

AICPA CORNER
A column by members of the
AICPA's Forensic and Valuation Services Section

Beware of the Risk of Financial Fraud in a Divorce

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There is one thing that has remained a constant in these uncertain financial times – an individual faced with the potential for a reduction to his personal net worth and / or discretionary income may be tempted to do “whatever it takes” to preserve his perceived entitlement.¹ On the heels of the Madoff, Stanford and Satyam financial scandals of 2008 and 2009, and in an economic climate still feeling the effects of Enron (2001) and AIG (2004), forensic accounting is becoming more mainstream, financial investigations are becoming more common and fraud risk awareness continues to grow. Rich or poor, allegations of unreported income, hidden assets, and other forensic puzzles abound in divorce. Whether it involves the local pizza shop owner or Shaquille O’Neal, allegations may exist that one or both parties are not fully disclosing asset or income information.²

Marital Dissolution: The “Perfect Storm” for Fraud?

Fraud risk often exists in matrimonial matters. A party to divorce litigation may not understand or appreciate the consequences of filing an *intentionally* inaccurate financial statement; that is, by submitting false statements under penalty of perjury to a court, he is committing fraud.³ The false statement itself may be accompanied by other fraudulent conduct,

¹ Use of a masculine pronoun is for ease of readership and should not imply or infer one gender’s having a greater propensity to commit fraud.

² As of this writing, news of the O’Neal divorce was just breaking:
<http://nbcsports.msnbc.com/id/20595448/>.

³ False statements frauds include intentional and materially false, fictitious or fraudulent representations (which include material numeric or non-numeric misstatements in financial statements or court filings), as well as use of any false writing or document when the party knows the writing or document contains a materially false, fictitious or fraudulent statement or entry. They also may include knowing and willful conduct to conceal or cover up a material fact by scheme or trick.

such as collusion, misappropriation, skimming cash, or other acts, which may only be uncovered by conducting a financial investigation which may or may not include a fraud examination.⁴ In this article, we will identify possible signs of financial fraud, and suggest ways that a forensic accountant, sometimes also referred to as a “financial investigator”, might analyze the issue.

To be effective, the financial investigator must possess a skill set above and beyond that which is customary for certified public accountants. Many forensic accountants earn advanced credentials in a financial oriented, investigatory discipline as evidence of their specialized expertise.⁵ In a domestic relations matter, attorneys may consider experts with an understanding and/or background in accounting and tax compliance; interviewing skills; a basic knowledge of the legal system; and good communication and courtroom skills, among other things. Some forensic accountants are also trained fraud examiners.

Signs of the Problem - “Badges of Fraud”

The Internal Revenue Service uses a “Badges of Fraud” concept to help distinguish taxpayer negligence from civil tax fraud. This concept is also helpful in matrimonial cases.

⁴ In the authors’ view, a financial investigation is a broad concept that relates to review and analysis of data for a specified purpose. The specific purpose of a fraud examination is to resolve allegations of fraud.

⁵ A number of certifications exist for financial investigators, including fraud examiners and forensic accountants. For example, the American Institute of CPA’s (www.aicpa.org) introduced the Certified in Financial Forensics (CFF) in 2008. The National Association of Certified Valuation Analysts (www.nacva.com) has a credential called the Certified Forensic Financial Analyst. The CFE (Certified Fraud Examiner) is available through the Association of Certified Fraud Examiners (www.acfe.com). The American College of Forensic Examiners (www.acfei.com) maintains the Certified in Forensic Accounting credential (Cr.FA). The Forensic CPA Society (<http://shopsite.fcpas.org>) offers the Forensic Certified Public Accountant (FCPA) credential. A discussion of these credentials is beyond the scope of this article.

Existence of one or more “Badges” of fraud is not necessarily confirmation that fraud is present, but suggests additional inquiry or scrutiny is warranted.

The IRS’ internal guidance for its agents and examiners states the following: “Since direct proof of a taxpayer’s fraudulent intent is rarely available, fraud may be proven by circumstantial evidence and reasonable inferences.”⁶ The IRS also identified conditions whose existence may alert the auditor to the *potential* for civil tax fraud.

These same concepts may be applied to a domestic relations case.⁷ While the potential for fraud does not mean it necessarily exists, the factors below may indicate further scrutiny is warranted and that engaging a financial investigator may be appropriate:

- Significant reduction in earnings or available cash flow shortly before the divorce or separation;
- Material decline in the number or composition of assets, significantly reduced liquidity of assets or material decline in asset values;
- Transfer of marital assets, for what appears to be less than full consideration;
- Assignment of title to assets; and
- Significant increase in debt, or issuance of new debt borrowings, around the date of separation.

These issues are often more complicated when there is an interest in a closely-held business involved. Some of the more common red flags that may indicate the existence of financial fraud when there is a business involved, include:⁸

- Sharp decline in revenues without response by management;

⁶ Internal Revenue Manual § 20.1.5.12.1 (10/1/2005), *Indications of Fraud*, available on line at: <http://www.irs.gov/irm/part20/ch01s09.htm1#d0e1943>

⁷ The examples which follow are not intended to present an exhaustive list of situations which may occur and which may lead to conclusions of fraud.

⁸ Note that the existence of any of these factors may also be due to increased financial difficulties in today’s economic climate.

- Decline in profitability or value attributed to change in business model which is not self-correcting;
- Significant increase in compensation for persons other than the divorcing spouse-business owner;
- Significant increase in other discretionary expenses of the business;
- Significant increase in business debt, without adjacent increase in operational requirements; and
- Decrease in distributions to owners as compared to business profit.

Fraud may occur prior to the parties' separation, if one of the parties engages in "divorce planning", by developing a strategy or mechanism to reduce his ultimate financial liability or asset reduction upon exiting the marriage. Fraud which arises during this period may take any number of forms. Misappropriation of marital assets, including redirected income, may be accompanied by false or misleading records or documents designed to conceal the deception.

The misappropriation may be accomplished in various ways, including:

- Diverting income to a trusted third party or to another (possibly new) business controlled by the spouse and not disclosed. This may be accomplished by assigning the right to the income to the third party, instructing the payor to make payment to the third party, or endorsing checks received to the third party.
- Siphoning investment income or even principal from marital accounts, and depositing the proceeds into new accounts located either out of state or out of the country.⁹ This may occur prior to separation or afterwards.
- Manipulating the timing of bonuses earned, so they are not 'received' until after the divorce action concludes. Or, one party may hoard bonuses received, only to

⁹ As an example, former attorney H. Beatty Chadwick was accused of hiding assets abroad during his divorce proceedings. He denied funds had been hidden abroad, and it was never ultimately proven that such funds existed. Mr. Chadwick was held in civil contempt for not cooperating on this issue and jailed in Pennsylvania for 14 years. He was released in 2009.

deposit them into new bank accounts after discovery closes or the divorce is finalized.¹⁰

- Shifting marital assets to other individuals, in an effort to shield these assets from equitable distribution. These transactions may take the form of transfers for less than full consideration¹¹ or loans which are allowed to move into default status, causing foreclosure of jointly owned collateral.¹²

Fraudulent financial reporting is defined for purposes here as “intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented [in conformity with a pre-defined basis of accounting.]¹³ Some common examples in the context of a divorce include:

- A party *actively impeding* discovery of material information or deliberately provides misleading or false information during an investigation. Consider these examples:
 - A business owner may instruct his bookkeeper to withhold key information, redact documents, remove canceled checks from bank statements or otherwise fail to provide full, complete and accurate information about the business.
 - A divorcing spouse may affirmatively state that the business has no life insurance policies on any key employees or owners, when, in fact, the business owners cross-own policies on each other.
- The submission of differing personal financial statements to each financial expert and purported as being prepared in the ordinary course of business when in fact it

¹⁰ The business may issue the bonuses to the individual, who merely defers the deposit into a personal bank account until after discovery closes or the divorce concludes. As a result, the business will report lower income, which would most likely depress the value of the business. At the same time, if the bonus has not been deposited by the individual and pay stubs or wage reports are not used to verify his income, the individual’s personal income may appear to be artificially low.

¹¹ Determining whether a transfer was for less than full consideration may involve valuation issues requiring the expertise of an appropriately trained professional. This is outside the scope of this article.

¹² In the latter case, the moneyed spouse may repurchase the property for the balance of the debt, which may be substantially less than the property’s value in equitable distribution.

¹³ Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit, ¶ .06.

was not, is another example. For instance, in one case the authors separately received personal financial statements as of a particular date, which showed different values for the subject business. Neither statement was consistent with the statement obtained from the bank's loan file at that same date. The three statements revealed three distinctly different values for the business.¹⁴ The statement provided to the bank also reported additional, significant assets which were not disclosed to the appraiser, the forensic accountant or the matrimonial attorney representing the dependent spouse.

The Work of the Forensic Accountant

An interview may yield an abundance of information about the couple's current and prior sources of income, any special non-recurring situations such as litigation or insurance settlements, inheritances, and lifestyle / living expenses. The session may also provide information about personal and business relationships – which may be helpful in identifying individuals who may have been entrusted with a 'cash hoard' or other assets/income which the spouse would like to hide from the Court. The goal is to obtain information concerning not only the 'standard operating procedure' during the marriage, but also information regarding each spouse's character. This may provide early hints of something potentially askew in how the couple manages its finances, influencing the approach to the investigation.

Following this, relevant information and documents are gathered and analyzed; the nature of the analysis depends on the particular engagement. Generally, the examiner will ask to interview the spouse either to clarify information previously obtained or to seek additional information. Questions may also be presented to the opposing spouse by client's counsel, under oath at deposition on these issues – and the forensic accountant will no doubt be relied upon to assist in crafting these questions.

¹⁴ It is possible the spouse in this case could have suggested that the difference was the result of application of different standards of value, since the statements were for different purposes – but he did not.

When a closely held business is involved, analyses of the company's financial results, possibly in comparison with the industry, may be helpful to pinpoint differences over time or compared to competitors. The explanations for these anomalies may point to unreported income or hidden assets.

Reviewing non-recurring or non-routine journal entries and the supporting documentation may be a 'treasure trove' for a forensic or fraud detection assignment. If material amounts of inventory, accounts receivable or any other asset are written off as lost, stolen or obsolete, the associated journal entries could be reviewed to gain more information.

Complex variations on cash skim may occur in a business that extends credit to its customers. In one scheme, payments received on account are simply not recorded by the company as collected and the funds are not deposited in the company's account. Alternately, the business could generate false documentation, possibly bogus credits 'issued' to cancel the receivable or unauthorized journal entries (or repeated credits authorized by the same individual) which reduce the customers' account balances to the appropriate levels.

Payroll fraud may result in disbursement of funds to an individual (real or fictitious) for work that was not performed by the payee. This may take the form of either falsified hours or fictitious "ghost" employees. The latter is more common to discover in an examination conducted due to a divorce. In these situations, a spouse may attempt to reduce his income by assigning a portion of it to a "ghost" or fictitious employee. Variations include over-compensating paramours or other trusted individuals based on the actual work performed.

Results from a Fraud or Forensic Investigation

If the investigation yields discovery of additional assets or income, the client's economic outcome may improve. However, counsel needs to consider the client's potential liability for

income of the opposing spouse, discovered during the investigation as under-reported (or not reported) on jointly filed income tax returns. Lack of knowledge of the unreported income may not be sufficient to qualify for innocent spouse relief under the Internal Revenue Code. If the erroneous tax filings are discovered during the pendency of the divorce case, divorce counsel should consider recommending the client engage file separate income tax returns from the opposing spouse, or obtain an indemnification from the other spouse on representations made by that spouse if a jointly filed return will be filed.¹⁵

If the court concludes income was under-reported, it may provide information on the issue to the taxing authorities. If the IRS not only imposes civil tax liabilities, but also successfully prosecutes the wrongdoer on criminal charges, he may end up in jail and the business will likely close its doors. That could be a financial and personal catastrophe for the innocent spouse and the children. Therefore, matrimonial attorneys and their clients need to proceed cautiously and take into consideration all of the legal, financial, tax, and psychological aspects of fraud investigations in domestic relations cases.

Conclusion

In these uncertain times, the potential for financial fraud may increase, so these are issues that may become even more prevalent in the near term. This article is not intended to be a primer on conducting a financial investigation or fraud examination for a divorce, but rather to alert you to some of the fraud risks you may encounter. We are providing you with some suggestions to help you identify situations where you may need to conduct additional due diligence, and possibly,

engage the services of a qualified, credentialed professional to assist you with your case – either as an expert or as a consultant to your firm.

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