Where’s The Money?

The National Association of Certified Valuators and Analysts

Unreported Income Can Be Detected By Direct and Indirect Methods; Indirect Methods Examine Cash Inflows and Outflows. Here’s How.

Joe Epps, CPA/CFF/ABV, CFE, CVA, explains how a forensic accountant goes about searching for unreported income—a commonly required practice in divorce and bankruptcy cases, contract disputes, and fraud investigations. The direct method is simply reviewing financial statements for the information they provide and taking it at face value. But there are also indirect methods: One indirect method of searching for unreported income is to compare all identifiable cash sources (cash inflows) and all identifiable cash uses (cash outflows). Find out more.

There are a number of situations where it is necessary to look for hidden income by determining if the income reported by an individual or company is representative of the actual money received. This can be described as a search for unreported income. Such a search is common, for example, in divorce and bankruptcy cases, contract disputes, and fraud investigations. Another reason for looking into unreported income, which has become more common during the recession, is when a creditor takes the position that they cannot afford to service their debts.

Identifying unreported income is accomplished by forensic accountants. The specific technique or analytical
methodology applied to uncover hidden income will vary depending on the nature of the case and the documentation and information available for review. Therefore, it is crucial that an attorney identify the issue(s) to be addressed when outlining an unreported income assignment with a forensic accountant. With a detailed understanding of the issue(s) that gave rise to the suspicion that income was underreported—or not reported at all—the forensic accountant is better able to determine the best approach to uncover any such amount.

Most people think of identifying income, individual or company aside, by reviewing financial records at face value (aka a “Direct Method”). Such records may include tax returns, financial statements, bank statements, or other reports purported to represent income. But when the amounts shown in these records are believed to be incomplete or inaccurate, forensic accountants apply “indirect methods” to uncover unreported income. These indirect methodologies corroborate and test data and information from multiple sources to determine the accuracy of the stated value in any financial report. Understanding the big picture of some of the most common indirect methods forensic accountants apply will help prepare an attorney to ask pointed questions in deposition or request the key financial records in the discovery process.

One indirect method of searching for unreported income is to compare all identifiable cash sources (cash inflows) and all identifiable cash uses (cash outflows). If the outflows are greater than the inflows, it is, at a minimum, an indicator that income may have gone unreported. A critical element of this method is to take care to include all potential sources of cash inflow and cash outflow.

“Identifying unreported income is accomplished by forensic accountants. The specific technique or analytical methodology applied to uncover hidden income will vary depending on the nature of the case and the documentation and information available for review.”

Sources of cash inflow, for example, can include wages, interest and other passive income, revenues from closely held businesses, loan proceeds, sales of assets, and any other source of cash inflow that can be identified. It is also critical to consider all identifiable cash outflows including personal expenses, business expenses (where there is a closely held business), payments on debt, and asset purchases. The key here is that if the cash outflows are greater than the cash inflows, there is at least a preliminary indication of potential unreported income. At a minimum, this would indicate that further investigation is warranted.

Another analysis used for determining unreported income is the Net Worth Method. Net worth is determined by deducting total liabilities from the total value of assets. This method compares the change in net worth during a period of time with the reported income during the same time period. This method is more comprehensive than the cash flow method and requires additional information. The benefit of this method is twofold. First, this method will identify increases in assets or decreases in liabilities, which cannot be explained by the reported income. Second, by going through this process, a specific identification will be made of the assets. This can be particularly important in cases where a division of assets is being considered. The critical information needed for this analysis is a complete identification of assets and liabilities at the beginning date and at the ending date. This information is typically developed through a combination of documentation provided by one of the parties, request for production from the opposing party, search for hidden assets, interrogatories, and depositions.

A search for unreported income can be complex, time consuming and expensive. Therefore, this analysis should be undertaken when there is a reasonable belief that (1) there is unreported income, and (2) the probable unreported income is significant.

Joe Epps, CPA/CFF/ABV, CFE, CVA, has over 30 years of experience in forensic accounting. His litigation support experience includes contract disputes, anti-trust, economic damages, fraud investigations, business valuation, and intellectual property litigation. Joe is currently President of Epps Forensic Consulting and teaches a graduate course on Forensic Accounting at Arizona State University. For more information, please call (480) 595-0943 or visit www.eppsforensics.com.
Where's The Money?, 6.7 out of 10 based on 3 ratings