? Specifically, what was the money used for? If used to expand the business, can all funds be accounted for? If not, they need to be traced carefully.
- Who is liable on the note? Is the company alone at risk, or is the owner-borrower a guarantor? Third parties dealing at arm's length will very often require a personal guarantee by an individual, particularly where the borrower is a corporation. Family members might not be so concerned.
- What are the terms of the note? Are they favorable to the business owner and unfavorable to the company, reducing its value? Are they favorable to the lender?
- Naturally, the forensic accountant should inquire about the identity of the lender and any relationship to the borrower. A loan by family members to a business, on terms generous to that family member, may be a convenient way of providing income for a parent or other relative, while at the same time decreasing the apparent profitability and value of the company.

Example 7–15. Edward borrows \$50,000 from his parents at the annual interest rate of 20 percent. Because his business is highly successful, any bank would be happy to lend him those same funds at 10 percent. The additional 10 percent of interest is one way Edward can support his parents without placing them on his payroll. Nevertheless, the excess interest payments should be added back to the company's income.

- To whom did the money actually go? Was it to the business or to the owner personally? If it went to the owner, the forensic accountant should adjust the income statement accordingly because this constitutes (at the very least) additional compensation to the extent that the company pays the interest and principal.

Other Areas to Investigate: Multiple Bank Accounts, Reason for Business Income Decline

Multiple Bank Accounts and Their Abuse

Chapter 3 mentioned the importance of examining the bank records of a company and issued this caveat: Make sure that statements and checks have been produced from all bank accounts.

No law prohibits a company from keeping more than one bank account, and there may be a number of legitimate reasons for doing so. For instance, attorneys are required to keep separate accounts to segregate their earned income from client funds held in escrow. Even legitimate accounts may contain hints of illegitimate activity. For instance, the attorney escrow account may be a convenient place to temporarily park income.

Example 7–16. Attorney Able, a highly successful personal injury attorney, has recently settled a lawsuit on behalf of her client, Baker, for \$150,000. Baker's agreement with Able calls for a one-third contingent fee to be paid upon conclusion of the matter. An investigation of the escrow account shows that Baker has been paid \$97,500 (the remaining \$2,500 presumably being reimbursement for Able's out-of-pocket expenses), but \$52,500 still remains in the account. It is a good bet that this money should have been booked as income by the attorney who, instead, is merely parking it in escrow until the matrimonial storm blows over.

A variation on the practice of keeping earned income in escrow accounts longer than necessary is the deposit of income directly into escrow rather than into the office account.


Example 7–17. Attorney Abel receives payment of \$5,000 from client Baker for services performed. Rather than deposit these earned fees into the office account, they are deposited into escrow under the heading “Baker, real estate down payment.” But Baker has no pending real estate deal.

Playing these games is a disbarable offense, so an attorney has to be particularly brazen to do so. Some do anyway. Courts have a special fondness for attorneys who do this. Quick and favorable settlement negotiations might follow the uncovering of such a scheme.

The forensic accountant should confirm all escrow holdings. If the attorney claims that the money is a down payment on real estate (in which case it must be held until title passes), the transaction should be confirmed. The forensic accountant may do so by requesting a copy of the contract for sale and contacting one of the parties or, better yet, the broker, to confirm the listing and the sale.

Note: Not all escrow funds belong to a third party, as in the case of a real estate transaction. There are matters in which an attorney might collect a sizable advance retainer but hold it in escrow until the fee is earned. If the entire amount is not earned, it still belongs to the client.

Example 7–18. Attorney Abel is retained by Denise Delta to defend her in a breach of contract action. Able estimates that the cost of this defense will be \$10,000 and requests a retainer of \$5,000 which, she promises Delta, will be held in escrow and released only as earned or as necessary for the payment of expenses for her defense. Because Delta has the ability to discharge Abel at any time, the unearned portion of this retainer still belongs to Delta and is properly in escrow. However, as Abel earns her fee, she should withdraw the appropriate amount from the escrow and deposit it into her office account.

 **Tip:** Whereas escrow accounts are most often associated with attorneys, collateral or security accounts are involved in other types of businesses also. Rental real estate and franchises such as gasoline dealers also maintain escrow or security. The forensic accountant should always ask whether any such accounts exist, regardless of which side of the business he or she is investigating.

Example 7–19. The forensic accountant is investigating Leona, who is in the residential real estate business. In fact, she owns three huge apartment buildings. Undoubtedly there is a separate bank account to hold tenant security deposits. The forensic accountant should review that account to determine whether Leona has deposited any rent checks into that account.

Example 7–20. The forensic accountant is investigating Wendy, the owner of a fast food franchise. Although she does not have an escrow account, the accountant should inquire about whether she has had to place any funds on deposit with the franchiser to secure her performance. The forensic accountant may find that there is such a security account credited to her on the books of the parent company, which, for some reason, has fallen off the books of Wendy’s franchise!


Escrow is not the only type of legitimate secondary account. Many medium-sized businesses, particularly those that use an independent payroll service, maintain a separate account for periodic deposits for use in meeting payroll obligations.

Example 7–21. Bill, the owner of Bill’s Bells, Inc. maintains separate accounts for operating expenses and for payroll. The payroll account is handled by an outside payroll company. Every two weeks, Bill is required to deposit an amount sufficient to cover his payroll as well as any taxes due—\$5,000 in his case. Bill does so, of course.

Even such a legitimate account may be used by the crafty business owner for nefarious purposes; see the following example.

Example 7–22. Right after he is served with divorce papers, Bill sees (or seizes) an opportunity to divert income: Rather than deposit \$5,000 into the payroll account held by the bank, he adds \$1,000 each pay period for good measure. His intent is to temporarily park these funds in his payroll account to make it seem like employee expenses or taxes are higher than they really are.

Naturally, all such accounts should be investigated carefully, and the forensic accountant should determine whether a larger-than-necessary amount is being transferred into them.

 **Tip:** Payroll or escrow accounts are not the only types of secondary accounts. The business may simply have another interest-bearing bank or money market account for parking excess funds not needed in the day-to-day operations. The forensic accountant should ask to see all bank accounts in the company's name and match them up to 1099s reported on the company's annual tax return.

Income Squeeze: Turning Off the Income Spigot

Suppose a business owner temporarily wanted to turn off the income spigot, knowing full well that he or she could turn it back on after the divorce becomes finalized. How would it be done? Understanding the way that certain businesses generate customers and sales, and recognizing some of the methods by which these sales can be slowed, is crucial to any investigation.

Some businesses have a steady repeat customer base that might purchase the entire output of the company. A food product delivery route is one such example. The only way to grow such a company operating at peak capacity is to expand it. The decision, however, about the size of the company that the owner wants to run is made by him or her, and is not usually a proper subject for speculation in valuing the existing company.

Example 7–23. Frank Furter operates a cold cut distributorship, and he has all the customers he could hope to accommodate with his two delivery trucks. Although his product is genuinely superior to that of his competitors, and he could probably grow the company to double its size in less than a year, Frank prefers not to be burdened with this headache. It is not proper to value the company at twice its size because the decision as to whether he wishes to work himself to death is Frank's alone.

On the other hand, there are companies that must consistently generate new clients to survive. An automobile dealer needs to constantly advertise to bring in new customers because the overwhelming majority of people do not buy a car every year. By the time they are ready to buy a new one, they must be reminded that the dealership is still around.

One way to cause a temporary decline in income in such businesses is simply to reduce the advertising budget. No advertising, no customers. Without customers, the business is worth less, right? As a result, advertising budgets and other such business-generating mechanisms must be investigated to determine whether there is a legitimate business purpose for the decrease in business. If the business has been in decline and the advertising budget has legitimately trimmed a massive ad blitz because the business cannot afford it, this is one thing; but if business has been good, and a correlation can be made between advertising dollars spent and income generated, then the forensic accountant might be able to adjust for this. Then let the attorney argue that the business owner has been attempting to temporarily lower the value of the company through this underhanded technique.

Example 7–24. During the past three years, Company X has consistently advertised in a particular medium and has just as consistently generated \$100 of sales for each \$20 spent on its advertising. For instance, if the company spent \$200 per week for a local newspaper ad, its revenues for that week were \$1,000. If it boosted its advertising to \$300, the revenues rose to \$1,500, and if it lowered its advertising to \$100 per week, it generated only \$500 of sales.

The forensic accountant notices that the company has raised its advertising budget annually, no doubt because the owner has noticed the same pattern. Company X now spends \$500 per week on advertising and generates \$2,500 in sales.

All of a sudden, after the divorce papers are served, the budget for advertising shrinks back to \$100 per week with a corresponding drop in revenue. The accountant might conclude, absent another satisfactory explanation, that this is an intentional attempt to lower revenue and, thus, the value of the business.

Bad Debts and Spoilage

Bad Debts

Bad debts, like uncollected accounts receivable, also require a careful investigation. While a certain amount of bad debt might be expected in any business, a large increase may be explained by means other than an economic downturn. Some of the more important questions to ask include the following.

- If there are any bad debts, is this a long-standing pattern or a more recent one?
- Have a larger number of accounts been written off as uncollectible recently?
- What is the industry standard for payment—or writing off—accounts receivable?
- Has the business owner continued to supply the alleged deadbeat?
- Is it possible that the debts have been paid off—in cash or to a middleman?

Naturally, if a large number of bad debts materialize overnight, at least relative to the date of the filing of the divorce action (or when it became apparent that such an action was imminent), the forensic accountant should be suspicious.

If bad debts are truly a significant cost of doing business in this particular industry, at some point the deadbeat client is no longer a client. Just as in the case of Lenny Lawless, Esq., who would have stopped performing services for a nonpaying client, it is unusual (to say the least) for a business owner to keep racking up losses to a nonpaying customer. So if the customer is still a customer, despite repeated bad debt write-offs, the forensic accountant must determine why this is so. As outlined above, the reason may be that payment was made—either in the form of cash or by payment to a third party—and the business owner simply pocketed the payment while accounting for it in the bad debt column. The forensic accountant should pay particular attention to cash businesses, as the following example indicates.

Example 7–25. Frank owns a delivery route for Pig’s Feet Brand deli products—cold cuts and the like. Experience and common sense dictate that it is probable that he is paid by deli owners in cash at least part of the time.

Frank’s books reflect six sizable bad debt deductions attributed to one of his customers, A-1 Deli, within the past three months. Could this really be?

Logically, if a particular customer has caused Frank to write off a large account half a dozen times over the course of three months, how eager would he be to continue making deliveries to this particular deli? In the real world, not very. Some customers are just not worth having. So if deliveries continue more or less

uninterrupted, it may be a tip-off that the deli is, in fact, paying its bills in full and on time, and that Frank is merely writing them off as bad debts to avoid booking them as income.

Even when a bad debt needs to be recorded, this should appear as a credit against the account with a corresponding explanation. Perhaps the business owner wrote off the charge because of a bad delivery or to appease a good customer with whom he or she has had an honest disagreement. When a single occasion turns into multiple write-offs, however, something may be amiss. If increasing numbers of customers are becoming bad debtors, the reason for this change must be investigated.



Tip: It is helpful to determine the industry standard for bad debt write-offs and compare that against subject company's procedures.

Example 7-26. Bigg Crane Co. manufactures materials for use by those in the construction business. Because of the nature of the construction industry, it is not unusual for Bigg, and other similar manufacturers, to be paid for their product as late as 90 days after shipment. At six months, if payment is not made, Barry Bigg might begin to worry. Even then, roughly 60 percent of the customers who owe him money half a year later will pay within the following six months. At 12 months after shipment, Bigg can reasonably presume that if a bill has not yet been paid, it will not be paid. Therefore, it writes off as bad debts any account older than 12 months.

After being served with divorce papers, however, Barry Bigg decides that a change in his accounting procedure is warranted. If an account has not been paid in 120 days, he writes it off as uncollectible, thus reducing his bottom line. Of course he knows that he might be paid later, but his wife need not profit from such knowledge, right?

The investigation might lead to an adjustment to the income statement to account for the probability that 60 percent of the outstanding bills will be paid some time between the sixth and twelfth month.



Tip: The forensic accountant should check carefully to determine whether an account receivable written off as a bad debt was not, in reality, a barter transaction. So, for example, if the client tells the forensic accountant that her carpenter husband often goes to a chiropractor, and the accountant notices a large account receivable written off to a chiropractor's office, this should lead the accountant (and the attorney) to investigate further.

Note: It is not only legitimate customers who might show up in the bad debt column. The forensic accountant should be very wary of new customers whose accounts are being written off as uncollectible. True, it could be a real deadbeat whose patronage is no longer welcome as a result of a default in payment very soon after becoming a customer. The forensic accountant, however, should look more closely at that "customer." It might very well be that the business owner himself or herself (or a family member) has set up a dummy corporation for the specific purpose of purchasing the product (for later resale, of course) without any intention of paying for it.

The lesson is to always check for family ties or self-dealing in any suspicious transaction.

Spoilage

The cousin to bad debt—at least in the forensic accounting arena—claims of spoilage must be investigated carefully. Thankfully, this does not mean that the forensic accountant has to rummage around in the garbage dumpster of the business, but an investigative analysis may be necessary. The specifics of this are discussed in the following chapter. Here is an example of how a very careful analysis can disclose a discrepancy.

Example 7–27. Dan runs a delicatessen that caters primarily to a lunchtime crowd. The forensic accountant suspects that not everything is kosher at Dan's, that his deli is exaggerating the extent of its spoilage. Investigation by a private investigator hired to determine traffic patterns shows that the gross sale of sandwiches is roughly \$2,000 per week. At an average charge of \$5.00 per sandwich, this amounts to 400 sandwiches. In addition, the investigator determines that each sandwich contains four ounces of meat; half of them also contain one ounce of cheese; and half of the sales are on hero bread.

According to the investigator's calculation, therefore, Bill requires 200 hero rolls per week, as well as 400 slices of bread for the remaining 200 sandwiches. At 40 slices of bread per package, this comes to 10 packages of bread. Based upon the investigator's findings, the forensic investigator concludes that Bill's deli runs through 100 pounds of cold cuts in a typical week (400 sandwiches, each containing a quarter pound of meat), as well as roughly 12.5 pounds of cheese (200 sandwiches containing one ounce = 12.5 pounds). So far, so good.

Bill's invoices show expenditures in line with what the forensic accountant has calculated. However, Bill claims that 10 percent of the meat, 15 percent of the cheese, and 20 percent of the bread is tossed out because of spoilage occasioned by lack of sales. Between the testimony of the investigator and the accountant's own number crunching, the accountant can establish that this is not the case.

Judgments Against the Company

If the company under investigation has been less than diligent in paying its debts, one or more creditors may have sued and received a money judgment. Normally, such judgments are liabilities and would be expected to legitimately reduce the value of the company. The forensic accountant should not stop there; for even in the world of lawsuits, there is room for abuse. The forensic accountant should report back to the attorney on any judgments he or she discovers. This is particularly true if the company seems until recently to have made a practice of paying its bills on time and has to date been blemish-free. The sudden change may be caused by a downturn in business. It may also be no more than a subterfuge. Here's how.

There is a legal concept known as *confession of judgment* whereby a purported debtor acquiesces to the entry of a judgment against it. This is usually done when a debtor has no defense to the action and wishes to work out terms for its payment without the need for declaring bankruptcy.

Example 7–28. Disks & Data Co. is a computer company that has legitimately fallen on hard times. It has not been able to pay its vendors for months. One of its vendors, ROM-It!, Inc. is owed \$50,000 by now and commences a lawsuit against D&D. D&D has no defense—it owes the money. The company's attorney advises Danielle, the owner, that she has several options: she could pay him \$10,000 to defend the lawsuit (but would lose anyway); the company could declare bankruptcy (which she does not wish to do); or it could seek a settlement in the form of a payout over time. She elects the last option.

ROM-It!'s attorney, after consulting with his client, agrees to the payment schedule, but insists that D&D sign a *confession of judgment*. As is the practice with such things, this judgment will not be docketed with the court unless D&D misses a payment. If the payment plan is completed, ROM-It! will prepare a "satisfaction of judgment and release," and the matter will be over. If D&D misses a payment, though, a judgment will be entered without the need for any further legal proceedings.

A confession of judgment, thus, can be a valid attempt by a cash-strapped company in the wrong to avoid throwing good money after bad. But what if the judgment in question was obtained by some subterfuge? For example, what if the business owner very conveniently confessed judgment in favor of a family member, with the intent of having it canceled (*satisfied* is the legal term) after the divorce became final? On paper—that is, in the court records—it would appear as a legitimate judgment. Yet it is anything but.

Example 7–29. Sam owns an electrical supply business, and business has been pretty good. Sam explains to his mother that his no-good cheating wife should be deprived of as much of his earnings as possible, and he has just the way of doing it: He forms a corporation with his mother as 100 percent stockholder. The stated business purpose of this corporation is to sell electrical supplies.

Sam then hires his brother-in-law (an attorney) to sue him on behalf of this new corporation. The claim: that Sam owes \$100,000 to this new corporation. Sam turns over the summons to his own attorney, who begins talks with Sam's brother-in-law. Sam tells his counsel that he does, in fact, owe this money and that he would agree to confess judgment in return for time to pay off the debt. The attorneys do their stuff and, voila, a confession of judgment in the amount of \$100,000 is prepared. It calls for Sam to pay the new corporation \$2,000 per month for 50 months.

Of course, Sam defaults in the very first month, and the judgment is entered in the court and on Sam's books. Instant liability! After the divorce is finalized, Sam's mother executes a satisfaction of judgment, effectively eliminating her son's obligation.

It might be obvious that no business would want its credit hampered by a judgment. After all, if the investigator cannot tell that it is not legitimate, how can a bank or a supplier tell? And could it not appear as a blemish on a credit report? The answer is yes, but anyone clever enough to confess a judgment is also clever enough to have the judgment vacated and the case dismissed. A judgment may be vacated—withdrawn as though it never existed—on the consent of the parties as easily as the confession of judgment can be entered. Any damage to a credit report could then be repaired with the assistance of the judgment creditor, who was never really a creditor at all.

Make no mistake about it: what has just been described is a clear fraud. This does not mean that it cannot occur, however. The forensic accountant must be vigilant and explore all judgments further, particularly as to the identity and relationship of the plaintiff and the company being investigated. If the judgment creditor is a recently formed corporation owned by a member of the defendant's family, there may be fraud. If the forensic accountant cannot conduct the investigation himself or herself, he or she should at least bring any suspicions to the attorney's attention.

A convenient method to begin the investigation is to have an inquiry conducted into the status of all civil matters in the court records. There are commercial sources that are cost-effective in performing these inquiries. Naturally, any lawsuit can be investigated to determine its legitimacy. Obtaining the relevant information should not be difficult either: Lawsuits are matters of public record, and the papers can be found at the court clerk's office. In a worst case scenario, the attorney can obtain them as part of the discovery process.

Once the forensic accountant has information on the underlying lawsuit, he or she compares the claims against the company's invoices and/or inventory. In other words, if Company X claims that the investigator's subject owes \$100,000 for supplies, the investigator should see whether the supplies were ever delivered. If they do not appear in inventory, and if they cannot be accounted for in sell-through to consumers, this should be brought to the attention of the retaining attorney. The forensic accountant should be especially vigilant in the case where Company X is a newcomer to the scene, that is, when it never appeared as a vendor before the spousal hostilities.

Summary

- Many possibilities are available for a business owner to behave in an intentionally dishonest and fraudulent manner in concealing the true value of the company. The forensic accountant should be very careful to uncover self-dealing and interfamily dealings.

- Sudden changes in income or expenses may be tip-offs to fraud. But first the forensic accountant must eliminate the possibility of a legitimate business reason for the downturn in business fortunes.
- New vendors—those that appear around the time of heightened matrimonial tensions or the filing of a divorce proceeding—should be carefully scrutinized to determine that they are legitimate.
- New customers should similarly be scrutinized, particularly if they merely replace old customers and do not result in an increase in business.
- Receivables and payables should be carefully scrutinized for economic reality and to potentially lead to other hidden assets or arrangements.
- The forensic accountant should carefully review all bank accounts of a company. Assets may be hidden in escrow, payroll, or other “secondary” accounts.
- If income declines and the decline is not attributable to any middleman situation, it may be because the income spigot is being temporarily turned off. Investigate expenditures for a reduction in revenue-producing activities such as a decrease in the advertising budget.
- Bad debt claims should be investigated carefully for veracity and to make sure that they are not being written off at a faster pace than usual.
- A business may confess judgment to make it appear that liabilities are higher than they actually are.

Case Study

William owns a dry cleaning business located in a small New Jersey town with significant competition among its dry cleaners. As a result, William normally devotes at least 10 percent of his budget to advertising and marketing. His marketing efforts are concentrated in two general areas: He advertises in the local newspaper and, in addition, mails out coupons (good for 10 percent off incoming orders) to every household within a one-mile radius of his business. In 2008, William sues his wife for divorce.

Jane Sleuth, a forensic accountant, is hired to review the company’s books, and she gains access to them in early 2008. In analyzing the business over a period of several years, Sleuth finds the following.

	2005	2006	2007	2008
Gross income	500,000	525,000	500,000	400,000
Expenses				
Cleaning chemicals	(25,000)	(30,000)	(30,000)	(45,000)
Other supplies	(25,000)	(25,000)	(25,000)	(30,000)
Advertising	(50,000)	(55,000)	(55,000)	(25,000)
Loan interest	0	0	(5,000)	(5,000)
Other expenses*	<u>(100,000)</u>	<u>(110,000)</u>	<u>(125,000)</u>	<u>(135,000)</u>
Net income	300,000	305,000	260,000	160,000
Loans payable	0	0	50,000	50,000

* For purposes of this case study, it is assumed that the “Other expenses” category contains expenses that are completely legitimate.

Sleuth’s suspicions are aroused for the following reasons.

1. Gross income has declined during the past two years, and Sleuth suspects this is due to the fact that the owner was planning to divorce his wife. When asked for an explanation (through proper channels), the owner says that the decline was due to increased competition among local dry cleaners.

Sleuth also observes that the advertising budget has been cut by more than 50 percent, leading her to suspect that the owner is intentionally causing a slowdown of business. William denies this. He blames the downturn on increased competition. There are, in fact, three other cleaners in his town—one located six blocks away and the others located about two miles away at the other end of town.

2. Sleuth notices that at the same time that gross income has declined, the cost of supplies has increased dramatically during 2008. Supplies consist primarily of “cleaning chemicals” including solvents and detergents, and “other supplies”: hangers, plastic bags, and boxes for returning items to customers, and two-part customer receipts. In reviewing invoices, Sleuth has also noticed that William’s main supplier of cleaning chemicals and other supplies changed in early 2008. Although the invoices—which look like they were printed up on a laser printer—list an address in Miami, Florida, Sleuth cannot locate a telephone number for this business. Interestingly, these invoices show an increase in the quantity of chemicals ordered by William and, in addition, an increase in price from what he had been paying previously.
3. The company took out a loan two years ago, but the physical premises do not appear to have been improved with the funds. Sleuth’s attorney finds out during the discovery process that the loan was given by William’s parents—now retired and living in Miami, Florida—and is secured by the cleaning equipment owned by the business. Sleuth also learns that the \$50,000 loan was used by William as a down payment on a beach house in New York’s Hamptons. This house is in William’s name alone, and other than the down payment, he has no equity in this property.

The following questions need to be considered.

1. *Competition and advertising.* How would Sleuth go about analyzing the legitimacy of the claim that increased competition resulted in a business decline? Because William claims that his business decline is due to increased competition, it is important to challenge William’s argument by showing that, all things considered, the decline was due to other forces—those which William controlled. This is the essence of this forensic undertaking.

The first thing Sleuth needs to know is the true impact of competition and, in fact, whether there was any at all. The mere presence of competitors in the marketplace is virtually meaningless. Unless Sleuth knows how much of a dry cleaner’s business hinges upon advertising or customer incentives, she may have a difficult time understanding the business and making her case. At this point, it may be wise to consult an expert. Sleuth hires one and learns the following.

- Most people will not travel more than half a mile to a dry cleaner unless they can save at least \$5.00 per order.
- The other dry cleaners in William’s town charge almost the same price and, while there may be a slight difference, the average difference in charges does not usually exceed \$3.00 from cleaner to cleaner.
- There is little loyalty to dry cleaners. People will not favor one over another barring clothing disasters (such as when a dry cleaner ruins a garment and refuses to satisfy the customer, thus alienating the customer regardless of the price of services).
- People have grown accustomed to receiving coupons from dry cleaners and prefer to use a cleaner that offers a discount in the form of a coupon. In fact, the expert says that 25 percent of every dry cleaner’s business results from a customer coming in and taking advantage of a coupon.

Armed with this knowledge, Sleuth might draw a parallel between advertising and increased/decreased business in a manner similar to that discussed in example 7-24. Sleuth would do so, perhaps, by examining customer invoices to determine how many received 10 percent off their cleaning orders. For example,

Sleuth discovered a consistent pattern: for every dollar William spent on advertising and marketing with coupons in 2005–2008, \$6.00 (less 10 percent) of income was generated.

Thus, in 2005, \$270,000 of net revenue (\$300,000 less 10 percent) was generated by \$50,000 of advertising. In 2006 and 2007, \$297,000 of net revenue (\$330,000 less 10 percent) was generated by \$55,000 of advertising. In 2008, \$135,000 of net revenue (\$150,000 less 10 percent) was generated by \$25,000 of advertising.

The consistency of this pattern tends to support the premise that William has intentionally slowed down his business. Certainly Sleuth's statistics should make a favorable impression on a judge.

2. *Supplies.* How would Sleuth demonstrate that the figure for supplies is tainted?

There appears to be ample proof here that something is amiss. In the normal course of events, the investigation might include the following steps.

- Determine why the old supplier was dropped. A call to that supplier might disclose that the same quantity is being shipped but that the new “buyer” is located in Miami, Florida. (Sleuth might even find that the old supplier billed the company in Miami but shipped directly to William in New Jersey. This would be a clear cut case of fraud.)
- Ask William for the telephone number of the new supplier. How many business people who purchase a substantial portion of their operating supplies would do so from a company that they could not contact on a moment's notice in the event of an emergency? One might do so if the company dealt in cut-rate supplies and one were saving a tremendous amount of money. But one would certainly not do so if the cost of supplies actually increased, as is the case here. (Sleuth should let the attorney know if she cannot contact the company. Additional information may be subpoenaed.)

In this case, however, these steps are probably unnecessary because it's pretty easy to see what is going on here. It is way too convenient that William's parents live in Miami, the exact location of the new “supplier.” If William still insists that the transaction is legitimate, Sleuth should compare his parents' home address with that shown on the supplier's invoices. Sleuth should demand the telephone number (or have the attorney do so) and compare that as well.

There is also a glaring inconsistency in the quantity of chemicals ordered from the Miami source versus the amount that should have been necessary given the alleged fall-off of business. Why is more product being ordered at a time when William claims his business is off over 10 percent from the prior year? Shouldn't less product have been ordered? Sleuth might check William's inventory; if the excess supplies are not present, perhaps a different conclusion is warranted. Either William did, in fact, order the additional product only to sell it to another cleaner off the books or, more likely, the invoices themselves are phony, and this “Miami mystery source” never shipped the quantity that William claims to have ordered and paid for.

What if William makes the following argument: his volume of customers increased, thus necessitating an increase in supplies, but increased competition forced him to lower prices, and, thus, profit on each customer. In this case, an investigation of the customer receipt slips (most cleaners will use a multi-part receipt) will disclose the quantity of clothing actually cleaned during the period in question. Comparing this number with figures supplied either by Sleuth's expert sources or with the clothing-to-supply ratio for prior years should show Sleuth whether there is a disparity.

For example, if receipts show that William dry cleaned 50,000 items of clothing in 2005 and 52,500 items in 2006 but only 40,000 items in 2008, and that the cost of chemical cleaner has remained steady during that period, then there is a good bet that the \$75,000 spent in 2008 for supplies is a heavily padded item. Alternatively, it may be that some of the customer receipts have been omitted from those given to Sleuth during her investigation and that these missing customer tickets may represent unreported cash receipts.

3. *Loan.* How would Sleuth treat the loan in valuing the company?

It is clear from the example that the loan is a personal expense and not related to the business. As a result, the \$5,000 of annual interest payment should be added back to the company's income. In addition, the \$50,000 loan should be removed from the company's liabilities before calculating its net worth.

8

Executives at Large and Publically Held Companies

Introduction

Although one would think that public disclosure rules would make it impossible, various methods exist for manipulating or concealing compensation at large and publically held companies. The greatest danger is that the information can be hiding in plain sight if the investigator is untrained in what to look for. It goes without saying that compensation is more than just salary. It may include bonuses, stock options, retirement benefits, and other deferred compensation and perks. Just as in the case of smaller companies, the forensic accountant should investigate whether any compensation appears disguised in a form not easily identifiable as compensation.

Executive Compensation Manipulation

Among the many ways for large public companies to defer or disguise executive compensation are the following.

- Bonuses might be deferred until after the divorce.
- Bonuses might be paid into executive partnerships rather than directly to the highly compensated employee. (One advantage for the employer in such arrangements is that the company avoids paying certain payroll taxes, including unemployment and FICA taxes, because the third-party partnership is involved. In fact, the IRS has identified this practice as abusive.)
- In multinational situations, or for an employee stationed overseas, compensation might be paid in a manner that is unfamiliar to American investigators. Local rules might not require certain items to be reported at all.

In the case of an employee headquartered in another country, prudence may dictate retaining competent investigators familiar with foreign accounting and reporting rules. For domestic corporations, the task is somewhat simplified—at least in theory—by the reporting requirements of the Securities and Exchange Commission. Although not designed to aid forensic accountants, these rules have that effect in certain cases. SEC Regulation S-K § 402 requires public companies to disclose a tremendous amount of information about their most highly compensated employees. The instructions for completing it are quite detailed and thorough as well.

For example, Regulation § 229.402(a) states the following.

(2) *All compensation covered.* This Item requires clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers designated under paragraph (a)(3) of this Item, and directors covered by paragraph (k) of this Item, by any person for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specifically excluded from disclosure in this Item

(3) *Persons covered.* Disclosure shall be provided pursuant to this Item for each of the following (the “named executive officers”):

- (i) All individuals serving as the registrant’s principal executive officer or acting in a similar capacity during the last completed fiscal year (“PEO”), regardless of compensation level;
- (ii) All individuals serving as the registrant’s principal financial officer or acting in a similar capacity during the last completed fiscal year (“PFO”), regardless of compensation level;
- (iii) The registrant’s three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and
- (iv) Up to two additional individuals for whom disclosure would have been provided pursuant to paragraph (a)(3)(iii) of this Item but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

Instructions to § 402(a)(3) describe how to determine whom information is required about. Note that item no. 3 provides a loophole in the case of highly compensated individuals whose compensation is due to overseas compensation.

1. *Determination of most highly compensated executive officers.* The determination as to which executive officers are most highly compensated shall be made by reference to total compensation for the last completed fiscal year (as required to be disclosed pursuant to paragraph (c)(2)(x) of this Item) reduced by the amount required to be disclosed pursuant to paragraph (c)(2)(viii) of this Item, provided, however, that no disclosure need be provided for any executive officer, other than the PEO and PFO, whose total compensation, as so reduced, does not exceed \$100,000.
2. *Inclusion of executive officer of subsidiary.* It may be appropriate for a registrant to include as named executive officers one or more executive officers or other employees of subsidiaries in the disclosure required by this Item. See Rule 3b-7 under the Exchange Act (17 CFR 240.3b-7).
3. *Exclusion of executive officer due to overseas compensation.* It may be appropriate in limited circumstances for a registrant not to include in the disclosure required by this item an individual, other than its PEO or PFO, who is one of the registrant’s most highly compensated executive officers due to the payment of amounts of cash compensation relating to overseas assignments attributed predominantly to such assignments.

Regulation § 229.402(c)(2) requires, in addition to disclosure of salary, bonus, and the like, disclosure of the following.

- (ix) All other compensation for the covered fiscal year that the registrant could not properly report in any other column of the Summary Compensation Table (column (i)). Each compensation item that is not properly reportable in columns (c)-(h), regardless of the

amount of the compensation item, must be included in column (i). Such compensation must include, but is not limited to:

(A) Perquisites and other personal benefits, or property, unless the aggregate amount of such compensation is less than \$10,000;

(B) All “gross-ups” or other amounts reimbursed during the fiscal year for the payment of taxes;

(C) For any security of the registrant or its subsidiaries purchased from the registrant or its subsidiaries (through deferral of salary or bonus, or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the registrant, the compensation cost, if any, computed in accordance with FAS 123R;

(D) The amount paid or accrued to any named executive officer pursuant to a plan or arrangement in connection with:

(1) Any termination, including without limitation through retirement, resignation, severance or constructive termination (including a change in responsibilities) of such executive officer’s employment with the registrant and its subsidiaries; or

(2) A change in control of the registrant;

(E) Registrant contributions or other allocations to vested and unvested defined contribution plans;

(F) The dollar value of any insurance premiums paid by, or on behalf of, the registrant during the covered fiscal year with respect to life insurance for the benefit of a named executive officer; and

(G) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (l) of the Grants of Plan-Based Awards Table required by paragraph (d)(2)(viii) of this Item;

Regulation § 229.404 also requires disclosure of transactions with related persons.

(a) Transactions with related persons. Describe any transaction, since the beginning of the registrant’s last fiscal year, or any currently proposed transaction, in which the registrant was or is to be a participant and the amount involved exceeds \$120,000, and in which any related person had or will have a direct or indirect material interest. Disclose the following information regarding the transaction:

(1) The name of the related person and the basis on which the person is a related person.

(2) The related person’s interest in the transaction with the registrant, including the related person’s position(s) or relationship(s) with, or ownership in, a firm, corporation, or other entity that is a party to, or has an interest in, the transaction.

(3) The approximate dollar value of the amount involved in the transaction.

(4) The approximate dollar value of the amount of the related person’s interest in the transaction, which shall be computed without regard to the amount of profit or loss.

(5) In the case of indebtedness, disclosure of the amount involved in the transaction shall include the largest aggregate amount of principal outstanding during the period for which disclosure is provided, the amount thereof outstanding as of the latest practicable date, the amount of principal paid during the periods for which disclosure is provided, the amount of interest paid during the period for which disclosure is provided, and the rate or amount of interest payable on the indebtedness.

(6) Any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

Instructions to Item 404(a) state the following.

1. For the purposes of paragraph (a) of this Item, the term related person means:
 - a. Any person who was in any of the following categories at any time during the specified period for which disclosure under paragraph (a) of this Item is required:
 - i. Any director or executive officer of the registrant;
 - ii. Any nominee for director, when the information called for by paragraph (a) of this Item is being presented in a proxy or information statement relating to the election of that nominee for director; or
 - iii. Any immediate family member of a director or executive officer of the registrant, or of any nominee for director when the information called for by paragraph (a) of this Item is being presented in a proxy or information statement relating to the election of that nominee for director, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such director, executive officer or nominee for director, and any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;
2. For purposes of paragraph (a) of this Item, a transaction includes, but is not limited to, any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships.


Example 8-1. Lex Patriott is CEO of American Parent, a company with a foreign subsidiary located somewhere in South America. Lex's talents are so highly sought that American Parent agrees to retain the services of a South American corporation, LutherCo, set up by Lex's brother, Luther. Lex is compensated by American Parent but also signs a large consulting contract with his brother. American Parent pays LutherCo. for Lex's consulting services; LutherCo. agrees to defer Lex's salary and/or bonus until after his divorce from his wife. American Parent's relationship with LutherCo. must be disclosed.

Hidden Compensation

Be aware that not all compensation or perquisites may show up on the books. It is possible that bonus payments are contractually (or by agreement) paid after a divorce or, for executives with the clout and position, may be paid in foreign currency in a foreign country. Additionally, if a highly-placed, highly-compensated employee works for a foreign corporation (not unusual in this day and age) the securities laws of the foreign corporation (called the "foreign private issuer") may govern disclosure. Foreign private issuers are required to disclose executive compensation on an individual basis domestically in an SEC filing (Form 20-F) only if such disclosure is required by the issuer's home country or if it voluntarily publicly discloses it in its home country. Absent these exceptions, a foreign company need only disclose executive and director

compensation in the aggregate. Therefore, an investigation of foreign filings may be required where a person is employed overseas or by a foreign corporation.

Note: U.S. SEC disclosure rules are required by foreign corporations with substantial U.S. operations or a large number of U.S. shareholders.

 **Tip:** The absence of something where it might be expected should act as a tip-off. If it is customary in an industry to award bonuses, the fact that the subject of your investigation did not receive one speaks loudly. Even if the absence is uniform among the co-workers of your subject this, again, should be considered in the broader context: are *all* employees having their bonuses delayed or diverted to an opaque vehicle?

Stock Options

The valuation of stock options can take up a whole volume itself. Here, we are concerned with locating them during times of marital disharmony. Among the possibilities for executives with sufficient clout are the following.

Delay of Options Issuance

It is a simple matter for a friendly board intent on keeping a key employee to delay the issuance of stock options until after the divorce. Determining whether this is so may be a function of examining the employment contract—the lawyer’s role—more than examining the financial materials presented for review. Your role may be limited to guiding the attorney on the practice of a particular industry or company based, perhaps, on your analysis of materials such as the Regulation S-K materials covering the current employee’s predecessor. Today, when corporate executives measure their compensation package against that of their peers much the same way as movie stars and sports figures do, it may be unrealistic to believe that the target’s package is substantially different from that of successors or contemporaries at other companies.

Options Cancellation and Reissue (also known as “re-pricing”)

At least twice in recent memory, a sinking stock market has made incentive stock options worthless or nearly so. Because options are issued, at least in part, to retain the services of talented employees, having worthless options is equivalent to releasing the key employee from his or her golden handcuffs. Companies wishing to keep their employees may consider reissuing stock options that have no realistic prospect of ever recovering their value. Doing so is not without risk to accounting, yet, in order to avoid having to adversely account for such re-pricing, the company must take an action that may actually benefit a key employee in the midst of a divorce.

In March 2000, the Financial Accounting Standards Board (FASB) issued Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation* (FIN 44). Among its provisions was clarification that either the reduction of an option’s exercise price or its cancellation and grant of a new option at a lower price to the same person within the six months before or after the cancellation would be deemed a re-pricing of the option. Such re-pricing would subject these options to variable accounting treatment. Variable accounting treatment requires a company to mark the option to market over the length of its term. Marking to market, in turn, would require the issuing company to recognize a compensation expense equal to the change in intrinsic value of the option for the duration of the option’s effective life. Consequently, the company would continually have to take a charge to earnings equal to each option’s intrinsic value.

The solution for the company is not to reissue the option for six months after cancellation. The lesson for the forensic investigator is not merely to review the viability of options at the time of the investigation but, perhaps, to examine them once again several months later. If, as occurred after the dot-com bubble of

2000–01 and the meltdown of 2008, many options became worthless and were cancelled, the seedling of value might once again be planted six months and one day later.

Reload and Creative Stock Options

Stock options can become complex and designed to produce separate or nonmarital property. Reload options represent new options generally acquired with more senior options. The terms can vary, but if options acquired during marriage are later exchanged for and traded for options after separation or divorce, the community or marital property may be disadvantaged. Consider comparing the original grant documents to the employer's periodic options statements to the employed spouse.

Retirement Benefits

Pensions earned while one spouse is employed by a foreign subsidiary or non-U.S. company may have substantial value that is not apparent from U.S. documents. This is particularly likely if retirement benefits have not begun or are paid to foreign accounts. Unfunded contracts payable at retirement may exist as deferred compensation plans, an obligation to a spouse for which there is no tax reporting until the employee vests and payments are actually made to the spouse. Overly aggressive actuarial assumptions can overfund or underfund retirement plans. An overfunded plan may represent a higher benefit in future years; thus, the nonemployee spouse may wish to retain retirement rights through a Qualified Domestic Relations Order (QDRO) and wait to collect benefits when the spouse receives them. If the retirement plan is underfunded, as is more likely the case, the plan may be a candidate for government takeover. Benefits then may be substantially reduced. In such a case, the spouse may wish to be "bought out" of the retirement plan in the dissolution.

Perks

The tabloids had a field day in 2002 as Jack Welch, former CEO of General Electric, and his wife Jane battled out their private differences quite publically. Divorce papers filed by Mrs. Welch that year disclosed that not only was the former chairman to be paid \$86,000 per year as a "consultant" following his retirement in 2001, but that he was to receive "lifetime access to company facilities and services comparable to those which are currently made available to him by the company," as the *New York Times* reported at the time. Apparently, those amenities included the use of a \$50,000 per month Manhattan apartment, preferential seating at sporting events (including at the U.S. Open and Wimbledon), country club membership, use of the company's jet and helicopter, security arrangements, and restaurant meals. Oh, and this was all on top of a \$9,000,000 annual pension.

The trial of Dennis Kozlowski and Mark Swartz, formerly of Tyco International (and now guests of the New York State Department of Corrections), revealed that Tyco paid tuition to private schools for Mr. Swartz's three children and \$1 million towards a 40th birthday party in Sardinia for Mr. Kozlowski's wife. That, in addition to Mr. Kozlowski's infamous \$6,000 shower curtain and \$15,000 umbrella stand.

At another trial (funny how these things come out in a courtroom!), it became known that media company Hollinger International purchased Franklin Delano Roosevelt's personal papers for its former chairman, Lord Conrad M. Black. The company paid \$8 million for this material because Lord Black was in the midst of writing a biography of FDR.

These, of course, are extremes, but the lesson is this: never assume that a company will act reasonably merely because its stock is publically traded. It should come as no surprise that perks are quite popular among the top-floor-corner-office crowd. (This will likely change during the current lean times, but that does not mean you should let your guard down.)

Many perks are available to high-ranking executives of public corporations. Among the most popular are the following.

- Use of corporate jets, helicopters, and chauffeur-driven luxury cars
- Membership at exclusive country clubs
- Outplacement services
- Un-scrutinized use of corporate credit cards
- Spousal and dependent life insurance
- Spousal and dependent travel expenses
- Home security monitoring
- Financial counseling and wealth management services

All of these perks have a value that is not necessarily reflected by traditional compensation-reporting methods. While in some cases it may seem hardly worth the trouble to investigate corporate goodies, you should be aware that these perks are not always minimal. According to one study, Kraft Foods spent \$52,000 on financial counseling for Kraft International head Sanjay Khosla, who earned about \$3,000,000 the same year, and defense contractor ITT Corporation paid \$37,000 for president Steven Loranger's financial planning even though he earned \$13,700,000 that year. Time Warner's chairman Dick Parsons reportedly earned \$18,600,000 in 2007, not counting his \$100,000 of company-paid financial services.

And if you ever wondered what it costs to feed the "Girls Next Door," Playboy's Hugh Hefner was reimbursed \$400,000 to provide food, housing, and "personal benefits" to his three live-in girlfriends, Holly, Bridget and Kendra.

Amusing as all of this might be, the point is that perks can hide a vast number of costs that one would otherwise be expected to shoulder personally. For instance, in 2007, the *Seattle Post-Intelligencer* newspaper published a table of the perks paid to corporate bigwigs of local publicly traded companies. Among the findings are the following.


- Kerry Killinger, CEO of Washington Mutual (before it imploded), in addition to receiving a salary of \$1 million, a bonus of \$7.03 million, and exercising stock options of \$5.38 million, also received \$350,085 in reported perks, including \$62,375 for air travel, \$10,000 for financial planning, a similar amount for his automobile, and \$32,938 for tax reimbursements (more on this later).
- To understand why its coffee costs so much, consider that Starbucks Chairman Howard Schultz, in addition to salary, bonus, and profits of \$102,970,000 (that is not a typo) from the exercise of stock options, received \$1.23 million in perks. which included personal security reimbursement of \$467,759.
- And F5 Networks CEO John McAdam, who brought home a total of \$9.36 million, also received \$600 to pay for internet access because a CEO cannot be expected to pay for his own internet access, right?

Gross-Ups

Perhaps the most bizarre compensation that corporate executives might receive is assistance paying income tax on their compensation and perks. This is referred to as "grossing up."

In a nutshell, grossing up means the company picks up the income tax liabilities an executive faces on his perks and sometimes even his pay and bonuses. An examination of nearly 3300 proxy statements filed in during the 12-month period ending February 2008 found that 20% of CEOs received tax gross-ups on part of their income. In one case, for example, it was found that Angelo Mozilo, then CEO of troubled

Countrywide Financial, requested that his board of directors reimburse him for income tax due when his wife traveled for free on the corporate jet (paid by the shareholders).

 **Tip:** If an item is reported as a gross-up, make sure you have accounted for and valued the items that have been grossed up. In the above example, the gross-up of income tax would have revealed the perk of free corporate jet flight.

Required Public Disclosure

SEC Regulation S-K (§ 402), discussed previously, requires companies to disclose any benefit worth more than \$10,000. Consequently, if you are engaged in a case involving a publically traded corporation, it behooves you to investigate SEC filings for such personal benefits. They will be found, generally, under the “Other Annual Compensation” column of the Summary Compensation Table in the annual proxy statement.

Among some of the provisions dealing with perk reporting are the instructions to Item 402(c)(2)(ix), which follow.

4. Perquisites and personal benefits may be excluded as long as the total value of all perquisites and personal benefits for a named executive officer is less than \$10,000. If the total value of all perquisites and personal benefits is \$10,000 or more for any named executive officer, then each perquisite or personal benefit, regardless of its amount, must be identified by type. If perquisites and personal benefits are required to be reported for a named executive officer pursuant to this rule, then each perquisite or personal benefit that exceeds the greater of \$25,000 or 10% of the total amount of perquisites and personal benefits for that officer must be quantified and disclosed in a footnote Perquisites and other personal benefits shall be valued on the basis of the aggregate incremental cost to the registrant. With respect to the perquisite or other personal benefit for which footnote quantification is required, the registrant shall describe in the footnote its methodology for computing the aggregate incremental cost. Reimbursements of taxes owed with respect to perquisites or other personal benefits must be included in column (i) and are subject to separate quantification and identification as tax reimbursements (paragraph (c)(2)(ix)(B) of this Item) even if the associated perquisites or other personal benefits are not required to be included because the total amount of all perquisites or personal benefits for an individual named executive officer is less than \$10,000 or are required to be identified but are not required to be separately quantified.

2. Registrants shall include in the salary column (column (c)) or bonus column (column (d)) any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation instead have been received by the named executive officer. However, the receipt of any such form of non-cash compensation instead of salary or bonus must be disclosed in a footnote added to the salary or bonus column and, where applicable, referring to the Grants of Plan-Based Awards Table (required by paragraph (d) of this Item) where the stock, option or non-equity incentive plan award elected by the named executive officer is reported.

In summary, the SEC filings themselves may provide a significant amount of information—a roadmap, even—to locating income and benefits that might not otherwise emerge.

9

Special Problems of Dealing with Cash Businesses

Cash businesses pose their own special investigation and valuation problems. How, for instance, can a forensic accountant really know how many sandwiches a coffee shop sells, or how many haircuts a barber performs? Aren't these numbers impossible to pin down? It may be difficult, to be sure, but not impossible. There are a number of ways in which the forensic accountant can minimize the possibility that the subject of his or her investigation will get away with understating the value of the business. They involve common sense, a keen instinct for investigation, and an understanding of the business being examined. Initially, these methods involve a recognition on the accountant's part that the investigative standard¹ required by the law is not "infallibility" or "exactitude" of result. No such standard could be met by any expert save, perhaps, one in the field of mathematics, physics, or chemistry. What is expected of the forensic accountant is diligence and a more credible explanation than that of the adversary's expert.

Knowing the Business Under Investigation

Previous chapters have discussed how business owners might attempt, through cleverness and stealth, to make their business appear less profitable. A thorough familiarity with the business under investigation—even if it means retaining an expert in that field—is crucial to developing a sense that something may be amiss. In a cash business, where business profits might easily disappear, two crucial pieces of information are needed to credibly recreate fact from the proffered fiction.

1. Know the typical markup practices or profitability of the business.
2. Understand the ordinary costs and expenses associated with the business.

In states with sales tax, the sales tax auditors will have developed a multitude of techniques to estimate total sales from questionable records. Some of these methods will have been examined by appellate courts in the forensic accountant's state. Courts may be more easily persuaded by the forensic accountant's methodology if it has been approved by another court in the same state.

Typical Markup or Profitability

This knowledge is very important to credibly establishing the amount of income that is claimed as unreported. For instance, if the typical markup of a delicatessen sandwich is 100 percent, and the owner's annual expenses for the ingredients are found to be \$50,000, then the forensic accountant can establish some

¹ States follow different standards for admissibility of evidence from an expert. The attorney can instruct the forensic accountant on the standard in his or her state.

criteria for supporting his or her analysis that the deli's sandwich income is \$100,000 rather than, say, \$60,000, as claimed by the owner. If the forensic accountant knows the cost of dough, tomato sauce, and cheese, as well as the average quantity of each such ingredient that goes into making a pizza, or that the typical pizzeria markup is 200 percent, he or she can credibly determine how many are being sold. (There are only so many pizzas that the owner can claim were dropped as they were tossed into the air to impress onlookers. Claims of spoilage, as discussed in the previous chapter, can be challenged and proven false.)

Is counting tomato slices or determining the weight of mozzarella cheese really necessary? Yes. Lay people may choose to shake their heads and chortle, but as an expert witness, the forensic accountant must assume that he or she will be called to testify before a court. The forensic accountant may rest assured that not only will the judge not ridicule his or her efforts but, on the contrary, will likely appreciate them and the accountant's thoroughness. It cannot be stressed enough: Thoroughness is what wins cases.

Note: Beyond this pep talk, there are two very practical reasons for such thoroughness. The first is that such preparation lays the legal foundation for the forensic accountant's testimony. The second is to prepare the forensic accountant to withstand a cross-examination that may be designed to embarrass him or her. For example, if the forensic accountant seeks to testify that the average deli sandwich contains ingredients costing \$2.00 and sells for \$4.00, he or she must first establish knowledge of the subject at hand. This is the legal foundation for the accountant's testimony. A typical line of questioning might proceed as follows.

Attorney: Ms. Accountant, you just testified that the defendant's sandwiches sell for \$4.00 and contain ingredients costing, in total, about \$1.75. How did you come to that conclusion?

Accountant: On six occasions during the weeks of August 5th and August 12th, I entered the defendant's deli and ordered a turkey sandwich on a Kaiser roll with cheese, lettuce, and tomatoes. When I returned to my office, I weighed each of the components separately. The turkey weighed four ounces, give or take a quarter ounce. The cheese weighed approximately one ounce. There were two slices of tomato and about half an ounce of lettuce on each sandwich. This was more or less consistent among all six samples.

I next compared the weights against the cost of the ingredients because those costs appear on invoices examined by me during the course of this litigation. According to those invoices, the defendant paid \$4.00 per pound for turkey and \$3.20 per pound for cheese. This would make the cost of the meat in each sandwich \$1.00 and the cheese an additional 20¢.

Tomatoes cost the defendant \$1.60 per pound, and I found that the two slices weighed in at slightly more than one ounce. So I added 15¢ for tomatoes. The lettuce cost 80¢ per head at that time, and the average head of lettuce weighs about a pound according to the supermarket scale I used for measuring. I allocated 5¢ for lettuce. In addition, according to the defendant's invoices, Kaiser rolls cost him 15¢ apiece. The total cost of the ingredients, therefore, was approximately \$1.55. Adding an additional 20¢ for condiments, wrapping paper, napkins, paper bag, and all other incidentals, I estimated that the cost was no more than \$1.75 per sandwich. I then added 25¢ to each sandwich to account for waste and spoilage—a sum I think quite generous, as it assumes that one out of every eight sandwiches is wasted—and I arrived at the conclusion that each \$4.00 sandwich cost the defendant no more than \$2.00 to prepare.

The total expense for the cost of the product, according to the defendant's invoices, is \$50,000, and the gross income reported from the sale of these food items as sandwiches is only \$60,000. It is my expert opinion that an expenditure of \$50,000 should have yielded—very conservatively, mind you, your Honor—approximately \$100,000 in gross sales. My conclusion is that the defendant has underreported earnings by approximately \$40,000.

Attorney: Thank you. I have no further questions.

Quite an impressive bit of testimony, and highly damaging to the defendant. The foundation for the expert's opinion about the underreporting was carefully laid out lettuce leaf by lettuce leaf!

This scenario can be contrasted with the hypothetical results of lack of preparation—assuming that the expert would even be permitted to testify about the alleged underreporting of income without being able to lay a foundation for such testimony.

A different situation develops when a forensic accountant attempts to testify about an opposing party's business without knowing the typical markup or profitability of the business, or without having done as thorough an investigation as outlined previously. The cross-examination might proceed as follows.

Attorney: You just testified that the average cost of a sandwich prepared by a deli is \$2.00 and that the average charge is \$4.00, is that correct?

Accountant: Yes, that is correct.

Attorney: And how did you arrive at these numbers?

Accountant: I examined a typical sandwich.

Attorney: One of my client's?

Accountant: No, actually, I went to a typical deli a block from my office.

Attorney: And that deli used four ounces of meat and one ounce of cheese?

Accountant: Yes.

Attorney: And how much meat and cheese does my client put on one of his sandwiches?

Accountant: I would assume the same.

Attorney: You would assume? Is it your testimony that you believe my client to be guilty of underreporting income by a factor of 40 percent based upon your assumption that the sandwich served to you in your quiet little neighborhood is the same as the sandwich served by my client in his highly competitive downtown delicatessen?

Accountant: Er . . . I guess that's my testimony.

Attorney: You have no idea how much food my client uses, do you?

Accountant: Well . . . actually . . . no, I don't.

Attorney: And if my client testifies that he uses twice as much meat and cheese as your local deli, would you not agree that your figures would be completely erroneous as they relate to my client?

Accountant: I suppose I would have to agree with that.

Attorney: So your testimony would be wrong as it relates to my client?

Accountant: Yes, I suppose so.

Attorney: In fact, it would be useless, wouldn't you agree?

Accountant: I . . . I

The foregoing description presents a clear picture of the importance of proper preparation.

Ordinary Costs of the Business

Analyzing typical business costs may be easy in the case of our deli example—invoices and bills will tell much of the story. The mistake is made, however, in glossing over these costs simply because they seem “ordinary and necessary” and are supported by legitimate invoices. If all the forensic accountant sees is a legitimate business deduction, it may be that he or she is missing the forest by looking only at the trees. The expense records of a cash business may contain a wealth of information about the income, not merely about the costs. The trick, as is so often the case, is to think creatively.

Example 9-1. Lon’s Lawns, Inc. is a landscaping/lawn mowing business. As is true of most such businesses, it is seasonal, and the customer base changes often from year to year. For the past several years, Lon has reported a modest income—largely in checks and very little in cash receipts. Nevertheless, Lon’s wife insists that his business generates more green stuff than merely his grass clippings. The forensic accountant is now hired to prove this. Go to it!

How on earth does one prove Lon is cutting more lawns than he lets on? The forensic accountant might examine his appointment schedule to determine if all of Lon’s time is accounted for. Lon is too clever; his cash-paying clients do not appear on his calendar, at least not on the one he has given to the forensic accountant. The forensic accountant might suggest that the attorney hire a private investigator to follow Lon’s three trucks around for a week or so. This is too expensive, the attorney advises, and the investigators would likely be spotted the very first day.

Perhaps the forensic accountant could examine payroll records to determine how many employees Lon has. But what would this really reveal? Suppose that they are paid for a full day’s work whether they are scheduled to cut 3 lawns that day or 10. No real help.

How about this: All those grass clippings have to go somewhere, don’t they? Indeed they do—they have to be dumped at the end of the week. What if Lon’s municipality imposes a per-ton dumping charge? If so, by calculating the typical lawn size of Lon’s reported customers and the typical weight of each lawn’s debris (something that either the forensic accountant or attorney might need to discuss with a lawn expert), it can be determined how many lawns were cut.

Say that clippings from the typical suburban lawn weigh 50 pounds and that Lon has claimed to have only 40 weekly customers. This translates into 2,000 pounds (one ton) of clippings each week. But when the forensic accountant examines the payments made to the town in the form of “dumping fees,” he or she finds that Lon has been charged for two tons. It could very well be (assuming that there is no minimum dumping charge) that Lon has underreported his earnings by one half. Instead of 40 customers, he actually has 80. If he charges \$30 per week per lawn, then he has underreported his earnings by \$1,200 per week. Assuming that the lawn mowing season is half a year, Lon has undisclosed income of over \$31,000. And that does not include lawn fertilizing, autumn leaf removal, or any other services.

A similar creative analysis, based upon a knowledge of the business, may yield comparable results in many cash businesses. All that is needed is to think in algebraic terms: the forensic accountant has several pieces of information already; now he or she must “solve for x.”

Typical Cash Businesses

Some examples of typical cash businesses follow.

Laundromat

This is a cash business for which it may be easy to calculate true cash flow because nearly all of the expenses are clearly determinable from unalterable third-party records.

Example 9–2. Lenny runs a coin-operated laundromat called Lenny’s Laundry. It costs a dollar to wash a load and another dollar to dry it. Lenny claims to gross only \$4,000 per month—about 2,000 wash/dry loads. How might it be proven that Lenny is underreporting his income?

One method might be the following.

The forensic accountant might request the operating manuals for Lenny’s equipment and, upon reviewing them, discover that each wash cycle requires 20 gallons of water and 2 kilowatt-hours (KWH) of electricity, and that each drying cycle uses another 3 KWH. The forensic accountant now examines Lenny’s utility bills. After making allowances for nonincome producing use of water and electricity (lights, bathrooms), the accountant finds that his monthly bills are as follows.

<p>Electricity: 15,000 KWH at 12.5¢ per KWH Water: 60,000 gallons at 2.5¢ per gallon</p>

A quick calculation indicates that 2,000 wash/dry loads should have used no more than 10,000 KWH and 40,000 gallons of water. It is a safe bet that Lenny is understating his income by about one third and that he is actually servicing 3,000 combined loads each month with revenues of \$6,000.

This method works well for any business that cannot manipulate its costs. A car wash is another example. There are, however, some difficult cash businesses that may require on-site investigation, and either the forensic accountant or an investigator² hired by the attorney will need to spend a bit of time in the field.

Bar

This is one of the ultimate cash businesses, but not impossible to investigate. The number of bottles ordered is a good starting point. From there, it should not be difficult to determine how many one-ounce shots can be poured. Allowing for spoilage and the inevitable “buy-backs” (giveaways) that bartenders are known to pour after a few rounds have been purchased, the forensic accountant may be able to determine whether the reported figures are way out of line with what should be the norm.

Example 9–3. For the three years before his divorce proceedings began, Joe would stop by an out-of-the-way liquor store and buy several bottles of liquor, paying cash, and then pocket the resulting profits. Although you suspect that this is the case—but cannot prove it—at least Joe has been more or less consistent. However, after divorce papers have been served, Joe gets greedy. Now he buys 30 percent of his liquor from sources other than his wholesaler. The result is an apparent 30 percent decline in the bar’s business. Despite the fact that his books reflect this decline, Joe hasn’t cut back his bartending staff at all. This inconsistency is suspicious.

Here’s how an examination might proceed in the preceding case: The forensic accountant calculates that a typical bottle of liquor yields 30 drinks, each selling for \$3.00. Judging from Joe’s invoices, he goes through 30 bottles each week. That’s \$2,700. Not coincidentally, Joe reports income of exactly that amount. But the investigator, sitting at the bar during a few typical days and counting drinks sold at various times during the hours the bar is open, has determined that Joe actually poured 40 bottles that week. Where is the other \$900? In this case, the first-hand observations and testimony of the investigator, combined with the accountant’s forensic analysis of the investigator’s observations, will likely serve to trap Joe in a lie.

² Private investigators are usually licensed by individual states. Some investigative services by a CPA may be exempted from the Private Investigator statutes. But some, such as observations of individuals in public areas, might not be. The CPA should check with his or her state licensing authorities if the proposed activity requires a licensed private investigator.

Hair Salon

It is certainly more difficult to determine cash payments in a business that is primarily labor-intensive rather than product-sales based, and it is nearly impossible to do so when the personal services offered by the business run the spectrum of the price scale. In the case of a bargain brand hair cutter, for instance, half an hour spent with a customer could be for a man's haircut (\$10.00) or for a wash, cut, and blow (\$15.00). A woman's appointment might be for a trim (\$15.00), a cut (\$20.00), a perm (\$50.00), a manicure (\$25.00). The services and prices vary widely.

In fact, short of an examination of business traffic patterns, it may be downright impossible to determine the extent of the gross income. Again, it may be necessary to call out the troops on this one. And the troops need to be well versed in the time it takes to accomplish a particular task. So, for instance, it helps to know that a man's haircut takes a particular length of time (half an hour, for instance) and that a woman's hair dyeing session takes three times that length.

Example 9-4. Franco owns a hair salon catering to both men and women. He employs four stylists and a manicurist, each working full-time five days per week. Franco himself works 60 hours per week, but this includes payroll and other business management duties. Franco's business is nearly 100 percent cash, and the forensic accountant is asked to determine whether he is reporting anything remotely resembling the true intake.

Franco has furnished his scheduling book to the attorney, but it is full of erasures indicating cancellations and changes of appointments. A quick calculation shows that the average weekly number of appointments is 160, spaced more or less evenly between the six workers (Franco and his five employees). But the book does not show that Franco's shop also caters to a walk-in crowd whose services do not find their way into the appointment book at all. Franco reports gross sales of \$4,000 per week.

A private investigator is hired to observe traffic patterns for a week. The investigation produces the following data.

During the week in which the investigator sat in his car observing traffic patterns, the following people entered the shop for services.

Monday	10 men	20 women
Tuesday	10 men	20 women
Wednesday	10 men	20 women
Thursday	15 men	25 women
Friday	15 men	30 women
Saturday	20 men	35 women
	<u>80 men</u>	<u>150 women</u>
Grand Total		230 appointments

At the same time, the appointment book (received subsequently) shows only 170 appointments for the week.

The investigator reports that most of the men received haircuts, which the forensic accountant calculated at an average price of \$15.00 apiece. The women's services were a bit more difficult to gauge from the parking lot, but it appeared that about 20 had their hair dyed (average listed cost \$50.00) in addition to cut (average cost \$25.00). At least two dozen people received manicures (\$25.00).

A quick calculation shows, therefore, that the following services were rendered.

Men's haircuts	\$1,200.00
Women's haircuts	3,750.00
Women's dyeing	1,000.00
Manicures	<u>600.00</u>
Total projected income	\$6,550.00

Even allowing a whopping 20 percent margin of error (\$1,310 off the \$6,550), the gross income should still have been reported as \$5,240, not \$4,000 as was reported. The understatement of income is enormous. Extrapolating the average \$2,500 of underreported income by 52 weeks, it is clear that Franco is earning approximately \$130,000 more per year than he is reporting. At this point, based upon the preliminary investigation it may pay to have a professional private investigator stake out the shop for a longer period of time to confirm the initial findings, as well as to give the courtroom testimony more impact. The potential increase in the award to Franco's spouse will more than justify the cost.

Proving unreported receipts in the preceding example is a difficult task because of the labor-intensive nature of the business being investigated. Unfortunately, there are few choices in such a case—other than personal observation by an investigator—because it borders on the impossible to expect to be able to extrapolate accurate figures by counting the ounces of shampoo used to wash hair or the amount of electricity used by the hair dryers.

Restaurants and Other Food Establishments

Thankfully, not every cash business poses such difficulties. There are some that, although they are nearly exclusively cash businesses, rely upon supplies that can be readily factored into any extrapolated figure. Fast food establishments come to mind in this respect. The key to investigating such businesses is to have a thorough understanding of what goes into producing the products, which may result in underreporting.

Example 9-5. Maria owns a pizzeria whose business comprises 20 percent sales of individual slices and 80 percent sales of whole pies. The cost of ingredients (dough, sauce, cheese) is \$2.00, and a whole pie sells for \$8.00. Maria's invoices show that she is spending \$2,000 per week on supplies. It should be clear, therefore, that her business is probably grossing \$8,000 a week in sales. If only \$4,000 a week is being reported, there is a good chance that the rest of this money is being spent on a lifestyle beyond Maria's visible means.

In the previous example, there was no sophisticated counting required, as in the case of the liquor at the bar. The invoices alone would prove the underreporting once the forensic accountant can establish the value of the ingredients. In this respect it is very much like the deli example illustrated earlier in this chapter.


What if Maria claims spoilage? Or that her pizza is superior because she spends nearly \$5.00 per pie on ingredients? Is there another way of determining that this isn't true?

How about this: an inventory of the pizza boxes. If invoices show that Maria orders 1,000 pizza boxes every month, how will she be able to claim the sale of only 500 pizzas? Even if the spoilage argument carried any weight, it will be tough to convince the judge that 500 cardboard boxes per month end up in the trash heap.

Again, the trick is to think creatively and open-mindedly. For every clever move that a business owner can think of, there is likely to be one step that he or she has not considered. That's the one that the forensic accountant needs to confront the business owner with! In one widespread tale, for example, the IRS is

alleged to have determined that a brothel was underreporting income by examining the laundry bills for the business. The IRS calculated how many towels would be used in a typical “transaction,” then examined how many were actually being laundered and, determining that more towels were being cleaned than were justified by the reported customers/income, assessed a tax based upon the excess.

Now that’s creativity!

 **Tip:** How can one possibly know the ins and outs of every business? Most of the time it is impossible, except by experience or, perhaps, by asking the attorney for pointers. But there is another way: The forensic accountant may have clients of his or her own in a particular business, and they will very likely know some of the tricks of the trade. The accountant might ask these clients what they would do in a similar situation. This natural resource of the forensic accountant’s office might prove invaluable. Indeed, he or she might even convince the attorney to hire the client as an expert consultant.

Determining Cash Payment From “Improbability” of Actions

This publication previously explored various examples of professionals who had been paid in cash and the methods of proving that those professionals had, in fact, been paid for their services. It is time now to look at such an inquiry from an entirely different angle. As may be imagined, not every business transaction is completed instantaneously. Sure, when someone leaves the car wash, the automobile is clean. Transaction finished. A customer leaves a coffee shop with a sandwich. Transaction finished. What about businesses or professions that perform services over a longer period of time? For instance, a litigation attorney’s work is not completed immediately. (Cynics might say that a litigation attorney’s work is never completed, but that’s a different story!)

The different angle approach to examining whether a business person has, in fact, been paid for services is to examine the underlying transaction to determine the probability that it was completed without payment of some sort.

There is an old story of how a certain “code” developed in New York City criminal courthouses between attorneys and trial judges. When the criminal calendar was called and a defendant’s trial scheduled to proceed, the defense attorney might claim that he or she was not ready to begin the trial because he or she was waiting for the appearance of the key witness, one “Mr. Green.” It was understood in these hallowed halls of justice that “Mr. Green” meant “payment”; that is, that the defendant had not yet paid the attorney, and counsel was seeking an adjournment of the case until the client had, in fact, paid in full. Attorneys—and judges—realized that once the trial was concluded, there might be little incentive for the client to pay, particularly if convicted and sentenced to a long prison term.

This anecdote may be a fiction, but the story points out the need to understand a bit about the normal practice in a business. Here, the odds are that a criminal attorney would not have concluded the case without payment. The same is true of bankruptcy attorneys who very often insist on being paid upfront—before the court discharges their clients from their debts—or risk having the client add the unpaid attorney fee as a debt to be discharged by the court.

The improbability factor is not limited to legal services, of course. In the case of anyone who does home improvements but claims not to have been paid, a mechanic’s lien may be filed against the deadbeat homeowner. Such liens are usually filed in the local county clerk’s office, and the business owner (or his or her attorney) should be able to make a copy available. Therefore, if a debt is claimed to be uncollectible but no lien has been filed, it may be that the debt was actually paid in cash (or by check deposited into an undisclosed account).

In any situation where work in progress is encountered but no financial closure is found, the questions to ask are the following.

- Was the work completed? If it has been, then a further investigation may be warranted. If not, the reason should be determined. Is it simply still in progress, or has it been stopped temporarily pending the outcome of the divorce proceeding? Or is this truly a customer or client whose account is in arrears, causing the business person to terminate services?
- Would the work have been completed without the payment now claimed not to have been made? In the example of “Mr. Green,” the case may not have been completed until a final payment was received. In the case of a contractor who has already received two of three promised payments, it may be the final payment only on which the builder has been stiffed.
- What action would the person claiming nonreceipt have taken or been expected to take? In the case of a builder, he or she might sue the homeowner-customer. At the very least, a mechanic’s lien would have been filed by anyone who knows that such a remedy exists. If the appropriate action was not taken, find out why. It could very well be because of cash payment.
- Is there any extraneous proof of nonpayment other than the mere claim of the party being investigated? For instance, a customer who cannot pay because of a downturn in economic fortune may have filed for a discharge in bankruptcy. The bankruptcy petition to the court will name the business debtor owed a certain amount of money. That amount should match what the business owner claims. There is little to be done about such a step taken by a third party, but at least the proceeding will confirm that the business owner is telling the truth about not having been paid.

Note: Although this is not a discussion of bankruptcy, there are several things that the forensic accountant should know. First, for a debt to be discharged by bankruptcy, the creditor must be listed in the bankrupt’s petition for discharge. This will seldom be a problem because a debtor desiring a clean start will normally name everybody who is owed money. However, there are reasons that someone might not name a creditor. For instance, the debtor is afraid of ruining the business relationship (which may be needed for a continuation of business after emerging from bankruptcy).

Second, the forensic accountant should know that a debt may be “reaffirmed” after bankruptcy, that is, the bankrupt can agree to pay it notwithstanding the discharge in bankruptcy. Again, this might occur when a future business relationship between the bankrupt and the creditor is desired by the bankrupt.

Third, the claim of bankruptcy does not mean that the creditor will receive absolutely nothing. It may simply be that the creditor will only receive a fraction of what is owed. If this is the case, the forensic accountant should not neglect to count that fraction as an asset or potential asset of the business under investigation. As a result, the forensic accountant should never rely solely upon proof that a bankruptcy petition has been filed. Find out whether the debt has, in fact, been discharged, whether it has been reaffirmed, and whether any payment might be expected.

Calculating Cash Received on the Basis of Cash Deposits Actually Made

One of the other things to examine in cash businesses is the consistency or lack of consistency of cash deposits. Naturally, the mere fact that cash deposits are being made does not mean that all cash receipts are being deposited. Sometimes the forensic accountant will find clues to the business owner’s actions by examining the pattern (or lack of pattern) of deposits. The forensic accountant should focus his or her observation on the following areas.

There Might Be Too Little Deposited for the Type of Business

An example of this might be the doctor under contract as a health care provider who receives \$10.00 from each patient as their contribution towards the cost of their care.

Example 9-6. Doctor Smith deposits \$500 per week of patient coinsurance payments into his checking account. The deposits are fairly evenly divided between checks and cash. At \$10.00 per patient, it appears as though he is seeing 50 patients per week. The accountant knows, however, that he is really seeing closer to 100 patients per week. It appears that Doctor Smith believes that as long as he deposits some cash, suspicions will be averted.

The Pattern of Deposits Might Be Too Consistent, With the Same Amount Being Deposited Every Time

A business owner who deposits the same amount each week, regardless of income or expenses, may tip off the forensic accountant as easily as a business owner whose deposits are surprisingly small at times. Further investigation of insurance billing records of reimbursements may quantify the actual understatements.

Example 9-7. Ron owns a deli and deposits between \$500 and \$550 per day of cash in the bank. He believes that this range proves that his business is consistent and above reproach. The owner fails to take into consideration, however, that Saturdays and Sundays are traditionally slower days. By depositing \$1,000 on Monday morning (the true, full income from the weekend), the owner may inadvertently be telling the forensic accountant that not all the cash is being deposited during the work week.

The Deposits May Be Too Inconsistent

The flip side of the preceding analysis is that there will be no discernible pattern to cash deposits. Even randomness has its own subtle patterns that the forensic accountant must learn to recognize. This will give him or her a distinct advantage because the business owner, convinced of the cleverness of his or her random cash deposits, may not be able to see those patterns. Take, for instance, cash deposits made in the following example.

Example 9-8. Patsy owns a hot dog truck from which she sells hot dogs, sausage, and soda. For a particular six-week period, weekly bank deposits have been \$1,500, \$1,100, \$1,100, \$1,500, \$1,700, and \$1,400. The lack of pattern here, particularly if it cannot be explained by seasonal, weather, or other factors, can be maddening. Patsy obviously believes that this randomness evidences her honesty in depositing all receipts. The forensic accountant cannot figure out where to begin the investigation.

The accountant could compare these figures with the invoices for supplies for the same period. Say, for example, he or she finds such expenses to be \$800, \$800, \$600, \$1,500, \$900, and \$900. (It is assumed for the sake of this illustration that Patsy uses only the freshest ingredients, which she purchases at the beginning of each week. No large inventory of product is carried over from week to week. It is further assumed that experience shows that the average cost per sale is \$2.00 and that the average markup is 100 percent.)

Comparing the figures side by side, the forensic accountant finds the following.

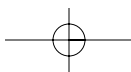
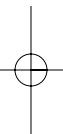
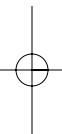
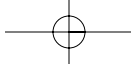
<i>Week #</i>	<i>Income</i>	<i>Expenses</i>
1	\$1,500.00	800.00
2	1,100.00	800.00
3	1,100.00	600.00
4	1,500.00	1,500.00
5	1,700.00	900.00
6	1,400.00	900.00

Because the cost of ingredients is a more reliable indicator of the business's success, the income might be proven to be a fabrication. In the above example, how credible will it be (absent some very plausible rationale) that in week 1 the defendant's 100 percent markup produced \$1,500 of income, whereas during the following week it produced only \$1,100 of income? And how to explain that in week 3, when Patsy spent less than in the week before, her income was the same? The true answer might be that she deposited more of her cash that week just to throw someone off the scent. It does not work, of course. And why is it that week 4 expenses equal income? Could Patsy be making up for cash "lost" the previous week? Again, why is it that in weeks 5 and 6 the expenses are identical, but the income varies by \$300?

Trying to make order look like chaos takes on a chaos of its own! The forensic accountant must be vigilant if the income and expenses appear to bear absolutely no rational relationship to each other. There may be more than meets the eye.

Summary

- Cash businesses pose difficult, but not insurmountable, problems for the forensic accountant when it comes to valuation because of the potential for underreporting income.
- It is important to have a thorough understanding of the cash business under investigation such as knowing the typical markup or profitability of a business and the typical costs associated with the business.
- A great deal of creativity is required to investigate a cash business. Much information can be obtained from examining those items the owner cannot (or has not thought to) conceal. The illustrations of the lawn mowing service or the IRS's brothel investigation are but two examples.
- One method of determining whether a subject has been paid, despite claims to the contrary, is to examine his or her actions carefully. Given the choice, most business people might elect not to complete a job if they have not been fully paid and have no expectation of receiving such payment. The completion of work despite this improbability factor may clue in the forensic accountant that a cash payment was received.



10

Marketing Forensic Accounting Services

Introduction

After reading this book, the accountant should have a fairly good feel for forensic accounting and should recognize whether this type of work is something that he or she wishes to pursue more actively. If the accountant likes solving puzzles or enjoys the thrill of investigative work, the answer will be a clear “yes.” A next-step, practical question is this: How to go about generating business in the field of forensic accounting, at least until word-of-mouth referrals keep the accountant as busy as desired?

This chapter is a brief introduction to some useful techniques to begin or grow a forensic accounting practice.

Identifying Your Market

The first goal of any marketing plan is to identify potential clients. The second is to educate them about the need for forensic accounting services. The final goal, once prospective clients have been identified and convinced of the need for a forensic accountant’s services, is to convince them to hire the accountant doing the marketing, as opposed to some other forensic accountant.

To begin, who is the “customer” for forensic services? In other words, who must get the word that a particular accountant does this type of work? Is it matrimonial attorneys? Or is it the litigants or potential litigants themselves? The answer “matrimonial attorneys” is only partially correct. It is that group, to be sure, but it is also the potential litigants. And it is also colleagues in the accounting field who have no interest in this specialty. And the accountant’s existing client base. And perhaps even the existing client base of his or her colleagues.

Here’s an important lesson for professionals who have never marketed their services before: The correct question in developing a marketing plan is not “Which group do I market to?” but “What must I do differently to market to different groups?” To grow a forensic practice, the accountant must reach as many potential sources of referrals as possible, as long as doing so is cost effective. He or she must be creative, thinking like a businessperson rather than solely as a person rendering professional services. The accountant is a salesperson, even though the “product” sold is a service. The accountant sells skill, experience, and results. He or she sells. Period.

Methods of Generating Business

In marketing to attorneys or other professionals, the accountant must first take stock of the fact that they will fall into two categories: Those who already know the accountant, and those who do not. Marketing to each group involves a different approach. The former group might be relied upon to furnish the accountant with referrals based upon an existing professional relationship. The latter group, of course, must somehow be convinced to do so.

By using one or more of the methods or ideas in this section, the accountant may be able to generate a few leads, just as any salesperson would. One of the fundamental principles of marketing is this: One need not generate 100 clients from any one method. If the accountant uses 10 different methods, and each generates 10 new clients, that will work just as well. In most cases, it is easier to generate 10 leads from 10 people than 100 from one.

Referrals

One of the most common ways to generate business is through referrals. These fall into three categories, listed below.

Personal Referrals

If the accountant knows attorneys who practice in the matrimonial field, he or she should approach them and tell them about his or her interest in obtaining some forensic accounting work from them. Assuming that they have no chiseled-in-granite relationship with another accountant, they might be willing to give someone else a chance.

It is not just matrimonial attorneys to whom the accountant should turn for referrals. Attorneys who do not practice in the field may know someone who does. After all, attorneys, like doctors, often refer cases outside their specialty to other specialists whom they trust. The accountant should ask for the names of these attorneys, or, better yet, ask for an introduction. Again, assuming no intrusion into preexisting relationships, they might be willing to give someone else a shot.

Accountants should be sure to approach attorneys for whom they do accounting or tax work. Chances are that if they like the accountant and appreciate his or her skills, they may be willing to spread that person's name around. Personal endorsement is always best for generating new business.

Referrals from Fellow Professionals

The accountant might not expect a colleague to share tax or business accounting clients, but this does not mean competition in one area must necessarily spill over into another. One accountant might know fellow accounting professionals who have no interest in forensic accounting and who are willing to generate leads, particularly if the accountant adopts a strict and ethical hands-off policy toward other work needed by the client being referred. In return for receiving introductions from fellow professionals, the accountant would be wise to refer matters to them in which he or she has neither the expertise nor the inclination to learn. The best professional relationships work in this tit-for-tat manner.

The accounting professionals need not be personal friends. The accountant might let it be known at professional functions that he or she is interested in forensic referrals.

Referrals from Existing Clients

The accountant's own clients are a source of referrals as well, though the subject might need to be approached gingerly. For example, if the accountant represents a business owner whose spouse is asking for a divorce—and if the spouse suspects concealed assets—this client may need forensic services. How will the accountant know that his or her client is in this position? It may be because the client asks about the soon-

to-be-new tax status (for example, “How does this single filing status work again? Who gets to deduct my kids?”).

A word of caution: Ethical considerations may prevent the accountant from undertaking this type of work if he or she performed accounting or tax services for both spouses and learned certain things about the spouses’ businesses as a result.

A final point about referrals: the accountant must ask for them. This may seem to be an obvious point—of course the accountant accepts referrals—but he or she will not get as many without actively soliciting them from clients. It need not be an elaborate solicitation. The accountant can merely tell a client who is satisfied with his or her work, “I appreciate the opportunity to be of assistance to you. If you know of anyone else who might use my services, I would certainly appreciate the referral.” Most people will not be offended by this.

Some of the best referrals may come from the opposing attorney on the last case. If the accountant is professional and constructive in the process and resists becoming involved in hostilities with the other party, the opposing counsel may consider retaining him or her on their next case. However, the accountant should never ask for a referral from opposing attorneys.

Seminars and Other Speaking Engagements

Has anyone run into someone offering a free taste of something and—unless they have just eaten an enormous meal or are dieting—turned it down? Nothing sells like a free sample. When the accountant lets people sample his or her wares risk free, he or she cannot help but pick up business. Now what does this have to do with forensic accounting? Professionals are salesmen, too, but what they sell is knowledge, expertise, a particular result. How can professionals offer samples of these services? One way is by giving seminars.

Seminars are a way to gather together a large (one hopes) group of people in one location at one time. One of the benefits of giving a seminar is that the attendees constitute a group that has, in essence, pre-screened itself regarding the sincerity of its interest. In other words, rather than wasting time soliciting people who are not interested but who will politely listen, this group is extremely interested in hearing what the accountant has to say.

Audience

The most important factor in conducting any seminar is reaching the target audience, in this case, matrimonial attorneys. Targeting the clients themselves may yield no results because even if the issue is raised in the mind of a party to a divorce action (or one contemplating one) that their spouse might be attempting to cheat them, few people will want to sit in a public seminar that identifies them as being in the midst of a divorce. It is way too personal a matter. In addition, most people will hire professionals such as accountants on the basis of their matrimonial attorney’s recommendation. On the other hand, one practitioner gets about 20 percent of her business from seminars directed to the general public. Some of the audience members ask their attorneys to engage her.

Audience is everything, and the accountant must reach the right one. Luckily, it should not be too difficult to do so. Depending upon the size of the practice area (geographically speaking), a list of invitees might be generated from such diverse sources as the telephone directory, the local bar association, or one of the many address databases currently available. The best bet is to contact the local bar association in the geographic area or areas in which the accountant wishes to generate the additional business (and, thus, hold the seminar) to see whether they will sell or provide a list of the names of practitioners in the matrimonial bar.

If they will not, here are some alternatives ranging in degrees of labor and sophistication.

- The accountant can determine whether there is a separate matrimonial law subcommittee of the bar (many bar organizations have specialized membership divisions to deal with the varying professional interests of their membership). If so, the accountant can contact the chairman and perhaps make arrangements to conduct a seminar directly for the membership of that committee.
- The accountant can advertise in the local bar publication. Many bar associations have a newspaper or newsletter that is sent out to their membership. They may accept paid advertising and, in fact, this may be a very efficient way of reaching members of the profession. (The subject of composing an advertisement will be discussed later.) Certainly if the local bar has a specialized matrimonial section with its own publication, the accountant should attempt to place an advertisement in this medium.
- The final method of gathering attorney names is quite labor intensive but, if all else fails, may be worthwhile to assign an assistant to do.

The name of the attorney or law firm handling matrimonial actions may be available directly at the courthouse in two ways. First, the lawyer's name will appear on any legal paperwork filed in the court. (The downside to this is that not every state makes its matrimonial actions public, unlike most other lawsuits. If records are public, though, the names of the parties can be determined.) Be warned: This is about as labor intensive an undertaking as one will ever conduct.

Which leads to the second method: Eventually, matrimonial actions (or specific motions, such as a demand for the production of documents being withheld) must be heard by a judge. Odds are that the court publishes a daily calendar listing the cases to be heard by each judge. This court calendar will not only contain the name of the case, but may also contain the names of the plaintiff's and defendant's respective lawyers or law firms. If a lawyer's name appears on this calendar, he or she does matrimonial work (even if only occasionally) and, so, over a period of weeks, the accountant may develop quite an extensive list of names of attorneys who have matrimonial matters before the court. In some larger geographic regions, there may even be a special section of the court that hears only matrimonial cases; this certainly will make the job easier. Again, the labor intensive nature of this undertaking makes it useful only as a last resort, but it is, nevertheless, a valid way of gaining names.

Subject Matter

If the accountant is going to conduct seminars, they should be focused on one subject exclusively, in this case forensic accounting. It is easy to fall into the trap of believing that as long as the accountant is planning on conducting a seminar anyway, perhaps he or she can gain additional business in a variety of other areas—such as general business accounting and taxation—by speaking a bit about those areas as well. This approach will most likely be counterproductive.

If the seminar is conducted under the guise of offering specialized knowledge, the accountant must appear, at least to this audience, to concentrate his or her practice in this specialized area. If too many general areas of accounting are addressed, the audience might get the impression that forensic accounting is, in reality, just another thing that all accountants do as part of their daily routine. If that happens, the overwhelming odds are that the attorney will ask his or her accountant whether they are capable of doing this type of work, and, if so, will likely offer it to him or her instead of the person conducting the seminar, who will have educated his or her audience right back into the arms of their own CPAs.

The question now is how to advertise the subject matter to gain the attention of potential audience members. The answer is simply this: in the same way that one believes would entice him or her to attend if he or she were curious about subject matter. Three of the most effective seminar draws are the "How To," the "Update," and the David Letterman-inspired "Top 10 List."

For example, an ad or invitation letter might be headlined as follows.

Free Seminar¹
How to Spot the Danger Signs of a Financially Dishonest Spouse

An alternative to the “How To” is the “Latest Development” in which the promise is to update attendees on things that they might not already know.

Spotting the Danger Signs of a Financially Dishonest Spouse:
Latest Developments

Conversely, if a more inexperienced audience is the target, the title might be the following.

Finding Hidden Assets for Your Divorcing Client: A Primer

There are limitless ways to present the seminar depending on the desired audience. Then there are the list-style teasers, such as the following.

25 Ways That a Business Owner Can Conceal Assets—and How to Find Them
Top Ten Ways That Business Owners Hide Cash and How to Root It Out

Unfortunately, the only way to determine what works in a region is to experiment. In fact, that is the essence of all good advertising campaigns: experimentation.

Seminar Materials—Slides and Handouts

Slides and handouts are not merely a good idea at seminars. They are crucial! Slides may be professionally prepared and projected from a slide projector, or they may be a PowerPoint presentation projected from a laptop. In either case, visual aids are important because, as the saying goes, a picture (or chart) is worth a thousand words. Graphic illustration of all the points is worth infinitely more than a mere verbal explanation, which is sure to be forgotten scant seconds after uttered.

Handouts serve two very important functions. First, they permit audience members to follow along with the presentation. Second, they provide attendees with materials—printed with the presenter’s name, address, and telephone number for future reference. And future reference may translate into future business. Attendees may also pass them along to a friend. Handouts have legs!

The Seminar’s Pitch

This chapter previously discussed the benefit of specifically asking for referrals. The same holds true at seminars. This does not mean that the accountant should actively solicit business in front of a large crowd.

¹ Assuming, of course, that it is free. A word on this matter as well. At least until the accountant becomes well established and seeks to give all-day seminars, he or she may wish to conduct free seminars. People will seldom pay to see someone speak unless they are assured of his or her credentials.

Neither should he or she merely walk away, leaving the audience with the impression that they are on their own in finding a professional to undertake forensic work or, worse yet, leaving them with the impression that this is the type of work that anyone, including their own CPA, can perform. The speaker should plant the seed that he or she is interested in working with them. More importantly, the speaker must explain what is in it for them (the attorney-audience members). The following can be stressed, subtly.

- Part of their job, of course, is to uncover hidden assets. The accountant can take this job off their hands, and the fee is the client's responsibility, not theirs.
- The accountant's good work will win them referrals from their own happy clients.
- The accountant can testify as an expert with great credibility (naturally, if the seminar was successful in that it informed, entertained, and impressed the crowd, they may believe that the speaker can do the same for a judge).

Speaking in Front of the Group

Worried about speaking to a large group? Here are a few tips for overcoming stage fright.

- *Practice, practice, practice.* And practice in front of ordinary people, if possible. Sure, the seminar is for professionals, but if a lay person can understand the subject matter, so can every professional, and they'll be impressed by an ability to communicate so clearly.
- *Get honest opinions.* Having a spouse falsely praise the speaker's eloquence is just a waste of time. This does not communicate with the intended audience. Conversely, criticism is not to be taken personally or argued with. The accountant should just listen and learn. If he or she argues with the critics, pretty soon they will be unwilling to help anymore because they will not want to be in the constant position of having to justify their opinions.
- *Be sure to schedule time for questions after the presentation.* If questions are taken during the course of the presentation, they will sidetrack the discussion, and it will not cover anywhere near the amount of material wished. Questions should be answered succinctly, with no evasiveness. If an audience member poses an unlikely or impossible hypothetical, the speaker should ask for more details or simply add enough additional information of his or her own to permit an impressive and helpful answer. The following exchange is one example.

Attorney: "I've got a case now where the husband is driving around in a new car, and I know there's cash there somewhere. But how do I prove it?"

Speaker: "What business is the husband in?"

Attorney: "General contracting."

Speaker: "There are probably a dozen ways that cash can be hidden in this kind of business. Let me give you one example . . ." (Then the speaker concludes with: "See me after the seminar and we'll talk about some more specifics.")

The accountant proceeds to discuss the one example. The question cannot be answered accurately as it pertains to that attorney's specific investigative target—the husband—because the speaker does not have all the necessary facts; however, by addressing the question, the speaker has accomplished several things. First, he or she demonstrated an ability to think quickly. After all, he or she answered a question that this bright attorney could not answer and did so with only a few seconds' thought. The second accomplishment was instilling in the audience the sense that the speaker has the answers (even though he or she has only given one possible answer). In other words, the question and answer period helps reinforce the fact that the speaker possesses the knowledge that they require.

In addition, by answering only part of the question, the speaker has not bored the rest of the audience (and has probably given someone else a chance to ask a question; there is nothing more frustrating to an audience member than not having a question answered).

Finally, asking this particular attorney to speak privately after the seminar has created the opportunity to establish a rapport, with the possibility of getting some business immediately. The attorney had said, “I’ve got a case now . . .” *Now* is the key word.

General Marketing Materials

Here are some other tips to make marketing more effective.

Websites

This book can give only limited attention to this critical marketing tool, and those interested in forensic accounting may want to read more extensively on the topic. According to *Effective Websites for CPAs*, CPAs have lagged other businesses in using the Internet to gain prospects and clients.¹ Though a daunting project to begin, a well designed website can pay off handsomely. A website visitor can quickly access the information most suitable for them; read testimonials and learn about company history, download forms; get answers to FAQs, etc. A website also enables the accountant to extend his or her reach beyond customary geographic boundaries. Some elements to consider in constructing or revamping your website include the following.

- Design your homepage to attract your ideal client—perhaps marital attorneys with robust practices or maybe marital attorneys just getting started in the practice. Take time to define this ideal client, then tailor your homepage to show that these are the people you serve. Pay close attention to the text, graphics, photos, and so forth.
- When listing your services, describe them and be specific. Make sure a marital attorney or suspicious spouse knows exactly how you can help them.
- On the Contact page, consider whether you want to give out your email address and risk spam attacks. Instead, post a form on the Contact page which asks for minimal information about the prospective client—name, phone number, email address, and reason for contact.
- A website can do more harm than good if it looks unprofessional or sloppy. Make sure text is well written, links work, design looks professional, and forms function properly.
- Site navigation should be clear and intuitive. A busy prospect who can’t find the information he or she needs will soon leave for another website.

Business Cards

There are two schools of thought on business cards. The first, and most traditional, is that they are merely informational: name, profession, address, and telephone number. The second, and certainly more effective, is that they constitute a part of the overall marketing plan. In other words, the business card is an advertising medium like any other.

¹ *Effective Websites for CPAs*, by Kristi Stangland, CPA (RJ Thompson Publishing, 2006).

Here is a closer look at this medium. The following two examples demonstrate the difference.

Telephone: (212) 555-5555	Fax: (212) 555-5556
<p>Jane Dough Certified Public Accountant 123 Main Street New Town, NJ 08880</p>	


Telephone: (212) 555-5555	123 Main Street
Fax: (212) 555-5556	New Town, NJ 08880
<p>Jane Dough Certified Public Accountant Income Tax Returns: Individual, Corporate, Partnership, Trusts and Estates Business Services: General payroll and bookkeeping services Legal Support Services: Asset investigation in divorce and business break-ups Always a FREE Initial Consultation</p>	

The second card, while taking up no more room, gives infinitely more useful information about the professional it represents.

Brochures

A tri-fold brochure is a standard, and yet very effective, marketing tool. It is a professional-looking way of letting prospective clients know a little about the accountant and the type of work he or she does. With today's technology, the brochure does not have to be professionally printed (although quantity discounts might make this more feasible if the print number is several hundred or thousand brochures). Inexpensive computer programs are readily available for automatically formatting brochures and newsletters. All it takes is a few hours.

Brochures can be included with seminar materials, left on tables at local bar association offices, mailed in a business-sized envelope, or left out in the waiting room. They are the most versatile type of marketing material imaginable.

 **Tip:** Many professionals make the mistake of preparing only one brochure in which they merely list every type of work that they do, as if the rest of the world understands what this means. For instance, a brochure saying only the following is meaningless to anyone but the person creating it.

We do:

- Federal and State Tax Returns
- Income Tax
- Long Form and Short Form
- Corporate Tax
- Subchapter S Corporations
- Accounting Services
- Business Accounting
- Bookkeeping
- Forensic Accounting

More specialized brochures can and should be used for each type of work done. Each brochure should explain why the potential customer should bring their business to the accountant. So, for example, if the firm performs general business accounting as well as forensic accounting, the two should not be lumped into the same brochure. Having a separate one for each area gives the flexibility of being able to send a forensic brochure to a potential client (or a business brochure to a general client) without diluting effectiveness.

This is not to say that each brochure should not mention the fact that the accountant does other types of work; indeed, it should. The point is that every time a separate brochure is printed, it gives the reader the feeling that the accountant devotes a sufficient portion of his or her business to the area outlined in that brochure to be an expert in that particular field.

Newsletters


Big brother to the brochure is the newsletter, one of the most effective ways of generating business. People love newsletters because they are informational. Well-prepared newsletters are often kept as references and read and reread. Newsletters need not be fancy, although again, modern word processing programs can make them appear as though they have been professionally typeset. The aim is for a mixture of news and helpful information, “war stories” (without mentioning client names, of course), and unintrusive business solicitation. The latter can come in the form of a list of the services the accountant performs, with a gentle “prodding” to the reader that they should feel free to contact him or her with questions or referrals.

Newsletters should go to existing clients; to other, noncompeting professionals; in the seminar packets—everywhere! A newsletter, even more so than a brochure, pegs the accountant as a serious player in his or her chosen business area.

Rotary Index Cards

One of the most valuable marketing tools, particularly in the professional arena, has been the use of rotary index cards. They come in two varieties: stand-alone (those that are merely included with the letter and, quite literally, fall out of the envelope) and attached, that being a die-cut card, part of a larger brochure, that the recipient can punch out and place in his or her rotary card index.

Any good office supply or specialty paper catalog will contain a variety of ideas and options on rotary index cards and brochures.

 **Tip:** Rotary index cards with tabs that protrude from the index itself are a good idea and are becoming more prevalent. With a tabbed card, the tab subject should be chosen carefully. “Accounting Services” or even “Forensic Accounting” are probably not as effective as the plain old English: “Divorce Accountant.” Make it easy for potential clients.

Giveaways

People love receiving giveaways such as calendars and pens. Unfortunately, most people will not say, “Now where did I put that accountant’s free pencil?” If they remember the name but not the number, they’ll dial telephone information. In this respect, those cute premiums are nothing more than cute premiums. They are not really business generators. If you believe that those cheap incentives work, then ask yourself the following question: How many free calendars and date books did you receive between November and January of last year? Now, how many of them do you still have?

Any more questions?

The point is to think creatively in the field of marketing, staying, of course, within the bounds of good taste and professional ethics. Rewards for loyalty and continued business, such as the occasional \$50 gift certificate, are smart marketing. “Thank you” cards and/or gifts of appreciation for referrals (in addition to business directly given to you) can keep those referrals coming. A fruit or gift basket at holiday time is also a good idea.

Endorsement Letter

The previous section discussed getting personal referrals, but how does this promise get translated into actual business? Sitting around waiting for the phone to ring would be a mistake because even the most earnest attorney-friend or attorney-client is too busy to make someone else’s future business a priority. Sure, they’ll keep the business card and refer someone if the opportunity arises, but this is not called “marketing.” It is called “waiting.”

One of the most underutilized but highly effective methods of marketing is the endorsement letter. It can be—in fact, it should be—a simple, short letter that can be mailed directly to a select target market or can be included as part of a larger packet of information, for example, at seminars. The target markets include those people who already know the accountant and those who do not. An endorsement letter is an attempt to effectively reach those who don’t know the accountant but who do know the person endorsing him or her. To understand the impact of a third-party endorsement, the following two examples show different letters that will include a business card and rotary index card.

Example 10–1: The Accountant’s Marketing Letter

Dear Attorney,

I’d like to introduce myself. My name is Sidney Arthur and I’m an accountant specializing in, among other things, forensic accounting in matrimonial cases. It is my job to locate assets that your client’s spouse may be attempting to conceal, whether they are business assets or personal assets, and I’ve been very successful in doing so.

The reason I’m contacting you is that you are a member of the matrimonial bar and your clients may benefit from my services.

I’ve enclosed my business card in the event that I can be of help to you. I can be reached during normal business hours, and there is never any charge to discuss your case with you.

I look forward to a profitable future.

/signed/

Sid Arthur

Example 10–2: Endorsement Marketing Letter

Dear Colleague,

I, like you, am a matrimonial law specialist, and I want to share a secret with you. His name is Sidney Arthur, and he's a CPA specializing in finding secreted marital assets.

I retained Sid a few months ago to help me with a difficult case. My client's husband ran a cash business, and I knew in my bones that he wasn't reporting all the income that he should have been. I needed to prove it, of course, but the job was too cumbersome for my small office. Enter Sid.

In the course of four weeks' work, Sid Arthur came up with proof so compelling and impressive that we settled the case on very favorable terms. When Sid asked me for this recommendation letter, I was more than pleased to provide it.

If you need a forensic accountant to "root out" an opposing party's financial picture, I certainly recommend that you call Sid. I've enclosed his card and my highest praise.

/signed/

Attorney

The impact of the first letter is much weaker than that of the glowing recommendation from a satisfied attorney.

Note: Although the second letter might have been written by the attorney (or ghostwritten by the accountant and approved by the attorney), it is obviously mailed out at the accountant's own cost and using his or her own labor. Someone who has just provided the endorsement should not be asked to stuff envelopes.

An attorney could be convinced to provide an endorsement because of the prospect of cross-endorsement. The tit-for-tat discussion early in this chapter applies here as well. The accountant might discuss with the attorney his or her own preparation of a similar letter endorsing the attorney's services. Certainly it is an area of marketing worthy of further exploration.

Direct Mail Solicitation

Kin to the endorsement letter is the direct mail solicitation letter. It may be less effective than the endorsement letter because there is no trust factor involved, but, if properly drafted, such a letter can be effective. There are several crucial considerations when drafting a direct mail piece. In fact, it is best to follow a formula similar to the following.

- First and foremost, the letter needs a grabber of a heading. Yes, a true letter begins with "Dear Sir or Madam" or some other such salutation. But this letter is not an attempt to impress any high school English teachers—it is an attempt to market services.
- The letter has about one half second to reach its target after he or she opens the letter. After that, if the reader's attention wanders, the solicitation is just one more piece of paper heading for the recycling bin.

The following are two examples of lead paragraphs. Which will buy more than one half second's consideration?

Dear Matrimonial Attorney:

I would like a few moments of your time to introduce myself. My name is Joanne Jones, and I'm a CPA practicing not too far from you. I would like to offer my services to you in the field of forensic accounting should any of your clients have need of these services.

The divorce is a bloody mess and—as if that’s not bad enough—you suspect that your client’s spouse is hiding assets. But how do you find them before it’s too late?

You don’t have to! That’s my job. And let me tell you why I do it so well . . .

Getting someone’s attention is only the first step, of course. Then the accountant must educate the reader in the following manner.

- First, the problem must be clearly described—why concealed assets are so difficult to spot, for example.
- Next, it should be made clear that this problem is not one that will simply go away.
- Then the readers must be convinced that the accountant can take the problem off their hands. In other words, the accountant is able to make their life easier.
- In addition, the accountant must convince the readers that he or she can solve the problem.

In addition to the above educational points, the accountant may wish to sell the attorney on his or her services by adding testimonials or references. It is not a bad idea to include an endorsement letter and newsletter, business card, or brochure.

Next, the reader should get some immediate and very real value: In the case of your professional services, it could be a free telephone consultation. Attorneys bill for their time. Time is valuable. Once spent, it cannot be replaced. Of the many professions, attorneys who bill by the hour are very likely to appreciate the value of the accountant’s time.

Finally, the marketing letter should end with a postscript. Marketing experts have referred to this as the “second headline” because studies have shown that, after the headline, people most frequently remember what comes after the signature. That may sound strange; after all, doesn’t a “P.S.” seem almost like an afterthought? It’s not. Quite to the contrary, it’s a well thought-out technique for closing sales.

Having discussed the rules for drafting a direct solicitation piece, it helps to examine one. Following is a sample of the copy that might follow the headline printed above.

Dear Colleague:

Would you agree that not every marital dissolution is friendly? Of course you would.

Would you agree that there are some spouses who might try to cut out your client's financial heart? Of course you would.

Unfortunately, there are many ways that this can be done, some of them so skillfully that you'd never suspect that your client was being cheated out of a fair property settlement.

Try this one for example: Spouse A, the owner of a small business, puts his first ex-wife on the payroll and pays her a salary instead of alimony. He writes her off as a business expense, reducing the net profits of his business, and thereby reduces the value of the share of the business which his current spouse is entitled to receive. Would you have missed such a move? I wouldn't!

Or how about this: You believe that Spouse X, the owner of a cash business, is not reporting a huge portion of that cash. But how do you prove it? It's a cash business, after all.

You'd be surprised at the creative ways that we can establish the true income of a business: from calculating the slices of tomato that a deli uses in one of its sandwiches, to matching customers with reported receipts.

Day in and day out, angry spouses think of new and better ways to cheat their other half. But then, if you're an experienced matrimonial attorney, I'm not telling you anything that you don't already know. So let me tell you a bit about me, instead.

My name is Jessica Fletcher, and I'm a forensic accountant. I don't deal with dead bodies. I deal with dead marriages. It may be your job to make sure that your client gets the fairest settlement or award possible, but it's my job to make sure that attorneys like you have all of the financial information necessary to do it.

I've been doing this type of work for several years now and boy, could I swap war stories! But let me do something better: I'd like to offer you my expertise absolutely free. If you currently have a situation where you believe that your client's spouse is stealing or concealing assets, or otherwise "cooking the books," but you're not quite sure how to prove it, just call me. If there's a possibility for spousal impropriety, chances are I'll be able to tell you how to find it.

There is no charge for picking my brain and, should you believe that my services are helpful to you or to your client, I can even make arrangements to be paid by your client directly, freeing you of any responsibility as to my compensation.

And should you ever require a professional expert opinion, I am well qualified to testify credibly and convincingly as to the findings of my investigation.

I look forward to assisting you with the protection of your clients, should the opportunity arise. In the meantime, I have enclosed some materials and a card for your rotary card index as well as a few of my business cards.

Sincerely yours,

P.S. Don't forget: You can call me any time for a free, no-obligation review of your difficult cases. If assets are being hidden from your client, let's see if I can't find them!

A few final points about direct mail solicitation follow.

- Use short sentences and short paragraphs. Short bursts make the letter flow more quickly, so that before the reader knows it, he or she is finished.
- No matter how large the mailing, use stamps, not a postage meter, and not a preprinted bulk mail permit indicia. Every study of unsolicited mail has shown that stamped letters have a much greater chance of being opened and read than either metered or bulk rate permit mail. If a mailing is large

enough, however, it may very well pay to use bulk mail. Bulk mail postage stamps are available at the post office.

- Inserts, such as a newsletter, brochures, or rotary index card, are naturals for inclusion with the solicitation. This is an opportunity to get as much information into the hands of the prospect as possible.

Advertising

No section on marketing would be complete without a few words on print advertising media, such as the telephone book or ads placed in the local bar association newspaper or newsletter.

The basic rule of advertising is this: Never use a one-shot ad. They do absolutely nothing. A one-shot ad is, as the name implies, a one-time insertion in a newspaper which will be clipped out by (one hopes) enormous numbers of attorneys for future use. Studies have shown that it often takes over two dozen exposures before advertising will make an impact on its intended audience. This means that if the local bar association produces a newspaper each month, the commitment is to an advertising campaign of at least two years. Eventually, some business may come out of the advertisement, but seminars and producing and mailing newsletters are probably better bets.

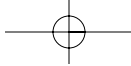
If an advertisement is to be used, it should not be of the sterile type that lists nothing more than the name of the advertiser, a standard list of the types of work that he or she does, and, if geared toward a professional audience, a line such as “Counsel to the profession.” Now what the heck does that mean? Has anyone ever responded to such an ad because this particular professional is willing to accept business from other members of their own profession? My guess is that people use these types of ads because they see them in other people’s ads, without a clue as to their effectiveness or, more appropriately, their lack of effectiveness.

The best ads are those that inform and educate. Inexperienced advertisers often believe that less is more. In other words, they believe that a simple ad with a name and telephone number as well as that all-encompassing list of “I do its” is a good ad. Exactly the opposite has been proven to be more effective. That’s why so many direct mail advertisers use full-page ads crammed with lots of body copy. They know that they are paying a lot of money for advertising space and that they have only one opportunity to motivate the reader, and they know that you motivate with more information, not with less. (Next time you’re thumbing through a newspaper or magazine, stop and read one of these direct mail ads. They’re often labeled “Advertisement” at the top or bottom because they appear to be articles.

Ad space should be used to tell why forensic accounting is so important. Or to relate a war story—anything to draw the reader into the ad and to make them want to arrange a meeting. Advertising space salesmen may recommend the use of lots of white space—which the advertiser is paying for.

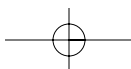
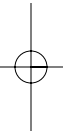
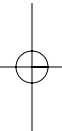
If the plan is to advertise in legal publications, here are some additional tips.

- *Just as in the case of seminar solicitation, headlines are crucial.* You have a scant one half second to catch the reader’s attention before he or she flips to the next page. A grabbing headline will make readers stop. A boring one or, worse yet, no headline at all, is a waste of money.
- *Test. Test. Test.* Just because an ad is placed does not preclude experimenting with other ads. One ad could draw over 100 responses, while another one, in the same medium, might draw only 3. A savvy advertiser will discard the latter and then test the former against yet another ad to see whether he or she can increase responses to even greater than 100.
- *There are certain key words in advertising.* Unfortunately, many apply to soap suds (“New and Improved” Blatz) but, alas, not to forensic accounting. The most important magnet word that does apply is “free.” It has been proven that prominently displaying the word “free” will increase the response. The freebie need not be anything fancy—a free consultation or a free brochure or newsletter. The important thing is to try to get that word into the advertising material.



Finally, the medium should be carefully chosen and tested. A general bar publication may draw better responses than the publication of a specialized matrimonial subcommittee. Perhaps this is because many of the matrimonial specialists already have associations with forensic accountants while the general membership—consisting of attorneys who only occasionally handle a divorce matter and who need all the help they can get—will likely call upon an accountant more readily. The point, again, is test, test, test!

This is especially true with telephone directory ads, which, for a subject such as forensic accounting, are likely not to be the best medium. When was the last time anyone chose a neurosurgeon or trial lawyer through the telephone book? It is unreasonable to assume that anyone would choose a forensic accountant in this manner. Perhaps the better idea is to save print advertising dollars for those professional legal publications.



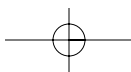
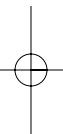
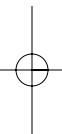
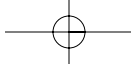
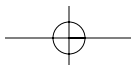
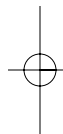
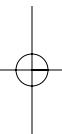


Table of Appendixes

The documents in these appendixes are aids to assist the client's attorney to obtain documents, records, and information for the CPA. There are differences in various states' family law and discovery rules. The attorney will modify the requests to comply with local law, rules, and customs. These are not intended to be all-inclusive and require editing to the requirements of a specific assignment.

Appendix A	Engagement Letter for Litigation Services
Appendix B	Interrogatories
Appendix C	Document Request for Bank and Brokerage Account Records
Appendix D	Request for Documents Regarding Income and Other Financial Information
Appendix E	Business Valuation Information Worksheet
Appendix F	Request for Documents Regarding Marital Standard of Living
Appendix G	Investigative Inquiries or Deposition Questions Regarding Undisclosed Income
Appendix H	Typical Deposition Questions of an Accounting Expert
Appendix I	Request for Personal Tax Documents and Related Information
Appendix J	Demand for Real Property Documents and Records
Appendix K	Real Property Questionnaire



Appendix A

Engagement Letter for Litigation Services

The following is a retainer agreement for accounting and investigative services.

AGREEMENT FOR SERVICES¹

I. Parties and Purpose

Parties: Smith & Jones, LLP
(Accountants)

Jane Doe
(Client)

Attorney: Clarence Darrow

Matter: Marriage of Doe

This letter will serve to confirm our understanding and agreement whereby you have retained Smith & Jones, LLP to perform accounting services in the above subject matter. You or your law firm and/or the court itself will advise us (with sufficient notice of at least 30 days) as to the work to be performed by us and the requirement for any appearance in court or deposition. Client agrees to pay for accounting services requested by attorney. If there is a substitution of attorneys, we reserve the right to withdraw from this engagement.

II. Services

Michael Smith will participate as Project Partner, maintaining overall project responsibility in terms of staffing, quality control, billing and client relations. Another member of the firm will coordinate daily management of the case. Other professionals who will be identified during the course of the engagement will provide technical support.

Our services will include the following:

¹ For a detailed discussion of engagement letters, see AICPA Business Valuation and Fraud and Litigation Services Practice Aid 04-1, *Engagement Letters for Litigation Services*.

1. Spendable income analysis for purposes of determining support.
2. Preparing a list of marital property with proposed division of community property.
3. Investigating the allegations of misappropriation of community assets.
4. Valuation of the business John Doe, Attorney at Law.
5. Tracing separate property interest in Brokerage accounts.
6. Analysis of separate property interest in Big Deal Inc. Stock Options.
7. Services that you or your attorney request and that we agree to perform.

We cannot and do not warrant or predict results or final developments in this matter. While we may discover, during the course of your case, undisclosed property or debts our services are not designed to uncover property or debts and do not anticipate fraud or concealment. Fraud detection or property/debt discovery services will not be rendered unless confirmed in writing as a modification of this agreement.²

The American Institute of Certified Public Accountants has determined that the above described services are subject to its Statements on Standards for Consulting Services No. 1 (SSCS No. 1). This statement requires that we inform the client of significant reservations concerning the scope or benefits of the engagement, as well as significant engagement findings or events. By signing this letter, you agree that our communications to your attorney as counsel will discharge our client communication responsibilities to you as described in SSCS No. 1.

III. Fees

The above services will be furnished on an hourly basis in accordance with our fee schedule, a current copy of which is attached hereto as Exhibit A. These rates are subject to periodic increases due to inflationary economic conditions, but will not be increased unless increased to all our clients.

Time spent on your case includes all hours associated with your case, including travel, preparation of fee declarations, supervision, telephone calls and all other time. Our billing rates do not include any out-of-pocket expenses, which are additional charges. You will also be charged for any other experts who in our opinion are required. You will also be charged for legal fees should we solely in our judgment be required to retain legal counsel to advise us in connection with the above matter.

In situations of this nature, it is usually not possible to provide an accurate estimate of the total time or fees required to complete the tasks assigned. The ultimate fees depend on a variety of factors including, but not limited to, the adequacy and condition of the records, the extent of the cooperation obtained from you and others and various other related factors.

IV. Deposit and Payment of Fees

To begin working on your case, we require a deposit of \$_____. This deposit is not intended to be an estimate for the total cost of the work to be performed nor have we given you an estimate. No interest will be paid on deposits held by us. The deposit will be held by us and applied to the final billing at the conclusion of the case. Any deposit in excess of the fees will be refunded. You agree to maintain this deposit by promptly paying each billing statement as it is presented.

At such time as the deposit is (solely in our judgment) insufficient to provide for payment of your fees, we will discontinue our services and request an additional deposit. If the additional deposit is not

² See addendum to agreement for fraud investigations services.

received within seven (7) days of our request, we may discontinue working on your case. All fees must be paid current and the deposit restored in full prior to our appearing or providing any testimony at court. If the deposit is not restored within fifteen (15) days, we may withdraw from your case.

V. Billing and Collection

Statements will be rendered on a periodic basis (weekly in some cases) and are due upon presentation (without credit for the deposit). Upon receipt of each billing statement client agrees to immediately review the billing statement. Client further agrees to, within 30 days of receipt of billing statement, bring to accountant and attorney's attention all questions, objections, and other reservations regarding the billing statement. If no objection is communicated to accountant by client then the billing statement is presumed to be correct and client waives future objections to accountant's billing statement.

If the amount is not paid by the client within thirty (30) days of the invoice date, commencing with the thirty-first day and continuing until paid, interest will be charged on a monthly basis on the unpaid balance at 16% per annum (or the highest rate allowable by law).

The balance of our fee, should it exceed the deposit, remains the client's individual responsibility. Credit will be given to the client for any funds the court orders paid from any source, provided such monies are actually paid to us. Client agrees and understands that it is not the firm's duty to attempt to collect fees from an adverse party, even after an award of such fees, without charging client for our time.

VI. Document Retention

Our conflict check for this engagement went back through _____ years of client activity; which period coincides with our firm's document retention period. You authorize our firm to destroy all files and documents therein _____ years after the completion of our assignment. You will have the opportunity to review your file at any time prior to destruction and retain those documents that are yours and copy any others.

Please note that it is not our practice to retain superceded Workpapers, e-mails, notes or data files that have been updated or superceded, unless shared with you or a third party working with you. However, we will retain copies of e-mails, analyses, draft reports or other materials provided by you or any third party, or provided by us to you and any third party.

If you wish us to follow a retention practice that differs from those described in the above paragraph, please indicate your specific request(s) in writing when returning a copy of this engagement letter. We reserve the right to decline the engagement depending upon the nature of your request(s). At the close of this engagement, we will require your instruction for the disposition of documents that we have accumulated.

VII. Disclosure

Sections 2100 through 2113 of the California Family Code require a full and accurate disclosure of all assets and liabilities in which either the client or the client's spouse have or may have an interest. You must make disclosure in the early stages of the proceeding for dissolution of marriage or legal separation, *regardless of the characterization as community or separate property*. These sections also require client to disclose all available income and expenses. Client is also required to update these disclosures for all material changes occurring prior to final resolution of the case. Client and attorney will prepare the required disclosure. Accountant will not be responsible to assist in the preparation of any disclosures unless specifically stated as a service to be provided in Article II of this agreement. Client understands and agrees that it is his or her responsibility to provide the attorney (and accountant if accountant agrees to assist with disclosures) with any and all information concerning the assets, liabilities, income and

expenses throughout the course of these proceedings. Client also agrees to keep attorney (and accountant if accountant agrees to assist with disclosures) fully informed of all changes to the disclosure and to any and all investment opportunities, which arise prior to final resolution of this matter.

VIII. Arbitration³

Client and accountant agree that any dispute over fees charged by the accountant to the client will be settled by arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof. The rules are available at www.adr.org or we will provide to you upon your request. Such arbitration shall be binding and final.

BY AGREEING TO ARBITRATION, WE BOTH ACKNOWLEDGE THAT, IN THE EVENT OF A DISPUTE OVER FEES, EACH OF US IS GIVING UP THE RIGHT TO HAVE THE DISPUTE DECIDED IN A COURT OF LAW BEFORE A JUDGE OR JURY, AND INSTEAD WE ARE ACCEPTING THE USE OF ARBITRATION FOR RESOLUTION.

IX. Right to Withdraw

Smith & Jones, LLP reserves the right to withdraw our services due to:

1. Failure by the Client to allow a reasonable amount of time for the agreed-upon assignment to be completed.
2. Client's failure to meet the financial obligations delineated in this Agreement.
3. Disagreement of opinion between the Client and Smith & Jones, LLP.
4. Disagreement between the Client and Smith & Jones, LLP over the conduct of the Client's case.

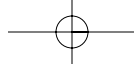
X. Acceptance

This offer to provide services remains open for twenty (20) days from the date signed by Smith & Jones, LLP, below. Acceptance by Smith & Jones, LLP occurs only after the signed agreement and deposit is actually received by Smith & Jones, LLP within twenty (20) day period.

XI. Expert or Other Designation

Smith & Jones, LLP or its partners or employees may not be designated as an expert, referee or special master in any matter until the signed agreement and deposit are actually received by Smith & Jones, LLP and a conflict check has been completed. No such designation may be made after the twenty (20) day provision for acceptance of this offer to perform services lapses.

³ Arbitration may be required of all claims or only professional fees. State rules regarding arbitration vary and an attorney familiar with local rules should review your arbitration clause. Error and omissions insurance carriers may have arbitration-related clauses in their policies and can provide helpful information.



XII. Signature of the Parties

A. By Smith & Jones, LLP

Smith & Jones, LLP
Michael Smith, CPA

Date: _____

B. By Client

I, the undersigned, hereby agree to the terms set forth above for the engagement of Smith & Jones, LLP. As security and collateral for payment thereof, I hereby grant to Smith & Jones, LLP an express lien upon my present and future sole and separate property. In the event fees are not paid as required, Smith & Jones, LLP expressly reserves the right to refuse to render future services even if adequate security and collateral are provided.

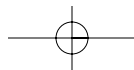
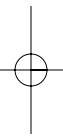
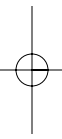
IN SIGNING THIS AGREEMENT I ALSO AGREE TO SUBMIT ANY FEE DISPUTE TO ARBITRATION.

Jane Doe, Client

Date: _____

I hereby acknowledge that I am the attorney of record for Jane Doe. I have discussed the agreement with my client and she is fully informed of its content.

Clarence Darrow, Attorney at Law



ADDENDUM TO AGREEMENT FOR SERVICES

Parties and Purpose

Parties: Smith & Jones, LLP
(Accountants)

Jane Doe
(Client)

Attorney: Clarence Darrow

Matter: Marriage of Doe—Investigation of Company

Company: Doe & Doe LLP (Law Partnership)

PURPOSE: This letter will serve to confirm our understanding and agreement whereby Smith & Jones, LLP has agreed to perform additional investigation services for undisclosed property and debts due to mistakes or intentional actions of others. This addendum does not change any of the terms of the Agreement for Services other than the scope of services in the above subject matter. All other terms of the original Agreement for Services remain in effect.

ADDITIONAL TERMS: Accountants agree to expand their original assignment to include the following investigatory services under the following additional terms and conditions:

- A. Our investigation will focus on the Company Doe & Doe LLP, a professional law partnership.
- B. Our investigation will initially focus on the two years prior to marriage but may be expanded if results warrant the expenditure of additional time. We will discuss the necessity of expanding our investigation with your attorney before performing additional services outside the first two years.
- C. If records and information we request are not available or cannot be obtained we will cease services and discuss with your attorney obtaining such information as we believe is necessary for our assignment.
- D. We will send to your attorney requests for documents and questions for interrogatories or depositions. It is your attorney's responsibility to obtain this information. We shall not be responsible to enforce or pursue discovery after our initial requests.
- E. If a private investigator or other experts are required, you agree to retain them and to be responsible for their fees and costs. We will have no responsibility for these additional services except to assist in defining the scope of such additional experts.
- F. In addition to the requirement in our original Fee Agreement to provide notice of at least 30 days as to the work to be performed by us and the requirement for any appearance in court or deposition, this requirement is extended to 60 days from the time ALL information and documents are actually received by us.
- G. Accountant is not providing any assurances that all undisclosed property and debts will be disclosed by these investigative services. If our investigation is suspended or terminated, accountant assumes no responsibility that preliminary findings predict the final results if the investigation were completed. If client and attorney settle the case before completion of the investigation, they assume all risks of not completing the assignment.

- H. Client and attorney agree to provide all information, documents, suspicions, witnesses and any other information associated with accountant's services. Client accepts responsibility and consequences of any failure to obtain and provide accountant information or to withhold information from accountant.
- I. Forensic investigations require a substantial investment in time and money with uncertain results. Billing and payment information is described in the original agreement. However the original retainer of \$_____ is increased to \$_____ for forensic investigations. All other billing and payment terms remain the same. We have not provided an estimate of our fees or costs for investigative services. If Client or Attorney notifies accountant in writing, we will limit our fees to the limited amount requested and obtain permission for additional fees as our investigation progresses. There are no assurances that we can complete our investigation.

Our additional investigative services will include.

1. Assist attorney in preparation of discovery requests for additional documents and information for the services covered by the original agreement and this addendum.
2. Investigate a sample of expenses paid from Company (Doe and Doe LLP) to determine if personal expenditures of John Doe are being paid by the Law Firm and deducted as business expenses by the Firm.
3. Review Law Firm billing procedures to determine if:
 - a. Unbilled time was appropriately billed each month and reflected in the firm financial statements.
 - b. Billed and unbilled time was appropriately recorded in the financial statements based on the Firm's billing system.
 - c. Transfers of payments to and from client trust accounts were recorded in the firm financial statements.
 - d. Write-offs of unbillable time and uncollectible billed receivables are appropriate.
 - e. There are any contingency cases which represent potential value.
 - f. Billings and production is appropriately allocated to attorneys consistent with the partnership agreement and firm practice prior to the divorce.
4. Review Law Firm financial records to determine:
 - a. Prepaid expenses are recorded as assets.
 - b. Property and equipment is reflected on the financial statements.
 - c. Determine current value (based on other expert appraisals) or estimated useful value (Generally Accepted Accounting Principles book value) of Property and equipment.
 - d. Current value of investments.
 - e. Accounts payable and accruals are appropriately reflected in the financial statements.
 - f. Loans are recorded at current balances and incurred for a business purpose.
 - g. That capital accounts reflect partners' share of income and losses defined in the partnership agreement, bonus programs and income allocation agreements among partners.
5. Trace the cash payments from firm to John Doe and determine how they were spent. Identify expenditures for these payments to John Doe, which have not been previously disclosed to Client (and subsequently disclosed to accountant).

6. Such other services as the Client or Attorney request and we agree to perform, but only if confirmed by us in writing as another addendum to the fee agreement.

Signature of the Parties

By Smith & Jones, LLP

Smith & Jones, LLP
Michael Smith, CPA

Date: _____

By Client

I, the undersigned, hereby agree to the terms set forth above for the engagement of Smith & Jones, LLP. As security and collateral for payment thereof, I hereby grant to Smith & Jones, LLP an express lien upon my present and future sole and separate property. In the event fees are not paid as required, Smith & Jones, LLP expressly reserves the right to refuse to render future services even if adequate security and collateral are provided.

IN SIGNING THIS AGREEMENT I ALSO AGREE TO SUBMIT ANY FEE DISPUTE TO ARBITRATION.

Jane Doe, Client

Date: _____

Acknowledgment by Attorney

I hereby acknowledge that I am the attorney of record for Jane Doe. I have discussed the agreement with my client and she is fully informed of its content.

Clarence Darrow, Attorney at Law

This document is intended as a sample only. It is included with the understanding that the publisher, authors, and editors are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.

Appendix B

Interrogatories

The following are sample legal interrogatories. One party may furnish another with a list of questions, called interrogatories, which must be answered by the recipient. Interrogatories may combine questions with a demand that documents supporting the answer be produced, too.

COURT OF THE STATE OF COUNTY OF

_____ x

Plaintiff

—against—

Defendant

_____ x

_____ requests that the _____ answer the following interrogatories within fifteen (15) days of the date of service thereof.

1. State your full name, date of birth, Social Security number, post office address, home street address, business address, home and business telephone numbers.

2. State the names, birth dates and present addresses of all children born or adopted during the marriage between yourself and _____. Indicate whether any of the children are emancipated or, if not, who has custody of each child.

3. Indicate whether any child receives extraordinary medical or psychiatric care or has special financial needs such as private school or college tuition and describe in detail the nature of said care or financial need.

4. State whether you have any need of extraordinary medical or psychiatric care or other special financial needs and describe same in detail.

5. Indicate the state of your present health as well as the names of your physician(s).

6. If you have any disability that impairs your ability to work or to earn a living, state precisely the nature of said disability, the names and addresses of all physicians who have ever treated said disability and the frequency and cost and nature of said treatment. Attach all medical reports relating to said disability.

7. Describe your educational background, stating the names of all schools attended, years of attendance, degrees conferred.

8. If you were married to _____ at the time you attended any of the above-mentioned educational institutions, indicate whether _____ contributed to the cost of your education and/or support and living expenses. State precisely the amounts of all such contributions.

9. State your residence address during the past five years indicating periods of residence at each address.

10. State whether you currently reside with your spouse. If not, state the names, ages and relationship to you of all of those persons with whom you reside.

11. If your current residence is rented or leased, set forth in detail the monthly rental cost of the premises, to whom said rental is paid and at what address, and whether any person other than yourself contributes to the payment of said rental and the amount of their contribution, if any. Attach copies of all cancelled rent checks for the last year as well as a copy of your current rental or lease agreement.

12. If you own your present residence, state (a) the date you acquired said residence, (b) from whom it was acquired, (c) the purchase price, (d) the amount of down payment, (e) the source of down payment, (f) the amount of the original mortgage, attaching hereto copy of said mortgage, (g) approximate unpaid balance of the mortgage as of the date of the service of the summons in this action, (h) the approximate

unpaid balance of the mortgage as of this date if different from the above, (i) market value of your residence both at the time of the service of the summons in this action and as of this date, (j) the tax basis of your residence when acquired, (k) the adjusted tax basis on your residence at the time of the service of the summons of this action and as of this date, (l) whether there are any liens or encumbrances on said residence, the nature thereof and the amount, (m) the current assessed valuation of your residence for real property taxation purposes. Attach hereto copies of the closing statement of purchase for your residence, deeds and copy of any and all appraisals obtained for your residence.

13. If the residence referred to above is not the marital residence, supply all information requested above with regard to the marital residence.

14. Indicate the source of all mortgage and/or tax or rent payments made on your present residence and on the marital residence from the date of the separation of the parties and/or the date the summons in this action was served.

15. If you have any interest in real property other than that referred to above, whether income-producing or otherwise, for each such property set forth the following: (Note: If any of these properties is located outside the United States, set forth the information, which under local statute or custom is equivalent to the information requested herein. Financial information should be reported in local currency and its U.S. dollar equivalent at the time of the transaction in question.)

- (a) Street address, county and state of the property's location;
- (b) Type of property and deed references;
- (c) Zoning of the property;
- (d) Date of acquisition and from whom;
- (e) The down payment and course thereof, showing specifically the contribution of each spouse;
- (f) Purchase price as well as the amount of original mortgage;
- (g) Unpaid balance of the mortgage as of the date of service of the summons in this action and as of the present date;
- (h) Name and address of mortgage lender and mortgage identifying number;
- (i) Current market value of the property;
- (j) Nature and amount of any liens or encumbrances on the property not heretofore set forth;
- (k) Names and addresses of all other persons having an interest in the property and the nature of said interest;
- (l) Itemize for the last 12 months all operating expenses including but not limited to taxes, mortgage payments, insurance, fuel, gas, electricity, water and maintenance on the aforesaid property;
- (m) The present assessed valuation assigned the property for real property taxation purposes;

- (n) The exact nature and extent of your interest;
 - (o) The tax basis of the property when acquired;
 - (p) The adjusted tax basis of the property at the time of the service of the summons in this action and as of the present date;
 - (q) The names and addresses of all tenants and/or occupants of said property, the amount of their annual rent, the frequency of their payment of said rent and their relationship to you, if any;
 - (r) Attach copies of the closing date of purchase, the deed, any mortgage on the property, and a copy of any appraisals obtained.
16. If you have sold or otherwise disposed of any real property in which you have had an interest during the last 5 years, state for each property in detail the same information as requested in interrogatory no. 15 above. Attach copies of each closing statement of purchase, deed, mortgage and a copy of any appraisals obtained.
17. If you have executed any contracts for purchase or sale of real property within the last 5 years, indicate whether you were purchaser or seller, the name of the other parties to the sale, location of the property, and the terms of the sale. Attach a copy of all such contracts.
18. If you held the lease of any rental property not heretofore disclosed, set forth all of the information with respect to same requested in interrogatory no. 11 hereof.
19. State the names, addresses and telephone numbers of all your employers during the last 5 years, providing the dates of employment, position held, reason for termination and salary.
20. With regard to your present employment, set forth the name and address of your employer, the type of business and your position, length of employment.
21. Set forth your current rate of pay or earnings specifically including your gross and net weekly salary, wages, commissions, overtime pay, bonuses and gratuities, if any.

22. Set forth the benefits provided you and/or your family by your employer including but not limited to the following: (a) health insurance; (b) life insurance; (c) pension, profit-sharing annuity and/or retirement income program; (d) expense account and/or drawing account; (e) credit card and/or reimbursement for business expenses charged for you on personal credit cards; (f) disability insurance; (g) stock purchase options; indicate whether you pay for any of the benefits listed above and if so, the amount of your payment and/or contribution. Attach copies of all books and records pertaining to the above-mentioned fringe benefits, credit and charge accounts, including all statements and receipts for the last five (5) years.

23. If you are furnished with a vehicle by your employer or by anyone else, set forth the year, make, model and license number of said vehicle, the name and address of the registered owner, the date you were furnished with said vehicle. Indicate the amount of money spent during the last year for gas, repairs, maintenance and insurance for said vehicle and indicate by whom said expenses were paid. If paid by you, indicate whether you were reimbursed for said expenses and if so, by whom and in what amount. If said automobile is leased, attach copy of the lease.

24. State and itemize all deductions taken from your gross weekly earnings including but not limited to taxes, insurance, savings plans, loans, pensions, profit-sharing, dues, stock options. Attach copies of your pay check stubs for the last year.

25. State whether you have an employment contract with any business entity at the present time or have had same during any of the last five (5) years. If so, attach a copy hereto. If said contract was oral rather than written, set forth the terms thereof.

26. If you are entitled to receive any monies from a deferred compensation agreement as a result of your employment at any time during the marriage, set forth the date such agreement was made, the names of the parties thereto, the amount you are to receive under the terms thereof and when you are to receive same. Attach a copy of said agreement hereto.

27. Attach hereto copies of all federal, state and local income tax returns for the last five (5) years as well as all schedules and worksheets thereof and all other papers, documents or memoranda referring to any adjustment or audit in connection therewith.

28. Indicate whether you have received in the past five (5) years or are receiving any form of compensation, monetary or otherwise, from any work and/or services performed for persons or business entities other than those individuals or business entities heretofore disclosed. Respond to interrogatories 20–27 in regard thereto.

29. Attach hereto copies of all IRS 1099 forms filed during the last five (5) years.

30. Indicate whether your salary will increase during the next 12 months as a result of any contract of employment or as the result of any incremental increase to which you are entitled.

31. With respect to any pension, profit-sharing, or retirement plan to which you are entitled by virtue of your employment or otherwise, set forth:

- (a) Type of plan;
- (b) Name and address of the provider of the plan;
- (c) Whether your interest is vested and if not, the terms and conditions under which the plan will vest;
- (d) Whether the plan is contributory or not and if contributory, the amount contributed during each year of the marriage;
- (e) The amount earned by you during each year of the marriage;
- (f) Whether you have the right to withdraw money from the plan and if so, under what terms and conditions;
- (g) If you have withdrawn or borrowed any money from the plan, set forth full details of these transactions including information concerning repayment;
- (h) Describe in detail any survivor benefits of the plan.

Attach copies of said plans as well as all documents concerning same.

32. Set forth all income and other benefits not already disclosed including but not limited to pensions, annuities, inheritances, reimbursed expenses, retirement plan, Social Security benefits, military or veterans benefits, lottery prizes, bank interest, dividends, and indicate the source, amount and frequency of payment for each, and whether taxable or not.

NOTE: If any of the assets or business entities about which inquiry is hereafter made relate to interests in real or personal property outside the United States, or in corporations or other business entities located outside the United States, or were issued by foreign governments or business entities, set forth the information, which under local statute or custom is equivalent to the information requested herein. Financial information should be reported in local currency and its United States dollar equivalent at the time of its transaction.

33. Set forth the names of the banks and account numbers of all bank accounts (savings, checking, certificates of deposit, or otherwise), which are in your name individually, jointly, in trust, as custodian for a minor, or otherwise, or upon which you are an authorized signatory. Attach copies of all passbooks, records and memoranda, check book registers, checkbooks, check stubs, and deposit slips for all such accounts, current as well as cancelled.
34. If you are self-employed or have had in the last 5 years a legal or equitable interest, individual or otherwise, in any proprietorships, joint ventures, partnerships, realty trusts, corporations or other business entities, set forth the names of these entities indicating the type of business and the nature of the interest therein. (For purposes of this question, include all corporations in which your interest is equal to or greater than 20% of stock outstanding.)
35. Attach copies of all financial statements, balance sheets and income statements issued during the last five (5) years with respect to any of the above-mentioned business entities.
36. With respect to partnerships, proprietorships, joint ventures, realty trusts or other noncorporate entities, list the names and addresses of all interested parties, their relationship to you and the extent of their interest and yours in said entity. Attach copies of any partnership agreements or other agreements in effect at any time during the last five (5) years and all tax returns filed during this period on behalf of the business entity.
37. With respect to corporations, list the names and addresses of all directors, officers and shareholders, the total number of outstanding shares and the percentage of outstanding shares held by each. If any of the foregoing persons are related to you by blood or marriage, indicate the relationship. Attach copies of all corporate records (certificate of incorporation, by-laws, minute books, etc.) as well as tax returns filed by the corporation during the last five (5) years.
38. With respect to all of the foregoing business entities, set forth with regard to your interest therein: (a) the market value of your interest during the last 5 years; (b) your income from the business entity during each of the last 5 years. Attach copies of IRS Schedule K-1 forms for each of these years; (c) all positions held by you in the management or operation of said entities during the last 5 years and the dates thereof. Indicate whether you were an officer, director, partner, etc.

39. If, during the last 5 years, your interest in any of the aforementioned business entities has changed or if the business has been sold or liquidated, set forth:

- (a) The date of termination or of the change in the nature of your interest;
- (b) The total sales price of the business entity;
- (c) The amount of compensation received by you and/or the form of compensation other than cash or negotiable instruments received by you as a result of the sale, transfer or change in your interest;
- (d) The terms of any and all agreements of sale;
- (e) The income received by you from the business entity during the year prior to the sale, transfer or change in your interest therein.

40. State for each of the above-mentioned business entities in which you have an interest the following:

- (a) The amount of your contribution to the original capitalization;
- (b) The amount of your contribution for any additional capitalization or loans to the business entity;
- (c) The source from which monies were taken for capitalization and/or loans;
- (d) Market value of the business entity at the time of the service of the summons in this action;
- (e) The present market value of the business if different from (d) above;
- (f) The market value of your share of the business entity at the time the summons was served in this action if different from (d) above;
- (g) The present market value of your share of the business entity if different from (f) above;
- (h) Amount of loans and/or reimbursement of capitalization paid you by the business entity at any time during the past 5 years, stating the amount received, the date received, and the disposition of the proceedings;
- (i) The present amount maintained in the capital account;
- (j) The names and addresses of all banks in which the business has or has had during the last 5 years, checking and/or savings accounts, the account numbers of each account, and the amount presently contained in each, if the account is open. Set forth the closing balance if said account is closed. Attach copies of all records and memoranda concerning the above-mentioned accounts during the last 5 years including passbooks, checkbooks, checkbook stubs, statements, cancelled checks and deposit slips;
- (k) The total value of the capital account;
- (l) The total value of all accounts receivable;
- (m) Attach a detailed statement of all such accounts receivable indicating the name of the debtor, amount due, likelihood of collection;
- (n) The dollar value of all work in progress;
- (o) The appreciation of all tangible assets of the business entity over and above book value;
- (p) Attach a detailed list of all liabilities, including the full list of accounts payable for the business entity.

41. Set forth the fringe benefits received by you during the last 5 years from any of the above-mentioned business entities in which you have an interest including but not limited to automobile expenses, travel expenses, personal living expenses, entertainment expenses, life insurance, bonuses, health, accident and hospitalization insurance. List all credit and/or charge accounts maintained at any time during the last 5 years by any of these business entities for your benefit or upon which you are or were an authorized signatory including account numbers as well as the titles and numbers of all accounts upon which you are not an authorized signatory but upon which purchases were, nevertheless, made on your behalf. Attach copies of all books and records pertaining to the above-mentioned fringe benefits, credit and charge accounts, including all statements and receipts for the last 5 years.

42. Indicate the names and addresses of personal and business accountants, and attorneys retained by you or by any of the above-mentioned entities in which you have an interest during the last 5 years. Omit the names of the attorneys representing you in this action if they have never represented you in any other matter.

43. Set forth the names and addresses of your stockbrokers and your investment advisers, if any.

44. Attach copies of all cash ledgers, books, accounts or records maintained by you or by any business entity in which you have an interest as defined in interrogatory #27 hereof.

45. Indicate whether you have a safe deposit box in your name individually or jointly, or to which you have access and indicate (a) location of the box and number; (b) the name in which the box is registered and the names and addresses of all persons having access thereto, (c) list the contents of said box.

46. State whether you have in your possession or under your control cash in excess of \$250 and if so, set forth the amount of the cash, its location, the source of that cash.

47. Indicate whether you have any interest of any kind in any vehicles including but not limited to automobiles, trucks, campers, vans, motorcycles, mobile homes, snowmobiles, boats, airplanes, bicycles and if so, state: (a) type of vehicle; (b) nature of your interest therein; (c) the name in which the vehicle is registered, if applicable, and its registration number; (d) the manufacturer model and model year of each vehicle; (e) date of purchase and purchase price. Attach copies of bills of sale; (f) the name of the principal operator of the vehicle, the present location of each vehicle, the nature of any interest in said vehicle other than your own (e.g. security interest) and the name of the person or institution so interested. Attach copies of all documents relating to financing for this vehicle; (g) indicate the present value of all such vehicles.

48. Indicate whether you have any interest in a horse or other animal valued in excess of \$250. If so, indicate (a) type of animal; (b) date of purchase and purchase price of same; (c) the present location of the animal; (d) its market value at the time of purchase and at present; (e) the names and addresses of any co-owners and the nature and size of their interest in the animal.
49. List all items of personal property (furniture, jewelry, furs, household goods, etc.) with a value in excess of \$250 indicating the nature of each, its present location, purchase price and date of purchase and present value.
50. Indicate whether you own or have any interest in art, stamps, coins, precious metals, antiques, books and other collections with a value in excess of \$250. State the nature of each, its present location, purchase price and date of purchase and present value.
51. State whether you own or have an interest in any minerals, gems, or commodities, and if so, state (a) the date and purchase price of same; (b) the nature of your interest, whether in a tangible item or intangible interest such as a future; (c) location of the item if your interest is a tangible one; (d) the present value of the asset (market value if applicable).
52. State whether you are receiving or are entitled to receive any royalty income. If so, state (a) the nature of such income including the nature and title, if applicable, of the creative work or patent from which such income arose; (b) the amount of income derived annually from such creative work or patent. Attach a copy of any agreement relating to same.
53. Indicate whether you have any legal actions pending for money damages and whether you are entitled to receive any settlements or insurance recovery. Indicate (a) the amount of money demanded in your pleadings or to which you may be entitled as insurance recovery or legal settlement; (b) the court in which the action is or was pending, the name of the action and its index number; (c) whether any person besides you has any interest in any amount recovered and if so, their name and the nature of their interest; (d) describe in brief the circumstances underlying your legal claim for your right to an insurance recovery or legal settlement.
54. State whether you have any Keogh or IRA plan. If so, indicate the date each such plan was created, the amounts contributed by you to each such plan, the current value of your account in each such plan.

55. State whether you are entitled to receive any gambling awards or prizes. If so, indicate the nature thereof and the amount and the manner in which you became entitled to same.

56. Indicate the names and addresses of all persons or institutions that owe you money and have not heretofore been disclosed, setting forth the amount of the debt, when and in what manner repayment is due, and attach copies of all written agreements concerning same.

57. Itemize all shares of stock, securities, bonds, mortgages, money market funds and other investments other than those items of real property already disclosed in previous interrogatories, setting forth the following:

- (a) Identity of each item as to type and amount of shares;
- (b) Whose name they are registered in and the name of any co-owners and their interest therein;
- (c) The source of the monies from which you purchased the item;
- (d) The original price of each item;
- (e) The market value at the time of the service of the summons in this action;
- (f) The present market value of each item if different from (e) above;
- (g) The amount of any dividends and/or other distributions received on a yearly basis during each of the last 5 years whether taxable or not;
- (h) The present location and custodian of all certificates or evidences of such investments. Attach hereto monthly and annual statements of these securities for the past 5 years.

58. With respect to any of the above-mentioned securities, if you are a party to any agreement with other owners of these securities, set forth (a) the date of such agreement; (b) the parties to such agreement; (c) the stated event that will bring about the sale or transfer under the agreement; (d) the sales price under such agreement. Attach a copy of said agreement hereto.

59. Itemize all assets (including but not limited to shares of stock, securities, bonds, mortgages, money market funds, and other investments), including real property in your name or in which you have an interest, which you have sold or transferred in the last 5 years, stating for each:

- (a) The identity of each item as to type and amount of shares, if applicable;
- (b) Whose name they were registered in and the names of any co-owners and their interest therein;
- (c) The source of the monies from which you purchased each item;
- (d) The original price of each item;

- (e) The market value at the time of the service of the summons in this action;
- (f) The amount of dividends or other distributions received on a yearly basis during each of the 5 years preceding sale or transfer, whether taxable or not;
- (g) The date each was sold, transferred or exchanged;
- (h) To whom each was sold, transferred or exchanged;
- (i) The amount received for each sale or transfer or the asset received in exchange;
- (j) The disposition of the proceeds of said sale, transfer or exchange. Attach hereto any and all monthly and annual statements of income earned on any of the above-mentioned assets during the last 5 years.

60. Itemize all assets (including but not limited to shares of stock, securities, bonds, mortgages, money market funds, and other investments) including real property during the course of your marriage, which you have purchased but which are held nominally by third persons stating for each:

- (a) The manner in which the person is holding said investment;
- (b) Identity of each item as to type and amount of shares, if applicable;
- (c) Whose name they are registered in and the names of any co-owners and their interest therein;
- (d) The source of the monies from which you purchased each item;
- (e) The original price of each item;
- (f) The market value at the time of filing of the complaint;
- (g) The present market value of each item;
- (h) The present location and custodian of all certificates or evidence of such investments;
- (i) The amount of dividends or other distributions received on a yearly basis during each of the last 5 years whether taxable or not;
- (j) If any of the above-mentioned assets held nominally by third parties were transferred, sold, or exchanged during the last 5 years, respond with respect to that asset to the provisions of interrogatory 59 hereof. Attach hereto any and all monthly and annual statements of income earned on any of the above-mentioned assets during the last 5 years.

61. Indicate whether you are the holder of any mortgage, account receivable, note, or other evidence of indebtedness not heretofore disclosed. If so, indicate (a) type of instrument; (b) the maturity date of the instrument; (c) the percentage rate of interest payable on the instrument, as well as the dollar amount of interest paid; (d) the substance of the transaction resulting in your holding of said instrument; and (e) your date of acquisition of the instrument. Attach copies of all such instruments.

62. With respect to all investments not heretofore disclosed, state the nature of the investment, your interest therein, amount of original investment and the source of monies used therefore, percentage rate of income yield and dollar amount of income from said investment calculated annually since its acquisition, and the present value of the investment.
63. With respect to any inheritances received by you during the course of the marriage, set forth (a) name of the person from whom you inherited; (b) nature and amount of inheritance; (c) ultimate disposition of inherited assets. If inherited monies were invested, trace these monies to the present time and give present value of these investments.
64. Set forth in detail the nature and amount of any inheritances you expect to receive.
65. With respect to any items of personal property that you have sold or transferred during the last 5 years, set forth the following information: (a) description of the property; (b) date and method of transfer; (c) name and address of transferee and his relationship, if any, to you; (d) amount received upon transfer; (e) disposition of proceeds from transfer.
66. With respect to any gift of money or personal property made by you during the last 5 years, indicate (a) name and address of the person to whom the gift was made and the relationship of that person to you, if any; (b) description of the gift or the total sum of money given; (c) date of gift.
67. With respect to any trust of which you are the grantor, beneficiary or in which you have the power of appointment, or of which your spouse or children are beneficiaries, or holders of powers of appointment, attach a copy of the trust instrument and any amendments thereto. Indicate the amount of trust principal at the time of the trust's creation and the present amount of the principal. Attach hereto income statements and balance sheets for the last five (5) years.
68. List all policies of insurance, annuity policies, disability policies not heretofore disclosed stating for each (a) name and address of insurance company; (b) policy type and number; (c) name and address of policy owner; (d) present beneficiary(ies) and any and all former beneficiaries indicating dates of change in beneficiary; (e) face amount of policy; (f) annual premium and name of person currently paying said premium; (g) present cash surrender value of policy; (h) details of any loans taken out against said policy indicating amount of loan and use made of proceeds thereof; (i) if said policy has been assigned, date of

assignment and identity of assignee(s); (j) if any such policy has been surrendered during the last 5 years, indicate date of surrender, cash surrender value at time of surrender, the nature and amount of consideration received for said surrender, and the name of the person who received same, as well as the nature and amount of consideration received for said assignment and the person who received it.

69. If you are entitled to any disability benefits, set forth (a) nature of your disability; (b) the amount of disability award and schedule of payment thereof; (c) whether there are survivor benefits and if so, the details thereof; (d) if you currently claim a right to any disability benefits, which have not yet been awarded you, state the nature and basis of your claim and the amount claimed.

70. If you receive any income, support or maintenance not heretofore disclosed, set forth:

- (a) The source of the income, including name and address of the person providing same, if applicable, and that person's relationship to you;
- (b) The amount of support received by you during each of the last five years;
- (c) The nature of said support, whether in money or otherwise.

71. List all credit cards upon which you are personally liable, whether individually or together with some other person, including:

- (a) The title of the account;
- (b) The total amount due at present;
- (c) Your average monthly payment, as well as the lowest permissible monthly payment.

Attach hereto copies of all statements for said credit cards received by you during the last five years.

72. If there are any judgments outstanding against you and/or your spouse, set forth:

- (a) The amount of the judgment;
- (b) The place entered and date of entry;
- (c) The caption of the action, including index and calendar number and court.

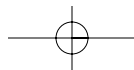
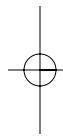
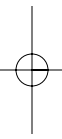
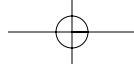
73. With respect to any of the aforementioned judgments, are there now pending or have there been during the last 5 years, any enforcement proceedings taken against you and/or your spouse, such as income execution, property execution, etc.? If so, set forth the dates of said enforcement proceedings, the amounts received by the judgment creditor on account thereof, and if any enforcement proceeding is ongoing, the amounts for which you are currently liable.

74. Attach hereto the following, if applicable:

- (a) Any financial statement, which you have prepared or which has been prepared on your behalf during the last five years;
- (b) Copies of any and all loan applications made by you during the last five years. If any loans were approved, attach hereto a copy of the loan agreement.

75. Indicate the amount you have agreed to pay your attorneys as and for counsel fees in the instant proceeding and the amounts of money paid thus far.

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Appendix C

Document Request for Bank and Brokerage Account Records

It is often necessary to obtain bank and brokerage account records from the other party. This may be accomplished by informal request but more likely by formal "demands" or "subpoenas" of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. The following is a nonexclusive list of possible documents that may be useful in an investigation. It is the attorney's responsibility to rewrite the requests into a legally appropriate form.

For each and every bank or brokerage account listed below provide the requested documents writings and records for the period XX/XX/XX to the present, unless a different time period is described in an individual request:

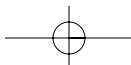
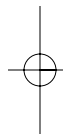
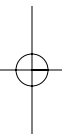
Bank and Brokerage accounts identified or described as follows:

- (1) List each and every known bank account with account numbers, if known.
- (2) And all other bank accounts open during the period requested on which your name appeared, over which you had signature authority or into which you deposited funds which were community property, separate property or funds for which you were trustee.

For each bank account identified above provide the following documents, records or writings:

- A. Bank or brokerage statements describing deposits, withdrawals, or any transactions in the account.
- B. Cancelled checks, and all other documents received from the bank or broker with or in support of the statements described in A. above.
- C. All check registers, listing of transactions, running balances, in hand or on computer.
- D. All transaction advices from brokers advising of buy, sell margin or other activity in any account.
- E. All computer listings of transactions in any account. Provide printed copy and data on electronic media. If a password is required to access the electronic media provide same to allow access to electronic data.

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Appendix D

Request for Documents Regarding Income and Other Financial Information

Identifying and quantifying income begins by obtaining basic documents and records that are generally available. The following list is a basic list and may be modified or followed up with another document request. A subsequent documents request may result from indications of the existence and usefulness of additional documents. A records request such as the following may be directed to the other party. This may be by informal request but more likely by formal "demands" or "subpoenas" of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. The following is a nonexclusive list of possible documents that may be useful in an investigation. It is the attorney's responsibility to rewrite the requests into a legally appropriate form.

Identify and provide the following documents, records, writings, or information, whether on paper or electronic media, for the period 36 months before the earliest claimed date of separation to the present (unless another period is indicated).

1. Provide complete copies of all federal and state business income tax returns including all schedules and attachments for the last three calendar or fiscal years.
2. Provide complete copies of all annual business financial statements for the last three full calendar or fiscal years and all interim financial statements from the last annual financial statements provided to most recent date.
3. Provide complete copies of federal and state personal income tax returns including all schedules and attachments.
4. Provide complete copies of all employment agreements.
5. Provide complete copies of all participants' statements for the previous full calendar year and current year for each and every IRA, 401(k) salary reduction plan, profit-sharing plan, pension plan or any other retirement and savings plan.
6. Provide complete copies of all cancelled checks for all medical insurance policies.
7. Provide complete copies of any other income (taxable or not); provide all documents describing the right, nature, or amount of income received. This includes income from bank accounts, investments or other property owned jointly with another entity or individual or held for you by another.
8. Provide complete copies of all documents for all loans to or from you in excess of \$1,000.
9. Provide information for each and every issue that will affect you or your spouse's income: all documents, records, and information.

10. Provide complete copies of statements of any amounts due from the IRS and, for all unresolved issues, all correspondence or notices to or from the IRS or any other tax authority.
11. Provide complete copies of all investment or brokerage statements for all stocks or investment securities owned by you individually or with any other person.
12. Provide complete copies of, for all loans, all bank or other lender statements showing principal balance, payments, and/or new advances.
13. Provide complete copies of all purchase/sale documents for each and every transfer of any property or cash of more than \$1,000.
14. Provide complete copies of all payroll check stubs, payroll withholding advice, or any other document provided to you with each individual paycheck.
15. Provide complete copies of all W-2s for the last three years.
16. Provide complete copies of all 1099s received in the last two years from any source for any reason.
17. Provide complete copies of cancelled checks for all uninsured medical expenses.
18. Provide complete copies of cancelled checks or payroll stub deductions for all union and professional dues, medical deductions, and 401(k) or retirement plan deductions.
19. Provide complete copies of information regarding child care. State the child care provider's name and address, and provide cancelled checks for all child care expenses.
20. State the number of children for which you have primary custody and your estimate of visitation or time spent with children and your estimate of the time spent with the other spouse.
21. List each child for which you are not the primary custodial parent and estimate the amount of time you spend with each child and the amount of time the child spends with the other parent.
22. Provide a list of all sources of income for the children. Provide documents, records containing information regarding the children's income. If the children have filed personal income tax returns, provide copies for the last two years.
23. If you are paying child or spousal support in a previous marriage or marriages, or for children from a previous marriage or marriages, please list the names and amounts of such support.

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Appendix E

Business Valuation Information Worksheet

Closely held businesses may be a significant asset in the marital estate. Significant funds may be involved and the opportunities for fraud in a small business are limited only by the imagination of the perpetrator. A records request such as the following may be directed to the other party. This may be by informal request but more likely by formal "demands" or "subpoenas" of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. Attorneys generally prefer the form of the requests to be divided into two groups (1) interrogatories (questions) or (2) demand for records (document request). The following is in the form of a working paper and is useful for an interview of the business owner, employee or/and associate. Although its primary use is for a business valuation it can be useful in gathering information. If a formal demand for documents or interrogatories is required significant modification may be required by the attorney. This worksheet may also be helpful to an attorney deposing the "business or professional spouse." But it is the attorney's responsibility to rewrite the requests into a legally appropriate form.

COMPANY BACKGROUND

1. Legal Structure and Operations Information:

- A. Legal Name: _____
- B. DBA (Doing Business As): _____
- C. Description of Business: _____
- D. SIC Code: _____
- E. Federal ID No.: _____
- F. Date commenced doing business: _____

G. Complete ONLY ONE of the following—(1) through (5):

- (1) Corporation (if applicable, circle one): 'C' Corp. 'S' Corp.
- a) Incorporation date: _____
- b) State incorporated: _____
- c) No. of shares issued and outstanding: _____
- d) No. of shares owned by the parties: _____
- e) Other types of stock: _____

- (2) Partnership (if applicable, circle one): 'General' 'Limited'
- a) Number of partners: 'General' _____ 'Limited' _____
- b) Date of partnership agreement: _____
- c) Managing partner's name: _____
- (3) Sole Proprietorship (if applicable, circle one): YES
- (4) Limited Liability Company
- a) Formation date: _____
- b) State: _____
- c) Elected to be treated for tax purposes as (circle one):
- Corporation Partnership Other
- (5) Other—Identify _____
- _____

2. Description of company's products or services: _____

3. Other businesses in which either party has an ownership interest:

Name of Business	Type of Business **	Name(s) of Owner(s)	Percent of Ownership	Time devoted to this business per week	Does this business conduct business with the company being valued? Yes No
					Yes No
					Yes No
					Yes No
					Yes No

**For type of business insert: S for Sole Proprietorship; P for Partnership; C for Corporation; L for LLC

9. What is the geographic market area serviced by the company?

10. A. Are sales concentrated in a few customers? (Circle one): YES NO

B. Indicate below what percentage and amount of sales are made to the five largest customers:

Customer(s) Name(s)	Annual Sales	% of Total Annual Sales
	\$	
	\$	
	\$	
	\$	
	\$	

11. A. Rank the following key selling features:

Unique Product ____ Price ____ Service ____ Business Relationship ____

Other: _____

B. How do you obtain new customers or clients? _____

12. A. How are pricing policies determined? _____

B. To what degree do competitors' prices affect the company's pricing policy?

13. Please complete the following table about the company's leading competitors:

Competitor's Name	Location	Approx. Annual Sales	Local Mkt %	Public Co.?	Comment—strengths & weaknesses

14. Are any suppliers of your products a sole or significant source? (circle one):

Yes No

If yes, list name(s) of supplier(s) and describe product:

Supplier Name	Product	Percent from this supplier of this product

15. Describe the company's organizational structure. Attach organization chart if available.

16. How old are the company's present facilities? _____ years old

17. A. Are buildings owned or leased? (Circle one): Owned Leased

B. Is machinery owned or leased? (Circle one): Owned Leased

C. If leased, attach pages of contracts listing basic terms of lease(s).

18. Does the company have difficulties complying with environmental regulations? (Circle one):

Yes No

If yes, please explain: _____

19. List key members of management (or at least the four highest paid employees), providing the following information:

Name	Age	Title	Total Compensation		Hrs/week devoted to business
			This Year	Last Year	

20. Discuss any problems with current owner(s), executives or managers, such as their health, retirement, difficulty in replacing, or any other problems: _____

21. Has there been any change in accounting principles during the past five years—cash to accrual, FIFO to LIFO, etc.—or similar changes that might affect the comparability of the financial statements? (Circle one):

Yes No

If yes, please explain: _____

22. Describe short-term sources of credit and how they were used during the last five years.

Year	Short-term credit amount	Lender's name	Used for
2000	\$		
2001	\$		
2002	\$		
2003	\$		
2004	\$		

23. Describe long-term sources of credit and how they were used during the last five years.

Year	Long-term credit amount	Lender's name	Used for
2000	\$		
2001	\$		
2002	\$		
2003	\$		
2004	\$		

24. For the last five years, please give the names of the following professionals rendering services (most recent first):

A. Attorneys for the business:

Name	Specialty	Firm

B. Certified Public Accountants:

Name	Firm

C. Pension Consultants & Administrators:

Name	Firm

D. Bookkeeping and Tax Services:

Name	Firm

E. Bankers:

Name	Firm

25. Please identify, explain, and provide the following:

A. Describe all positive attributes that give value to the company:

B. Describe all negative attributes that reduce the value of the company:

C. Describe the prospects of the company for the next two years, and after two years.

D. Describe all offers, inquiries, or discussions to purchase, sell or value any portion or asset of the company or the entire company.

I, _____ (print name), have completed this questionnaire providing full disclosure of all information requested. I declare under penalty of perjury the foregoing is true and correct.

Signature

Date

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Appendix F

Request for Documents Regarding Marital Standard of Living

Marital standard of living provides an insight into the finances of the marital estate. Clues to the existence of property or income may not be apparent by other forms of analysis. But spending patterns may indicate the nature and amount of undisclosed income and assets. Depending on the time and resources available the following document request may be a beginning point to the investigation. No one document list can adequately define all the necessary documents in a spending analysis. But this list may be helpful at the onset of the information gathering process. A records request such as the following may be directed to the other party. This may be by informal request but more likely by formal "demands" or "subpoenas" of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. The following is a nonexclusive list of possible documents that may be useful in an investigation. It is the attorney's responsibility to rewrite the requests into a legally appropriate form.

Identify and provide the following documents, records writings or information whether on paper or electronic media for the period 36 months before the earliest date of separation to the present (unless another period is indicated).

1. Federal and state business income tax returns, including all schedules and attachments.
2. Annual business financial statements for the last three years and all interim financial statements from the last annual financial statements provided.
3. Federal and state personal income tax returns, including all schedules and attachments.
4. Provide all investment or brokerage statements for all stocks or investment securities owned by you individually or with any other person.
5. Provide all bank account statements, cancelled checks, deposit slips, check registers or listings, pass books and other documents for each and every bank account in petitioner or respondents name, in which community or separate funds were on deposit regardless of name on the account, and every account over which Petitioner or Respondent has signature authority.
6. Provide copies of any and all personal financial data, information or writings in electronic form or media. Identify the computer program used to create the electronic information and state the password required to access the electronic media. If the electronic media contains more data over a longer period of time than requested do not erase, block access to, or in any way modify earlier information.
7. If Petitioner or Respondent is paying spousal or child support, provide copies of all support judgments, orders, or agreements setting forth any and all terms of the support obligations.

8. Provide all lists, accountings, or information setting forth the expenses of the children of your household.
9. Provide all lists, accountings, or information setting forth the expenses of Petitioner in your household.
10. Provide all lists, accountings, or information setting forth the expenses of Respondent of your household.
11. Provide all lists, accountings, or information setting forth the expenses of any nonfamily member of your household.
12. Provide all financial, tax, investment, or any other plans prepared for or by Petitioner or Respondent.
13. Provide all documents, writings and records, which describe, limit, explain, or in any way are relevant to the personal and business finances of Petitioner, Respondent, or others who have an impact on Petitioner or Respondent's finances.

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Appendix G

Investigative Inquiries or Deposition Questions Regarding Undisclosed Income

An attorney may request the CPA to prepare a list of questions designed to disclose significant funds or identify opportunities for fraud. The attorney will ask these question in a deposition in which the deponent must answer under oath and subject to the penalties of perjury. While depositions are as much art as science on the part of the attorneys a list of questions and the technical explanation of their objective can be provided by the CPA. It may be the CPA will actually attend the deposition and propose additional questions as he or she hears the answers to previous questions. Questions such as the following may be directed to the other party. But it is the attorney's responsibility to pose the questions and follow-up questions in a deposition.

The following questions may be used in an interview or deposition. They are representative of a broad range of questions that may provide useful information. Select a period appropriate in the introduction to the questions. For example, from the date of marriage to the present please answer the following questions. These questions do not include all those that may be posed on each topic. Not all topics may be included in an interview or deposition.

1. Personal Information
 - A. State name and the following information:
 - B. Have you ever been known by or used another name?
 - C. Identify each and every address at which you have resided in the period from ten years before marriage to the present.
 - D. Social Security number, including all other Social Security numbers used at any time.
 - E. Driver's license number. Do you have or have you had any other driver's license in other states or countries?
 - F. Date and place of birth.
 - G. Prior marriages.
 - H. Children of prior marriages.
 - I. Employment history for 10 years before marriage to the present, including for each employer.
 - (1) Employer name, address and telephone number
 - (2) Dates of employment
 - (3) Supervisor's name and department
 - (4) Salary at hire
 - (5) Salary at termination

- (6) Each year's total compensation
 - (7) Reason for leaving
 - (8) For each and every gap in employment, what was the source of cash to pay living expenses?
2. For checking, savings certificates of deposits and all bank accounts from the date of marriage to the present, state:
 - A. Name and address of bank
 - B. Name(s) on the bank account (title)
 - C. Bank account number
 - D. Date opened
 - E. Source of initial deposit, if over \$5,000.00
 - F. Date closed
 - G. Disposition of cash when account was closed
 - H. Purpose of account
 - I. Source of deposits into account
 - J. Identify any of the following records available for each account:
 - (1) Bank statements
 - (2) Cancelled checks
 - (3) Duplicate checks
 - (4) Check register and/or any form of checks and deposit listings
 - (5) Any and all electronic media containing any bank account information including, but not limited to, spreadsheets, financial management software and any other media
3. For all stock brokerage accounts, investment funds and all other such investment accounts from date of marriage to present state:
 - A. Name and address of the investment account
 - B. Name(s) on the investment account
 - C. Investment account number
 - D. Date opened
 - E. Source of initial deposit, if over \$5,000.00
 - F. Date closed
 - G. Disposition of cash when account was closed
 - H. Purpose of account
 - I. Source of deposits into account
 - J. Identify any of the following records available for each account:
 - (1) Investment statements
 - (2) Cancelled checks
 - (3) Duplicate checks
 - (4) Check register or any form of checks and deposit listings

- (5) Any and all electronic media containing any bank account information including, but not limited to, spreadsheets, financial management software and any other media
4. Describe and provide all employment agreements.
5. Describe and provide all participants' statements during marriage to the present for each and every IRA, 401(k) salary reduction plan, profit-sharing plan, pension plan or any other retirement or savings plan accounts.
6. Describe and provide copies of all cancelled checks for all medical insurance policies for the last three years.
7. Identify and provide all purchase/sale documents for each and every transfer of any property or cash of more than \$1,000.00.
8. Identify and provide for any amounts due from the IRS and for all unresolved issues all correspondence or notices to or from the IRS or any other tax authority.
9. Identify and provide a listing of dates and amounts of all loans to or from you in excess of \$1,000.00.
10. For all loans, provide all bank or other lender statements showing principal balance, payments and/or new advances.
11. Provide copies of all payroll check stubs, payroll withholding advice or any other document provided to you with each individual paycheck.
12. Provide copies of all W-2s for the last 3 years.
13. Provide a copy of all 1099s received in the last 2 years from any source, for any reason.
14. List and provide cancelled checks or payroll stub deductions for all union and professional dues, medical deductions and 401(k) or retirement plan deductions.
15. List and provide cancelled checks for all uninsured medical expenses.
16. For any other income (taxable or not) provide all documents describing the right, nature, or amount of income received. This includes income from bank accounts, investments or other property owned jointly with another entity or individual or held for you by another.
17. State the number of children for which you have primary custody and your estimate of visitation, or time spent with children, and your estimate of the time spent with the other spouse.
18. List each child for which you are not the primary custodial parent and estimate the amount of time you spend with each child and the amount of time the child spends with the other parent.
19. Provide a list of all sources of income for the children. Provide documents, records containing information regarding the children's income. If the children have filed personal income tax returns, provide copies for the last 3 years.
20. If you are paying child or spousal support from a previous marriage or marriages, or for children from a previous marriage or marriages, list the names and amounts of such support. State the source of cash used to make these payments.
21. Provide information regarding child care. State the child care provider's name, address and provide cancelled checks for all child care expenses.

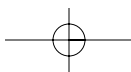
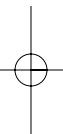
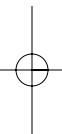
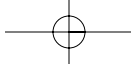
22. For each and every payment after separation of a community or separate debt or obligation, which existed at the date of separation, provide the following:
- A. Payee's name.
 - B. Date paid.
 - C. Amount paid.
 - D. Why amount paid is a community obligation. Be sure to state if obligation arose before or after separation.
 - E. Bank or other account paid from.
 - F. Check number.
 - G. State if you have been reimbursed for the claimed payment.
 - H. Legal basis of the claim.
 - I. Identify and produce the following documents and records:
 - (1) Invoice, receipt, contract or other evidence of obligation for expenditure.
 - (2) Cancelled check.
 - (3) Bank statement for month in which check cleared bank.
 - (4) Any writing or document that supports the derivation of the amount, character or justifies the claim.
23. Are you now, or in the past, associated with a trust? If yes, state:
- A. As a Trustee.
 - B. As a Beneficiary.
 - C. Transferred property, cash or other rights to a trust.
 - D. Received any distributions from a trust.
24. For your income tax withholding, state for the last three years:
- A. Number of exemptions claimed with all employees.
 - B. Marital status.
 - C. Provide copies of all W-4 forms filed with all employers.
25. For all amended income tax returns you have filed, state:
- A. Year amended.
 - B. Federal and each state amended.
 - C. Purpose and reason for amendment.
 - D. Provide copies of all amendments.
26. For all gift tax returns you have filed, state:
- A. Donor or donor's name.
 - B. Date of each gift.
 - C. Description of each gift.
 - D. Value of each gift.
 - E. Tax basis of each gift.
 - F. Provide copies of all gift tax returns.

27. For all property received by you from inheritance, state:
 - A. The decedent's name.
 - B. Executor or Trustee name and address.
 - C. Date of death of the decedent.
 - D. Description of property received.
 - E. Date property was received.
 - F. Value of property received.
 - G. Tax losses of each individual property.
 - H. Provide copies of decedent's Estate Tax and State Inheritance returns, court orders of distribution and all other notices of distribution from any estate.
28. For all gifts either received or given, which are over \$1,000.00, state:
 - A. Donor or donor's name.
 - B. Date of each gift.
 - C. Description of each gift.
 - D. Value of each gift.
 - E. Tax basis of each gift.
 - F. Provide copies of all gift tax returns.
 - G. Relationship to you of Donor or Donee.
29. Have you ever been convicted of a crime?
30. Have you ever had a judgment entered against you in court?
31. Do you have now, or in the past, any options, contingencies or any other rights to acquire, control or manage any property?
32. Have you ever filed bankruptcy? If yes, state when and which court.
33. Has any company, of which you owned any interest, to which you loaned money or were employed by, filed bankruptcy?
34. Do you have any income not disclosed on your income tax returns?
35. Do you have any income not already disclosed in writing in this divorce proceeding?
36. Are there any items of property, claims, options or any other rights not already disclosed in writing in this divorce proceeding?
37. Are there any debts, claims by others or contingent liability not already disclosed in writing in this divorce proceeding?
38. For each and every business in which you have an ownership interest or rights to acquire an ownership interest, consider the business valuation questionnaire in Appendix E.
39. Identify any assets of debt, which you contend is separate property or debt. For each individual item state:
 - A. Facts that support your contention that an asset or debt are separate.
 - B. Identify and provide all documents or other proof that supports your separate claim.
40. During the last five years have you received any written offer to purchase or had written appraisals of any assets that you claim are property (community or separate) of the marriage or that exist today.

41. Identify each of the following insurance policies that you now own or that covers you, children or property:
 - A. Health
 - B. Property
 - C. Liability
 - D. Automobile
 - E. Life
 - F. Umbrella
 - G. Any other policies
42. Describe your education, disclosing schools attended, degrees awarded and dates attended.
43. Are there any unfiled income tax returns for any period?
44. For the following personal expenses, for the three years prior to separation please give your actual or estimated monthly expenses for you and the family household. State if these were paid in cash, credit card, debit card or check.
 - A. Home rent or mortgage
 - B. Real property taxes
 - C. Homeowners or renters insurance
 - D. Homeowners association dues and assessments
 - E. Maintenance and repairs on residence
 - F. Health care costs not paid by insurance
 - G. Child care
 - H. Groceries and household supplies
 - I. Eating out
 - J. Utilities
 - i. Gas
 - ii. Electric
 - iii. Water
 - iv. Trash
 - v. Other
 - K. Telephone, cell phone and e-mail
 - L. Laundry & Cleaning
 - M. Clothes for:
 - i. Yourself
 - ii. Spouse
 - iii. Children
 - N. Education
 - i. Yourself
 - ii. Spouse
 - iii. Children
 - O. Entertainment

- P. Gifts, Christmas, other family occasions
- Q. Vacations
- R. Auto/Commutation Expenses
 - i. Insurance
 - ii. Gas
 - iii. Repairs
 - iv. Other commute expenses (train, bus, subway, etc.)
- S. Insurance
 - i. Life
 - ii. Accident
 - iii. Umbrella
 - iv. Other (except homeowners and auto)
- T. Savings and Investments
 - i. IRAs
 - ii. 401(k) plans
 - iii. Regular savings and investments purchased
- U. Charitable Contributions
- V. Monthly payments for installment payments. List each separately and state:
 - i. Who payment was to
 - ii. What payment was for
 - iii. Amount
 - iv. Balance owing currently
 - v. Date of last payment
 - vi. Date for final payment
 - vii. Security for payment (car, house, etc.)

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Appendix H

Typical Deposition Questions of an Accounting Expert

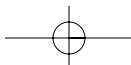
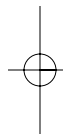
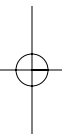
At some point in an investigation it may become necessary to depose either or both experts. The attorney may request the CPA to prepare a list of questions designed to defend his or her expert from the other attorney or to pose questions to the other attorney. Depositions of an expert can be difficult for attorneys. The attorney may not be conversant in all technical areas and will require the CPA's explanation of technical topics. The CPA may attend the deposition and propose additional questions as he or she hears the answers by the expert to previous questions. Local rules may exclude experts from attending the other's deposition. Questions such as the following may be directed to the other party. But it is the attorney's responsibility to pose the questions and follow-up questions in a deposition.

1. Engagement:
 - a. When retained?
 - b. Is there a written agreement?
 - c. Retained by whom?
2. Assignment:
 - a. What was the original assignment?
 - b. Assignment completed?
 - c. Were other services added to the assignment?
 - d. Any assignment not already described.
3. Work product:
 - a. List each and every report prepared.
 - b. Provide copies of each report prepared.
 - c. List each and every conclusion arrived at.
 - d. Provide copies of each conclusion listed.
 - e. List each and every analysis prepared.
 - f. Provide copies of all analyses.
 - g. Describe workpapers prepared.
 - h. Provide copies of all workpapers.
 - i. Describe every document and all information relied upon for your report, conclusion, analysis and workpapers.
 - j. Provide copies of all documents.

4. Conclusions:
 - a. Explain (in detail) each and every report prepared.
 - b. Explain (in detail) each and every conclusion arrived at.
Keep asking until there are no more "conclusions" or issues.
5. Documents Provided:
 - a. List and describe all the documents provided.
Keep asking until there are no more documents.
 - b. Of these documents, which ones were relied on and why?
Keep asking until there are no more documents relied on.
 - c. Of the documents provided, which ones were rejected/excluded?
 - d. For each document rejected, why was it excluded?
Keep asking until there are no more documents rejected.
 - e. Are the documents available for copying?
 - f. Who provided the documents?
 - g. List all documents you had requested but did *not get*? If so, were you given any reasons why such documents could not be provided?
6. Case Law:
 - a. For each issue, list each and every case relied on and instructions from attorney.
 - b. For each case listed, what is its significance to the issue and conclusion reached by CPA?
Keep asking until there are no more issues and/or cases relied on.
 - c. For each issue, list each and every case that may have been relevant but was rejected/excluded.
 - d. For each case listed, why was it excluded?
Keep asking until there are no more cases excluded.
 - e. Ask for comparison of cases used and or relied upon, and why one is more important than another.
7. Assumptions:
 - a. List **EACH & EVERY** assumption used in the reports, conclusions, analysis and workpapers.
Keep asking until there are no more assumptions.
8. Fees:
 - a. For each step of the case, how many hours were spent?
 - b. For each step of the case, how much were the billings to date?
 - c. How much has been paid to date?
 - d. Who has made the payments to date?
9. Further Services:
 - a. Is there to be any further work performed?
 - b. Are there to be any revisions to the work already completed?
 - c. Does the expert intend to perform further work or analysis in this matter between now and trial?

10. Credentials:
 - a. Copy of C.V.?
 - b. Relevant education?
 - c. Relevant experience to the assignment in this case?
 - d. Any credentials in area relevant to case?
11. Contacts:
 - a. Did you interview your client?
 - b. Did you visit the site which is the subject of this litigation?
 - c. Did you have contacts with your client's independent accountant?
If so, provide the name of the party(ies) you talked to
When and how often did you talk to this party(ies)?
For what purpose did you have to contact the accountant(s)
Was the party (ies) forthcoming and cooperative?
 - d. Did you have any contacts with defendant's independent accountant? If so, provide the name of the party (ies) you talked to.
When and how often did you talk to this party(ies)?
For what purpose did you have to contact the accountant(s)?
Was the party (ies) forthcoming and cooperative?
If not, why not?
12. Did you independently investigate each and every allegation made by plaintiff(s)? If not, which ones did you not investigate and why?

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Appendix I

Request for Personal Tax Documents and Related Information

The most common readily available financial information of the marital estate is the annual income tax filings. Due to 1099 matching and other IRS monitoring techniques clues to the existence of property or income may be apparent in the party's income tax returns. But the reliability of the information contained within the tax filings may be questioned. The following document request may be helpful in assessing the accuracy and reliability of the tax returns. But this list may be helpful at the onset of the information gathering process. A records request such as the following may be directed to the other party. This may be by informal request but more likely by formal "demands" or "subpoenas" of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. The following is a nonexclusive list of possible documents that may be useful in an investigation. It is the attorney's responsibility to rewrite the requests into a legally appropriate form.

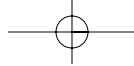
The following document request pertains to personal income tax returns and related documents and records. Please provide the documents and records requested for the "applicable period". The "applicable period" is the full years 20XX through and including 20XY, and as of the date responding to this request. Individual requests that follow may proscribe different periods than above.

1. For each year of the applicable period, provide a complete copy of the federal personal income tax return, Form 1040, and all schedules and attachments.
2. For each year of the applicable period, provide a complete copy of each and every state personal income tax return filed as well as all schedules and attachments.
3. For each year of the applicable period, provide copies of each and every W-2 for income reported in the personal federal or state income tax returns. This includes the taxpayer and spouse.
4. For each year of the applicable period, provide a copy of each and every Form 1099 for interest, dividends, or any other payments (whether or not such payments were actually received).
5. For each year of the applicable period, provide copies of Forms 1099, reporting real estate sales.
6. For each year of the applicable period, provide a copy of Form 1099, reporting individual retirement account or any retirement plan distributions, whether or not rolled over into another account.

7. For each year of the applicable period, provide all documents stating the state tax overpayment for the current and/or prior years.
8. For each year of the applicable period, provide all forms, documents, and records relating to all tax-exempt interest received in each year.
9. For each year of the applicable period, provide all documents, records, and writings evidencing any income received from interest or dividends earned and/or paid in each year for which a 1099 form was not received.
10. If, during any of the applicable period, income was received from a business or profession, provide the following documents and records and/or writings:
 - a. For income from clients, customers, or any other source, all Forms 1099, copies of customer checks, remittance advices, and billing statements or invoices to customers or clients during the applicable years.
 - b. All invoices and checks issued for advertising expenses.
 - c. All invoices and checks paying for car and truck expenses of the business or profession.
 - d. All invoices and checks in payment of commissions and fees.
 - e. All invoices and checks paid for employee benefit programs.
 - f. All invoices and checks in payment for insurance.
 - g. All invoices and checks in payment for interest paid for business or other loans.
 - h. All invoices and checks in payment for legal and professional services.
 - i. All invoices and checks in payment for office expenses.
 - j. All invoices and checks in payment for pension and profit-sharing plans.
 - k. All invoices and checks in payment for rent or lease of vehicles, machinery, and equipment.
 - l. All invoices and checks in payment for rent or lease of other business property.
 - m. All invoices and checks in payment for rent or lease of business premises.
 - n. All invoices and checks in payment for repairs and maintenance.
 - o. All invoices and checks in payment for supplies.
 - p. All invoices and checks in payment for taxes and licenses.
 - q. All invoices and checks in payment for travel.
 - r. All invoices and checks in payment for meals.
 - s. All invoices and checks in payment for entertainment.
 - t. All invoices and checks in payment for utilities.
 - u. All invoices and checks in payment for all other expenses not previously requested.
 - v. Copies of all W-2s for each and every employee during the calendar years.
 - w. Copies of all 1099 forms issued to individuals receiving payments from the business.
11. For the sales of any property, stocks, bonds, real estate, or any other real or personal property, for each year of the applicable period, provide all documents, records, and writings giving the date of purchase, cost of purchase, and cost of all improvements during ownership. Also provide all documents, records, and writings evidencing the date sold, sales price, sales proceeds, and gain realized on the sale of each and every individual real or personal property item.

12. For each real property that produces rental income, provide the following documents, records, and writings for each year of the applicable period:
 - a. All tenant leases.
 - b. All documents, records, and writings for each rental payment during the applicable period.
 - c. All invoices, billings, and statements for expenses, and checks paid for, advertising, for the applicable period.
 - d. All invoices, billings, and statements for expenses, and checks paid for, auto and travel, for the applicable period.
 - e. All invoices, billings, and statements for expenses, and checks paid for, cleaning and maintenance, for the applicable period.
 - f. All invoices, billings, and statements for expenses, and checks paid for, commissions, for the applicable period.
 - g. All invoices, billings, and statements for expenses, and checks paid for, insurance, for the applicable period.
 - h. All invoices, billings, and statements for expenses, and checks paid for, legal and other professional fees, for the applicable period.
 - i. All invoices, billings, and statements for expenses, and checks paid for, management fees, for the applicable period.
 - j. All invoices, billings, and statements for expenses, and checks paid for, mortgage interest paid to banks and all others, for the applicable period.
 - k. All invoices, billings, and statements for expenses, and checks paid for, other interest, for the applicable period.
 - l. All invoices, billings, and statements for expenses, and checks paid for, repairs, for the applicable period.
 - m. All invoices, billings, and statements for expenses, and checks paid for, supplies, for the applicable period.
 - n. All invoices, billings, and statements for expenses, and checks paid for, taxes, for the applicable period.
 - o. All invoices, billings, and statements for expenses, and checks paid for, utilities, for the applicable period.
 - p. All invoices, billings, and statements for expenses, and checks paid for, all other expenses associated with the production of rental income, property management, or any other expenses of each property, for the applicable period.
13. For each year of the applicable period, provide copies of federal and all state Forms K-1 for each and every partnership during the applicable period.
14. For each year of the applicable period, provide copies of each and every federal and all state Forms K-1 for each subchapter S corporation, received during the applicable period.
15. For each year of the applicable period, provide copies of all federal and every state Form K-1 received for each and every trust during the applicable period.

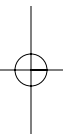
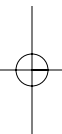
16. For each year of the applicable period, provide copies of all documents, records, and writings for all unemployment compensation received during the applicable period.
17. For each year of the applicable period, provide all documents, records, and writings received for Social Security benefits, paid or payable, during the applicable period.
18. For each year of the applicable period, provide all documents, records, and writings evidencing the receipt of income not previously requested, which, whether taxable or non-taxable, was earned or received during the applicable period.
19. For each year of the applicable period, for each and every real estate tax paid during the applicable period, provide the County Assessor's billing statement and copy of canceled check for payment of all real estate taxes.
20. For each year of the applicable period, for each and every personal property tax paid during the applicable period, provide the County Assessor's billing statement and copy of canceled check for payment of all personal property taxes.
21. For each year of the applicable period, for all gifts to charity, provide every document, record, or writing, which evidences either the character or the value of the donation, and identifies the charitable organization.
22. Provide copy of Form 1099 for each and every mortgage loan for home mortgage interest paid during the applicable period.
23. Provide all records, documents, and writings evidencing home mortgage interest paid for which you did not receive a Form 1098, during the applicable period.
24. Provide all documents, records, and writings setting forth the tax preparation fees, investment fees, safe deposit rent, and any other unreimbursed employee expenses during the applicable period.
25. For each year or period for which a Form W-2 is not available, provide for that period copies of each and every wage statement accompanying the payment of each and every payroll check.
26. For each and every estimated income tax payment to the federal government (Internal Revenue Service/Treasury) for each year of the applicable period, and to each and every state, provide a copy of all estimated tax deposit forms and checks in payment thereof. If estimated tax deposit forms are not available, then such other documents, records, or writings which describe the amount, period, and payee of each estimated income tax deposit.
27. If a refund was received for any year of the applicable period, provide a copy of the bank account statement, check register notation, or any other document, record, or writing evidencing the account into which the tax refund was deposited.
28. For each year of the applicable period, for each and every tax preference item used in computing the Alternative Minimum Tax, provide copies of documents, records, and writings advising of the nature and amount of each individual preference during each individual applicable period.



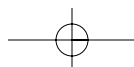
Appendix I: Request for Personal Tax Documents and Related Information

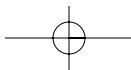
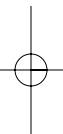
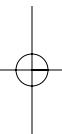
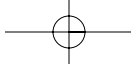
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29. For each year of the applicable period, provide all documents, records, and writings from all tax authorities' correspondence, audits, assessments, involving all prior, present, or future tax claims whether contingent or actual.



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Appendix J

Demand for Real Property Documents and Records

Real property often represents the largest asset of a marital estate. Significant funds may be generated or consumed by real property. A records request such as the following may be directed to the other party. This may be by informal request but more likely by formal “demands” or “subpoenas” of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. The following is a nonexclusive list of possible documents, which may be useful in an investigation. It is the attorney’s responsibility to rewrite the requests into a legally appropriate form.

For the real property described¹ as XXX located at XXX provide the following documents, records and writings whether in printed or digital form. If the information sought is in both printed and written form and digital form, produce both.

1. At **original purchase of the property** and for each subsequent acquisition of any interest in the property provide the following:
 - A. Accepted offer to acquire the property.
 - B. Loan application (including all pages and attachments) to all lenders for the purpose of acquiring the property whether or not those loans were secured by the property acquired.
 - C. Grant Deed, Quitclaim, Deed of Trust, and all other documents transferring ownership or title, whether document was actually filed.
 - D. Closing escrow statement including all pages and attachments.
 - E. All checks to acquire property. Includes down payments, earnest money, and all other payments required to acquire the property.
 - F. Mortgage note or other loan documents for money borrowed directly or indirectly to acquire property.
 - G. Appraisals of value of property.
 - H. If acquired by gift provide: 1) IRS Form 709 Gift Tax Return, which reported the gift.
2) All documents, writings or evidence of the Donor’s intent to gift the property.

¹ The actual property description may be replaced or used in combination with the phrase “For each and every real property for which you have an interest or claim as an owner or lender or lien holder either directly or indirectly provide the following information.”

- I. If property is claimed to be separate property provide:
 - 1) All documents, records or writings, which establish the property was acquired before marriage.
 - 2) All documents, records or writings for payments made from separate property to initially acquire the property.
 - 3) All other documents, records or writings, which establish a separate property interest in the property at acquisition.
2. After marriage for each **refinance of the property** or new debt, which is secured by the property provide:
 - A. Loan application to all lenders for the purpose of refinancing the property whether or not those loans were secured by the property acquired.
 - B. Grant Deed, Quitclaim, Deed of Trust, and all other documents transferring ownership or title, whether document was actually filed.
 - C. Closing escrow statement including all pages and attachments.
 - D. All checks paid into escrow or paid outside escrow in the refinancing or addition of a new loan.
 - E. Mortgage note or other loan documents for money borrowed directly or indirectly to acquire property.
 - F. Appraisals of value of property.
 - G. If any of the loan was paid by gift provide:
 - 1) IRS Form 709 Gift Tax Return, which reported the gift.
 - 2) All documents, writings or evidence of the Donor's intent to gift the loan pay down.
 - H. If property is claimed to be separate property provide:
 - 1) All documents, records or writings for payments made from separate property to refinance the property.
 - 2) All other documents, records or writings which establish a separate property interest in the property at refinance.
 - I. If cash was received from the refinance, provide the bank statement, or any other documents, records or writings, which present the disposition of these funds.
3. For all **loan payments**, which are claimed paid from separate property funds provide:
 - A. Check for each individual payment.
 - B. Bank statement showing the check cleared for each payment listed in A. above.
 - C. All documents, records or writings, which establish each individual loan payment was made from separate funds.
4. For all **payments which improved the property** and are claimed paid from separate property funds provide:
 - A. Check for each individual payment.
 - B. Bank statement showing the check cleared for each payment listed in A. above.

- C. All documents, records or writings, which establish each individual loan payment were made from separate funds.
5. For all **other events or occurrences**, which are claimed to create a separate property interest in the property, provide all documents, records or writings, which establish each individual event or occurrence were made from separate source.
6. Most recent Assessor's billing statement for property taxes.
7. All appraisals of the property created or received during marriage not requested above.
8. Lender's loan statements for the earliest date of separation and each month thereafter to the current date.
9. For all capital improvements to the property provide the following:
 - A. Copies of all cancelled checks.
 - B. All invoices, statements and documents describing either the cost or nature of work performed and who performed the work associated with the improvements.
 - C. For each payment or group of payments, all documents, records or writings that establish the funds paid for capital improvements were from separate funds.
10. Provide all other documents, records or writings, which establish any of the following:
 - A. A separate interest in the property.
 - B. The value of the property at any time beginning one year before marriage to the present.
 - C. Any document that evidences an impediment to the title to the property.
 - D. All documents relating to circumstances, which do or could potentially relate to the current condition of the property, such as termite reports, estimates of repairs, etc.
 - E. Any liens or secured creditor's claim.
11. If the property has ever been rented to others please provide the following documents, records or writings for the period beginning three years prior to the earliest alleged date of separation to the present (unless another period is requested):
 - A. All rental agreements, leases, or writings describing the terms of each and every rental agreement or lease in effect during the applicable period.
 - B. For each and every tenant deposit, last month's rent or any other tenant funds provide:
 - 1) Bank statements in which such funds are on deposit.
 - 2) All notices, statements or communications of any type, which evidence the amount of tenant's deposits or a change in the terms of the tenant deposits.
 - C. A copy of the previous three calendar year federal and California income tax return depreciation schedules (or any other documents or writings), which contain any of the following:
 - 1) Original cost of building, components of building and any and all additions or contents.

- 2) The computation of each year's depreciation and accumulated depreciation at the end of each year.
- D. All reports or writings, which contain or present rental income and or expenses.

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Appendix K

Real Property Questionnaire

Real property is an important investment in many marital estates. Real estate can be complicated and involve voluminous documents. The following questions can serve as a list of issues that may require investigation. This may be by informal request but more likely by formal “demands” or “subpoenas” of records or documents. Attorneys will commonly ask CPAs for a list of the documents they require for their assignment. Attorneys generally prefer the form of the requests to be divided into two groups (1) interrogatories (questions) or (2) demands for records (document requests). The following is in the form of a workpaper and is useful for an interview of the business owner, employee and/or associate. If a formal demand for documents or interrogatories is required significant modification may be required by the attorney. This list may also be helpful to an attorney deposing the “spouse.” But it is the attorney’s responsibility to rewrite the requests into a legally appropriate form.

Please answer the following questions as completely as possible. Also provide the documents requested. Please duplicate this sheet for each additional real property if applicable:

1. Property description:
 - a. Physical address including county and state.
 - b. Assessors parcel or identifying number.
2. Please specify the exact name(s) on the title and type of ownership. Provide copies of all Grant Deeds or other title documents created or recorded during marriage.
3. When was the property purchased—provide the following:
 - a. Original purchase price.
 - b. Date purchased.
 - c. What was the source of the cash for the down payment?
 - d. State why the source or sources of the down payment are separate property.
 - e. Provide a copy of the purchase closing escrow statement.
4. Regarding the mortgage please provide:
 - a. A copy of the original promissory mortgage note showing the amount borrowed, interest rate and monthly payment amount.
 - b. For every refinance, the refinance escrow closing statement and copy of new promissory mortgage note showing the amount borrowed, interest rate and monthly payment amount. If cash was received from a refinance, state where it was deposited and or spent.
 - c. State why the source or sources of the mortgage payments are separate property.

5. For all capital improvements to the property provide the following:
 - a. Details of each payment. For each payment show date, amount, payee, check number, bank account, invoice or statement of purpose of payment.
 - b. Provide copies of all cancelled checks and invoices.
 - c. For each payment or group of payments state in detail why the funds in the bank account were separate property.
 - d. If separate property funds were used on any of the above real property expenditures, please state in detail why the funds are separate property.
6. Please provide the “fair market value” or any other opinion of value at the following dates:
 - a. Date of marriage:
 - b. Date of separation:
 - c. Current value:
 - d. Date of each refinance or title change:
7. Provide complete copies of all appraisals of the property from date of marriage to the present.

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Forensic Accounting for Divorce Engagements: A Practical Guide offers both new and experienced forensic accountants a wealth of information and tools to assist with searches for assets that a spouse may try to conceal. Using real-world examples, the book will teach you how to outsmart fraudsters by thinking creatively. Substantial appendixes supply templates for thorough information gathering.

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Ezra Huber, JD, is an admitted attorney in New York and California and has more than 20 years' experience in the field of financial and asset protection planning. He is a prolific author of books and articles and is a frequent speaker on a wide variety of financial and legal matters throughout the country.

Donald A. Glenn, CPA, ABV, CVA, CFE, CFF, has more than 30 years' experience and is frequently a court-appointed expert in the California Superior and Federal Bankruptcy Courts. He is a member of the national standards committee of the National Association of Certified Valuation Analysts and has served on the national board of directors of the Institute of Management Accountants. Mr. Glenn is a nationally known lecturer to judges, attorneys, CPAs, and other groups on forensic accounting.

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