Chapter 3A

Forensic Investigation of a Professional Practice

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§3A.01 INTRODUCTION

There are numerous potential reasons to perform forensic reviews on professional practices involved in a divorce. Knowing the correct income of both parties is crucial in resolving maintenance and support issues, and knowledge of asset values is needed for property distribution. Significant adjustments to both the reported profitability and the reported assets of a spouse's business may need to be made in order to reflect its true economic income or value.

Divorce disputes involving professional firms, when they occur, seem to be more bitter than most. Above-average lifestyles are often at stake. Professionals also appear to be more tenacious in holding on to what they believe is theirs, as they feel it was earned solely as a result of their particular skills, intelligence, efforts, and investments in themselves.

Business assets and income of a professional practice may be concealed in a number of ways:

- In a cash business, receipts may be diverted and unreported.
- Professionals often have the ability to delay billings, defer income recognition, and park client payments in escrow or retainer accounts.
- Assets such as software and libraries may be recorded as expenses in the accounting system.
- Personal expenses may be run through the business, reducing its reported profitability.
- Professionals may be involved in associations or alliances that facilitate income or asset shifting.

§3A.02 IS A FORENSIC INVESTIGATION OF THE PRACTICE NEEDED?

A forensic review is an investigation relating to a legal proceeding. Just as a forensic medical examiner studies evidence to look for causes of death and clues that would identify criminals, forensic accountants study evidence to look for hidden or undisclosed assets and income and to assist in determining the ownership of assets held in dispute.

Spouses in divorce cases commonly feel that they are being taken advantage of. When one of the spouses (the "in-spouse") is an owner of a professional practice, the non-owner spouse may suspect the business is being used to hide assets or income.

If the business is being valued for purposes of a settlement, it may be necessary to perform a forensic examination prior to performing the valuation. A valuation done with misstated information will itself be misstated. Since the value of the business being divided depends on its ability to generate income, you need a fair picture of that ability. This usually involves a detailed review of the books and records and adjustment for unusual items or owner quirks. For example, expensive gifts for an illicit lover, paid for by the practice, should be added back to profit in order to get a fair representation of true results. A medical practice that pays and expenses all of the costs of an expensive sail boat should also probably have those costs added back to the practice's reported profits, unless it can be shown that the boat was a necessary and related business expense.

The emotions of the parties often outweigh the potential value of what they are fighting over. It is important to initially determine what you really stand to gain by the investigation, and whether the investigation will be cost-effective. There are many different *levels of service* that can be provided:

—An overview or financial consultation, a "quick and dirty" desktop evaluation

—A business investigation that searches for specific hidden assets or income

—A personal lifestyle investigation, or

—A full and complete search for fraud.

In general, you should not engage a forensic examiner unless the following *four conditions* are met:

—You have a reasonable suspicion that assets or income are being hidden.

—The in-spouse has significant control over the management of the practice.

—A valuation or determination of proper income levels are needed for support and distribution agreements.

—The benefit will outweigh the cost.

The non-owner spouse typically knows very little about the business or investments and has an exaggerated view of their operation and profitability. Nevertheless, this spouse may have access to important business records such as tax returns and financial statements, bank and credit card statements, brokerage records, names of employees, identification of key customers and suppliers, and other key business relationships. Non-owner spouses may know quite a bit about the family's lifestyle, personal assets, and spending patterns that so often point to fraud.

Most professionals receive *perks* from their practices. Some of these include payment of personal expenses, travel and entertainment, automobiles, telephones, computers, repairs and club memberships. The likelihood that there will be abuses usually correlates to the percentage of business done in cash and the strength of the practice's controls. Single-owner practices often have more opportunity for abuse than those with multiple shareholders or partners watching over each other and splitting the pot, although it is common for partners to "help each other out" by hiding such abuses when a marriage is on the rocks.

When potential tax fraud is an issue, the non-business spouse must weigh many factors in deciding how much he or she really wants to know and expose. In one extreme case that I worked on, the wife was so eager to follow a "scorched-earth" approach that she insisted on turning significant evidence of intentional tax fraud over to the IRS, even though she was not eligible for innocent-spouse protection—and the most likely outcome would be the seizure of marital assets and the probable loss of her potential source of support. In more normal cases, the parties would rather settle than have an expert testify in open court about fraudulent activity.

[a] Legal Strategies for Hiding Assets and Income

It is possible for the in-spouse to hide assets and income without committing tax fraud. Tactics include:

—Deferring receipt of payments from willing clients or patients

—Accelerating expense payments

—Accelerating expansion plans

—Increasing investments in items such as advertising or research and development

—Buying future market share through lower current pricing

—Accelerating maintenance or equipment replacement

—Pre-funding benefit plans

—Paying advance deposits

Those (and others) are common ways of making a practice look bad in the short-term while setting the stage for future (post-divorce) benefits. Business owners have been known to "park" assets by selling them at a loss to friendly businesses, with an understanding that they can buy them back after the divorce case has settled. Practices that experience deteriorating profitability prior to the initiation of a divorce action, especially if economic conditions do not support the deterioration, may warrant a forensic review to determine if income has been shifted across time periods.

[b] High Income, But Not an "Owner"

In the case of a law firm I investigated, one of the partners was only a 2% owner and had no official management capacity, but he was the firm's major rainmaker. He had significant influence in every management decision, including current and deferred compensation. In cases like this, a forensic review may be warranted even if neither of the divorcing spouses controls the practice. If at least one spouse is very highly compensated, understanding his or her habits can be of interest—does this spouse travel a lot; divert or invest significant amounts of compensation; own real estate in varied locations; maintain multiple bank accounts, brokerage accounts, or safe deposit boxes; or give other indications of hiding assets? Has this spouse deferred compensation until after the divorce?

[c] Other Uses of Forensic Examination

In addition to searching for hidden assets and income, a forensic examination can be used to accomplish the following:

—Determine total family disposable income when there are items such as tax-free income, deferred income, business perks, and cash from rental activities or partnerships—which often generate cash but show as a loss on income tax returns.

—Identify the standard of living of the parties for purposes of alimony and child support.

—Validate or refute claims of separate property by tracing ownership.

§3A.03 THE WORK PLAN

Once it has been decided that a forensic review is warranted, the keys to a good forensic investigation are:

Objective. Determine the objective of the investigation (find hidden marital assets or income) and the known facts from the client and the client's attorney. Establish exactly who your client is and the role that you are retained in (investigator, consultant, or expert).

Operations. Understand the business or individual's operations—how do they make their money, what types of transactions take place, how are these accounted for, what type of trails do they leave, and what opportunities for concealment are there?

Documents. Gather and analyze the key documents and files that are discussed below. Focus on consistency and logic: Does everything fit together and make sense? Review the details carefully—front *and* back sides of cancelled checks, both sides of transactions purporting to transfer funds from one bank account to another, vendor names and addresses, contract obligations, etc.

Control. Analyze the subject's control over the accounting system relative to his or her financial management and accounting expertise (which they will usually grossly understate if they are involved in fraud), and relative to the documents being reviewed. For example, financial un-sophisticates typically have few accounts with financial institutions, while financially sophisticated people tend to have multiple accounts. Finding many accounts for a subject who proclaims ignorance is a good tip-off to concealed activity. Another is finding the initials of the person who "never gets involved in that accounting stuff" on numerous accounting documents.

Curiosity. Be intensely curious about everything that you look at. By definition, fraud is a disguise set up by someone in a position of trust. It is usually first uncovered by pulling on a little string that looks out of place or inconsistent with the things around it, then eventually unraveling the whole scheme.

If you believe that a fraud did in fact occur, you must gather evidence of when, how and by whom it was perpetrated, and what assets were involved. Quantify the extent of the fraud that you have discovered.

Depending on the case, subpoena or otherwise request additional documents (e.g., undisclosed bank accounts that you found transfers into, remittance records of large customers, regulatory filings) that will help further substantiate and quantify the fraud.

Communicate your findings to your client and/or the client's attorney.

Prepare your report(s) based upon the original objectives of the engagement.

§3A.04 UNDERSTAND THE PRACTICE BEING INVESTIGATED

[a] Follow the Cash

The first step in the investigation is to determine how the business of the practice functions. How does the practice obtain clients or patients, how does it bill and collect for its services, how long is the billing cycle (the time between the start of work and the collection of payment), and how do transactions typically occur. This can be done

either by observation, interviews, or discussions with third parties (clients, insurance companies, similar practices, etc.).

Examples of possible sources of business for professional practices include:

Lawyers:

- walk-ins due to advertising
- walk-ins due to office location
- referrals from groups (e.g., labor unions)
- referrals based on reputation
- referrals from other lawyers

Doctors:

- walk-ins due to advertising
- walk-ins due to office location
- referrals from hospital or other doctors
- corporate alliances with local employers
- managed health care or other insurance plans
- referrals from government agencies such as schools or county health
- referrals from ambulance service
- reputation

Architects:

- walk-ins due to advertising
- walk-ins due to office location
- referrals from contractors
- referrals from satisfied customers

[b] Sources of Clients and Patients/Sources of Payment

The source of clients usually determines the method and timing of billings and collections. For example, a doctor who has mostly walk-in traffic often is paid with cash, check, or credit card. Doctors in poorer neighborhoods or in areas with larger immigrant populations are more likely to be paid in cash, while doctors in more affluent areas are more likely to be paid primarily by third-party reimbursement, with co-payments made by check or credit card. Referrals from other doctors are usually covered under insurance plans. High-cost elective procedures, such as cosmetic surgery or Lasik eye surgery, may involve finance agreements with deferred payment schedules or outside finance companies.

If the doctor receives patients primarily from insurance companies or corporations, he is likely to be paid with checks or wire transfers that will have stronger paper trails than there will be for walk-in cash payments. There will be fewer sources to go to to confirm the doctor's income levels if the practice deals with few source companies. I was involved in one case for only about thirty minutes—as soon as I mentioned asking for subpoenas of payment records from the insurance companies the doctor worked with, a settlement discussion began and there was no longer a need for a forensic investigation.

Even though independent walk-in traffic that pays with checks leaves a paper-trail, it may not be as easy to find, if the checks are deposited in undisclosed accounts. The investigator should always be cognizant of the possibility of off-books, undeclared bank accounts into which client or patient money is deposited. I have seen such accounts in medical, legal, and accounting practices—they are usually titled correctly and checks are properly endorsed with the practice's name. The only difference between these accounts and the officially sanctioned accounts are that these are not recorded in the accounting records of the practice, and the revenue is kept hidden from partners, spouses, or tax authorities.

Some practices pay referral fees when new clients are referred to them. An architect or mortgage broker who pays referral fees should be able to show client revenue for every client for whom a referral fee was paid.

Other implications of analyzing sources of business could include identifying possible illegal acts. The spouse of a labor lawyer whom

I investigated in a divorce case alleged that the law firm had improper relationships with union stewards who were steering all injury cases and grievances specifically to that law firm, with cash payment involved. Union stewards testified under oath that there was no illegal steering of business, no kick-backs were paid, and there were no unrecorded payments between the union, its members, and the law firm. The stewards further testified that members went to the law firm because of the firm's reputation and not because of any specific lawyers at the firm. While this testimony was detrimental to an investigation of unrecorded income, it was very helpful in establishing that the goodwill of the firm was practice goodwill as opposed to personal goodwill. Practice goodwill was an asset that was eligible for distribution as part of the marital estate.

Generally, in larger practices, the practitioners are more removed from the actual cash collection process and have less ability to divert or under-report cash collections. Sole practitioners have the greatest ability to hide income, and also the greatest propensity to have other types of off-book transactions such as barter.

Investigate the ownership of labs or other companies that receive large amounts of referral or outsource work from the practice being investigated. A fertility clinic I investigated sent a tremendous volume of business to the same laboratory. The doctor insisted it was the only lab that he trusted. His trust in the lab became more understandable when it was disclosed that he was also one of its major shareholders.

Larger practices will tend to have controls and procedures specifying who receives money, how it is accounted for, where it is deposited, and who performs these tasks. When a small practice operates under the name of the individual (such as "Michael Goldman, CPA"), it is easy for the individual practitioner to cash or deposit client checks virtually anywhere, not just in a controlled business checking account. Banks are much more accepting of checks that appear to be made out to an individual payee than they are to checks made payable to a corporation, partnership, or LLC.

If the investigator finds that checks have been diverted from the intended payee to bank accounts controlled by someone other than the intended payee, look particularly closely at how those checks were endorsed. In one case I worked on, significant sums of money were recovered from five different banks for accepting checks that were

deposited into accounts not titled to the payee company and not endorsed by the payee company or noted "pay to the order of." In fact, the recovery from these banks for being unwitting accomplices in a fraud was great enough that we did not have to trace all the way to the ultimate source of the absconded funds.

When off-books accounts are detected it is usually through observation of money transferred out of them back into business or personal accounts of the subject being investigated, or from looking at check endorsements or documents provided by third-party reimbursers or corporate affiliates. This is one reason why it is just as important to pay attention to the money coming into a practice as it is to the money going out. "Tattle-tale" spouses or employees are also an excellent source of information on off-books transactions.

Perhaps the most useful attribute of stolen money is that it is worthless unless it can ultimately be spent. Many fraudsters are adept at making sure the diverted money is never missed, but are less careful when they go to spend it. Diverted money in one case was found invested in a horse-stable business nominally owned by the professional's thirteen year old son. In another case the money turned up in the form of a new car, fully paid for, but the source of the money that paid for it could not be explained.

In one of my most challenging cases, the business owner had a separate sequence of invoice numbers that directed customers to use a separate, unrecorded lock-box. Neither the invoices nor the separate bank account were recorded in the company's accounting records. Diverted money was suspected, but an intensive investigation turned up no evidence of it. A snide remark by a former employee led to the discovery that the business owner's girlfriend, an $18,000 per year clerk working in the owner's company, had made a 50% down-payment on a $750,000 house. Enough of the down-payment was traced to customer funds deposited in the unrecorded lock box to initiate a criminal investigation.

§3A.05 WHAT DO ACCOUNTING RECORDS SAY (OR NOT SAY)?

Tax returns of professional practices tend to be unreliable for determining the practice's true income. Virtually all professional practices

complete their tax returns on a cash basis, which does not accurately match revenues with the costs incurred in generating those revenues. In most types of professional practices, the costs are usually paid before their associated billings are collected, which tends to understate profitability unless the practice is in decline.

Examples of the mis-match between costs and revenues include:

- law practices that pay all court costs, witness fees, investigation costs, etc. before judgments are collected or fees are earned
- medical practices with long collection cycles from insurance companies or government agencies
- law firms that take cases on contingency and win judgments or settlements that are paid out over time in structured agreements
- architecture firms paid on a percentage-of-completion basis as the building they have already designed progresses

Different professions have different billing and collection cycles. Accountants typically are paid within thirty or sixty days of providing service. Lawyers can receive advance retainers, contingent fees, hourly fees paid within thirty or sixty days of service, or structured settlements, depending on the type of practice or the specific matter. Doctors receive a combination of immediate cash and deferred reimbursement from governments and insurance companies. Architects and engineers tend to do project work and get paid as the project progresses, which could be years after the initial work was performed.

Accounts receivable, unbilled work, and accounts payable are all items that can be easily manipulated to affect the reported profitability on a cash basis report. It is easy to slow down collections on accounts receivable to defer cash income. Practices can further defer income by building up an "inventory" of unbilled work that can be detected only by thoroughly comparing time sheets or appointment books to invoices. Professionals with "higher quality clients" (i.e. those with the ability and willingness to pay) will be more willing to defer their revenue collection. While this usually is seen in accounting, legal, engineering, and architecture practices, medical practices can easily build their inventory by slowing down the processing of insurance claims.

Whether it is through legitimate accounting practices or through fraud, professional practices have a lot of leeway in hiding income by either understating revenues or overstating expenses.

§3A.06 UNDERSTATEMENT OF REVENUE

Retainer accounts offer wonderful opportunities for income deferral. With the money in the bank, the professional can defer billing and "collecting" on the retainer for significant periods of time. Lawyers can make this practice even harder to detect with structured settlements. Again, time sheets of professionals in the practice should be reviewed and compared to collections to determine what income is still waiting to be recognized. While it may be difficult to obtain access to client files, attempts should be made to analyze and age the funds sitting in retainer or escrow accounts, especially if the balances only seem to increase over time.

Retainers held by lawyers can be subject to attorney-client privilege issues. Nevertheless, large fluctuations in the balances, or the absence of fluctuations when they would be expected due to the observed caseload, should be challenged. Accountants, on the other hand, are not generally granted client privilege, and the investigator should be able to demand full and complete detail of what is in the retainer account.

There are many ways to divert funds out of a medical practice. The methods can be as simple as stealing a cash payment made by a patient, to as complex as overbilling the government or an insurance company and depositing the excess funds in a secret account. In a medical practice these diversions usually involve the manipulation of patient accounts and billing records. A paper trail may be created, but it can be shielded behind patient confidentiality issues.

Revenue reconstruction in a professional practice can be more difficult than in most businesses, because the relationships between income and effort are not always straightforward. Some practices use a multitude of different billing schemes at the same time—hourly charges, value billing, fixed fees, different rates for different procedures, fee compromises, contingent fees, no-charge services, etc. For

this reason, it is almost always preferable to get the billing records in electronic format than in the massive paper-dump that many lawyers use to reply to their opponent's information requests.

Records in electronic format allow the investigator to search much more easily for unrecorded revenue, including the following indicators:

- compare time spent to amounts billed and ensure that all billable time was actually billed
- analyze non-billable time and challenge its characterization; determine whether value was created but unrecorded for this time
- look for billing rate anomalies by calculating hourly rates and sorting by professional, by client, by type of service, or other indicators that may lead to identifying unbilled or misbilled time
- investigate gaps in invoice sequences
- investigate gaps in time records
- analyze client survival rates to determine if clients are falling out of the billing system or being diverted to another entity
- investigate mismatches between clients and referral fees paid,
- investigate mismatches between bank deposits and accounts receivable postings
- analyze account write-offs and unusual credits

Records in electronic format can also offer other indications of unreported revenue not mentioned above much more easily than can be determined through paper documents.

Laws regarding *patient confidentiality and client privilege* may make it more difficult to analyze revenues than in a typical business. It is very easy for doctors to hide behind the many federal and state statutes granting confidentiality to patient records. This is where the understanding of the practice becomes so important, as the investigator must often develop alternate procedures in the hunt for unreported revenue. Knowing the source of revenue can help determine how to look for it.

The *type of practice and type of client* can provide insights into the likelihood of hidden income:

- Accounting and law firms that serve primarily businesses are less likely to understate income than practices that serve individuals, because payments are usually much easier to trace. Highest risk practices have clients that are likely to pay in cash such as in criminal law practices, traffic court lawyers, or high-volume tax return mills for low-income clients.
- Law firms that obtain settlements in structured pay-outs may defer income recognition of their earnings for years.
- Architects and engineers that deal with homeowners and small jobs have a greater opportunity for getting paid in undocumented cash than do practices that focus on large corporations or municipalities.
- Veterinarians and dentists are more likely than most medical practitioners to have a cash business, because their patients are often uninsured. In other medical practices, co-pays and deductibles often are paid with cash or check.
- Medical practices that provide procedures where the patients prefer secrecy and may not be covered by insurance, such as plastic surgery, psychiatry, and psychology, are more likely to deal in cash.

Professionals are less likely to understate their activity or revenue on their applications for *malpractice insurance* than they are in other venues, because understatement could cause their coverage to be voided. Many insurance applications ask for detailed breakdowns of the different types and amounts of services provided. Some insurance applications even require the individual listing of large accounts or high-risk clients. Similarly, lease or loan applications may give a more realistic appraisal of the profession's activity than tax returns or other declarations of income. These documents should always be a part of the review of a professional practice.

Some professionals sell *products* on the side or in conjunction with their primary services and consider this a separate business that does not

get reported along with the financial results of the practice (and may not get reported at all). Examples can include veterinarians selling pet food or flea treatments, dentists selling oral care products, doctors selling over-the-counter drugs or vitamins, or lawyers selling form packets. This off-book activity can often be detected by reviewing purchase expenditures or by direct observation of in-office displays or marketing material.

Vendor invoices to professional practices often include information that can be compared to time and billing information to ensure that everything has been properly reported. Invoices to lawyers from court-reporting services, messenger services, copy services, and record retention companies often list client names. Lab invoices to doctors are usually billed with references to patient names. Accountants use tax and write-up software that usually has a home-base or main screen that lists each client's file. All of these can help identify clients that should have been billed, but whose billings do not appear in the practice's records.

Some types of practices have a more demonstrable relationship between revenue and consumption of *consumable supplies*, and supply consumption can be used to infer actual practice activity. For example, a doctor getting paid in cash may show many vacancies or cancellations in his appointment book, but if he examines every patient on an examination table or bed, and covers the examination surface with a new paper covering each time, than the amount of covers purchased can be used to infer the actual number of patients seen. These observations can often be corroborated with usage of other consumable supplies, such as latex examination gloves or those little plastic covers the doctor uses on the otoscope (the instrument she uses to look into her patient's ears).

Other supply items that may be used to infer the volume of a professional practice's activities include the number of tax return folders or envelopes purchased by an accounting practice, the number of court filings or certified mailings paid for by a law practice, the number of check-list forms printed for a home inspector, permit applications filed by an engineer or architect, or the number of file folders purchased by high-volume service providers. While none of these in themselves will provide direct evidence of understated income, if their usage appears to be much higher than would be expected given the reported activity levels, they can provide a great starting point for a deeper investigation.

One more potential source of information about unreported revenues is *disgruntled former employees.* It is usually difficult to get client or patient records to use for revenue analysis, but typically an investigator will be given access to payroll records of a practice being investigated. Finding an employee who left under less than pleasant circumstances can lead to a treasure of information. New employees, who may have been there long enough to see unusual office procedures but not long enough to be endowed with an overly strong sense of loyalty to the professional, are also an excellent source of information.

§3A.07 OVERSTATEMENT OF EXPENSES

While the manipulation or non-recording of client/patient billing information is the most fertile avenue for understating practice income, the investigator should not overlook opportunities to overstate expenses.

On the expenditure side, petty cash can offer an easy vehicle for diverting cash. I have seen professional practices where more money went out through petty cash than any other type of expense, and there was no accountability for this cash. Other expenses can be aggressively built up (overstated) by paying invoices too quickly, or pre-paying items such as insurance, dues and subscriptions, utility bills and supplies. Erratic trends in these expenses when viewed over a number of years can be a tip-off to this practice.

In a potential case of expense overstatement that I was investigating, hundreds of thousands of dollars had been paid in retainers to criminal lawyers, even though the business owner was not being investigated for any fraud or criminal matters at the time the retainers were paid. The retainers had been sitting idle for as much as thirty months with no activity on them. Attorney-client privilege made it very difficult to challenge the propriety of these payments or whether they should be considered to be property of the business being investigated. It seemed likely that these funds were just being safely parked until after the divorce case was settled. The propriety of most other categories of expenditures is easier to ascertain.

Most owner-operated businesses leave plenty of opportunity to convert *personal expenses* into business expenses, and professional

practices are certainly no exception. Automobile expenses, travel and entertainment, medical benefits, professional fees, practice development, conventions, telephones, home offices, and dues and subscriptions are all fertile ground for lowering the apparent profitability of a professional practice.

Expenses that can be legitimate from a tax perspective may still need to be adjusted when calculating the real economic income of a professional practice. As a professional, I am constantly solicited for professional development seminars in pleasant locations such as Las Vegas, East Coast cities in the summer, or Phoenix and San Diego in the winter. I've been invited to accounting seminars offered in Jackson Hole, Wyoming and Salt Lake City, Utah during ski season and on cruise ships steaming towards Hawaii. The information in these seminars can easily be obtained in my home town of Chicago. Tax law may allow my seminar trip to San Diego to be deductible, but someone investigating the real economic income of the practice should consider adding at least some of the cost back in as an owner perk.

It is not uncommon to see spouses (or other love interests) and children at training seminars attended by professionals from across the country. Many are scheduled with golf, tennis, fishing, tours, and other networking events to help the practitioner establish new professional contacts. It is up to the investigator to challenge whether all the money spent on these activities is a legitimate business expense when determining the earning capacity or actual earnings of a professional practice.

Entertaining clients or potential clients can also be tax deductable, even when the entertained party is also a friend or relative. These expenses should also be evaluated for possible add-back to the practice's reported profits.

Most professional practices have specific patterns in their revenue generating function, and to find these personal expenses buried in a business, it is important to understand exactly how a practice operates and what is really needed for the professional to make her money. Expenditures that don't contribute to or aren't necessary for revenue generation should be added back to reported profitability. For example, an accountant specializing in litigation support may generate business by attending or speaking at specialized legal seminars all across the country and may be able to easily justify a large travel budget. Another

accountant specializing in client write-up and personal tax returns of local residents of her state may find justifying a travel budget much more difficult.

Payroll expense is usually the largest expense item in a professional practice. W-2 forms and quarterly payroll tax returns should be reviewed for irregular activity. An effort should be made to determine if all of the payroll went to bona-fide employees and not to relatives, lovers, or ghosts.

Professional practices, especially medical practices, often own assets outside of the practice and rent them back to their business. Any rent or lease payments to related parties should be reviewed to determine if they are for actual business assets, if they are at market rates, if there are bargain-purchase options, and if they are being consistently paid. If there is a significant payment stream to another entity, it is generally easy to determine from the secretary of state who the owner of that entity is, or at least if it has factors in common (same registered agent, same official address, etc.) as the practice being investigated.

Again, whenever possible, the investigator should get the accounting records in electronic format. This will facilitate data analysis that could identify other areas of expense overstatement:

—Analysis of payments to vendors to identify fictitious vendors, multiple vendors with the same billing address, vendors in unusual locations for that type of practice, duplicate payments, and unusual patterns in check amounts or sequences

—Analysis of purchases to identify excess purchases (possible kickbacks or unrecorded returns) or inconsistent price fluctuations

—Analysis of expense trends to find unexpected fluctuations over time in or in relation to other activity

Professional practices can have large amounts of value stored up in unexpected places such as in their *libraries, databases, or computer software*. In most professions the amount of knowledge, standards, and documentation requirements, and the technology being utilized to implement and comply with them, is constantly increasing, making these items more expensive than they were in the past. These assets are often written off as expenses, reducing reported income rather than

properly recording the asset values. Knowledge of the functioning of the practice, visual observation, and examination of property insurance policies can all disclose the existence of this type of asset.

§3A.08 LOOK BEYOND THE ACCOUNTING RECORDS

Most professions have *professional associations* that routinely survey their members and publish statistics regarding practice operations and profitability. Practices that either vary significantly from the averages or that have exhibited changes in trends that do not conform to the trends in their industry should be closely examined to understand the cause of these differences.

Loans to and from partners or shareholders are usually straightforward transactions, but they can leave valuable hints about cash flow irregularities that should be investigated (large work inflows, asset acquisitions, mis-characterized revenues, or significant cash movements with no apparent business purpose). It should be determined where each loan payment was deposited, as undisclosed bank accounts may be found. Looking at the sources of the funds or the cancelled checks used to pay back the loans can also provide valuable information about undisclosed personal accounts.

If there are many loans back and forth between a practice and the professional, the purpose or need for them should be challenged. Most professionals understand that their business is an entity separate from themselves. Constant shuttling of money back and forth between the professional and the practice indicates sloppy cash management at best, and possibly something a lot more revealing about the true income and assets of the practice.

The existence of *multiple entities* should raise a flag, especially if separate preparers prepare their tax returns. It is much easier to make improper transactions look proper when only half shows on each set of books. Often different partners have different feelings about financial shenanigans, so they set up side entities to allow the looser partner to roam while the more conservative partners stay insulated.

Multiple entities allow greater opportunity for income shifting, asset hiding, check kiting, money laundering, and other financial

shenanigans. There may well be a legitimate reason for multiple entities such as protection from creditors, estate planning, separation of truly separate business operations, and allowing different ownership interests. Many states require the ownership of professional practices to include a certain percentage of licensed professionals, and the only way to share ownership interests with unlicensed partners is to isolate the regulated portion of the business from the unregulated portions. For example, only doctors can practice medicine, but this restriction may not apply to ownership of medical testing laboratories. Similarly, an accounting firm usually has to be more than 51% owned by licensed CPAs to use the CPA designation, so business consulting partnerships between CPAs and non-CPAs may operate as separate legal entities. If there are multiple entities, it is important to understand the reasons why.

Investigators are often provided with bank statements, daily or monthly revenue statements, and supporting documents such as time sheets, appointment books, pre-numbered billing slips and deposit slips. It is not enough for the investigator to just tie these all out to each other. I have seen many instances where there were two sets of books used, or off-book transactions. The investigator who still suspects understated income but could not find it via the types of analysis discussed above needs to look outside of the business for further clues. Some other items to look at include:

- Phone records—frequent or consistent calls to a specific number could lead an investigator to customers, vendors, brokers, or banks with whom transactions are being conducted but not recorded.

- Frequent flyer statements and passports can give indications of both expenditures and destinations that may not appear anywhere in the general ledger.

- An absence of expected payments in the accounts, such as for utilities, auto expenses, insurance premiums, travel and entertainment, and legal bills, could indicate that they were being paid by off-books accounts.

- Account for all numerically controlled documents. This is an effective control that is often ignored in practice. In a case I worked on, stolen

funds were found by obtaining bank copies of checks that were missing from the company's bank reconciliations—they were missing because they had been made payable to the bookkeeper, who changed the payee in the accounting records after the checks to herself were cut.

- Federal Express or other shipping records may disclose off-books customers. Comparing FedEx bills to the company's invoice register in one case showed a large number of shipments that a company made, but which were billed by one of the manager's other companies instead.
- Look for companies with similar initials or permutations of the owner's initials in the vendor or customer list. For some bizarre reason, people who are creative enough to develop sophisticated fraud schemes cannot seem to make up original company names. If you are investigating ABC Company and see vendors named BAC, AbC, and CAB, it is worth a couple minutes to make sure these are not related parties.

§3A.09 THE RELATIONSHIP BETWEEN REVENUES AND EXPENSES

There will be cases where by themselves, both the reported revenues and the reported expenses of a practice will appear normal, ordinary, and unsuspicious. Comparing the two, however, can often bring new perspectives into light. Here is a case in point.

During the valuation of a mortgage broker in a divorce case, I found that the owner of the business was very good at selling mortgages, but his company was barely profitable. Comparing this business to industry statistics, I noticed that certain expense ratios were out of line with the industry averages. Expenses for rent, telephone, office support, travel and entertainment, and other costs all seemed to be too high based on the company's reported sales.

What was most suspicious in this company was the amount of commissions paid. The company paid its salesmen a percentage of revenues, and the ratio of commissions to sales in this company (39%) was almost double the industry average (20%). My interviews

with a number of companies and salesmen in the same industry indicated that at that time the 20% commission rate in this industry was a fairly standard figure that didn't vary with sales volume, experience of the salesman, type of customer, transaction size, or any other variable. A call to one of the company's salesmen confirmed that he was being paid the standard commission rate of 20%.

Other than extreme generosity that seemed out of character with the business owner, the only possible explanations for this unusual ratio of commissions to sales were either that revenue had been understated or that expenses were being overstated. I reconciled the reported commissions to the company's payroll tax returns and ruled out the theory that commission expenses were being overstated.

The apparent lack of profitability was occurring during the beginnings of the now famous mortgage boom. According to the general ledger and financial statements, the owner of the company did not appear to be taking enough money out of the company to live on. It didn't make sense that the company I was looking at was the money loser that appeared in its tax returns. The logical conclusion was that there had to be significant unrecorded revenues and/or payments to the owner.

I decided to focus on the sales cycle to see if I could identify the revenue leak. The accounting detail showed an inordinately large number of refunds being issued that were evidenced by checks written that were recorded as negative sales. These checks broke down into two different categories—those that could be matched to a specific sale and those for which no sales had been recorded. Many of these refunds were easy to trace to voided sales transactions, since every sale was recorded individually in QuickBooks and identified the borrower's name. Revenue was recorded when the sale was made and a refund check was issued when the sale was cancelled. Then there were other transactions that looked like refunds, but there was no corresponding sale originally made for those customers in the accounting records. Cancelled checks showed that the refund checks did in fact go to the payees that they were made out to, and had been deposited into too many different bank accounts than would be possible if the company was running a false refund scheme. The only implication of these refunds, therefore, was that the original sales that related to them had never been recorded.

Interestingly, when I added up three years of refund history and calculated the ratio of total refunds to refunds of identified customers, and multiplied that ratio by the reported sales, the result was a derived sales figure that was very close to the sales that would be needed to justify the commissions paid based on the standard industry rate. For example assume that over three years there were $80,000 of refunds paid to customers, and only $40,000 of those could be traced to recorded sales. This would imply that possibly one half of the sales were not recorded. Further assume that the company's records indicated that 40% of the sales were paid out in commission, but industry practice and other information indicated that the normal commission rate was 20%. If based on the testing of refunds you inferred that the sales were actually double the amount reported, that would bring the commission ratio down from the unexplainable 40% to a much more reasonable 20%. Thus, both the unexplained refunds and the level of commissions paid seemed to indicate that actual sales were about two times higher than what was actually reported.

The evidence had become strong enough that sales were being skimmed out of this business to warrant further subpoenas for additional accounting detail. The greater level of detail now available, particularly credit card statements, led to discoveries of the husband obtaining flowers, jewelry, hotel rooms, and a European vacation for someone who was not his wife. All of a sudden, a hopelessly deadlocked divorce case settled.

§3A.10 WHEN TO GO PERSONAL

Sometimes the most interesting material to review in the investigation of a professional practice is not in the books and records of the practice at all. Personal records of the individual professionals—financial statements, tax returns, asset registrations and titles, bank statements, brokerage statements, insurance policies, credit card statements, and travel itineraries can often give details of life-styles and real income that the business records would never show. The house that the professional lives in, the car the professional drives, the schools the

professional's children attend, the vacations that they take, etc. can all provide valuable clues as to the true income of the practice.

When reviewing the professional's personal financial information, determine whether or not the professional can afford the lifestyle lived on the income reported. Also investigate any large deposits into the professional's personal accounts that cannot be accounted for from practice income. Information in bank or credit card statements can lead to the disclosure of other accounts that were not listed by the professional.

There are many innovative, highly analytical methods for determining whether or not a professional practice has been under-reporting its income. Don't forget what may be the simplest method of accomplishing this objective—very often the out-spouse has or knows of evidence that can make the case, and is angry enough to use it. In many other types of fraud cases, family information is difficult to obtain, but in divorce there is often an aggrieved spouse salivating to turn this type of information over to an investigator.

One method used to determine net income when under-reporting is suspected is *the net worth method*, which was first successfully used in the tax fraud case of Al Capone. The investigator adds up all assets and liabilities of the subject to calculate a net worth figure from bank statements, brokerage statements, insurance policies, and the other information sources mentioned above. Changes in net worth from one period to another must equal the subject's net income. A concern in using this method is that the initial or base net worth figure may be understated due to hidden assets, or that subsequently obtained assets may not be visible to the investigator. The method may not be totally reliable, but is better than no method at all, and if anything, the problems mentioned will understate the income you derive, not overstate it.

Paper trails may not always exist on the subject's personal spending, but this is where a cooperative client can help substantially. A divorce case I worked on involved a husband and wife who each owned a separate cash business. While their joint tax returns never showed more than $45,000 of income, they drove matching Jaguars (fully paid for), took lavish vacations, wore expensive clothing and jewelry, and built quite a nest egg for themselves. The couple had done a remarkable job of paying cash for almost everything they

bought, but there are some things—like insurance policies and airline tickets—where cash just isn't practical; and nowadays nobody has expensive assets such as Jaguars and jewelry that they don't list on an insurance rider somewhere. The wife was able to document most of their spending and assets, as well as the real income of her business, all for a three-year period. The difference between her inflows and their combined outflows was determined to be the husband's real income. The wife's reported income was $24,000 per year, and she received about $60,000 per year of unrecorded cash income. Based on the wife's description of their standard of living (groceries, restaurants, entertainment, clothing, etc.), we were able to estimate that the couple spent $6,000 per month on routine cash purchases. After adding in mortgage payments, taxes paid, utilities, and large asset purchases (cars, jewelry, and investments), we were able to come up with a net outflow of about $280,000 for each of the last two years. By subtracting the $84,000 of annual income attributed to the wife, we derived an income figure of $194,000 per year for the husband.

I was involved with another divorce case in which the husband disclosed $4 million of assets and $350,000 a year in income. Two-and-a-half years later, when he and his new wife applied for a mortgage, he listed $9 million in assets on his mortgage application. We were able to establish that his income had not substantially increased, the values of the assets that he had disclosed had not substantially increased, and the new wife had not brought any assets to the marriage. The only remaining conclusion, therefore, was that assets had been understated in the divorce disclosures. Not surprisingly, this led to additional court actions.

A variance of the net worth method is being able to show that the subject under investigation spent more money than could be accounted for by his available assets and income. Review the subject's standard of living: expenditures for mortgage and car payments, education, grocery, entertainment, travel, clothing, domestic help, health care, home improvement, etc. Even in today's society, where most consumers are over-extended in debt, the money had to come from somewhere, and if that somewhere is not identifiable, then there must be unrecorded income.

§3A.11 COMMUNICATING THE RESULTS OF THE INVESTIGATION

Written communications about a forensic investigation can take many forms and will usually be dictated by the attorney on the case. They can include a brief letter, memorandums, affidavits, declarations, and detailed reports. Communications may include description of the work performed, detailed schedules or exhibits, or copies of specific documents. If the investigator is designated as an expert witness, his or her work product is usually discoverable by the opposing party.

Investigators generally should not disclose an apparent fraud to law enforcement authorities, regulators, or potential victims of the fraud without the clear consent of the client or the client's legal representative. Professional standards regarding confidentiality must be observed at all times.

Investigators will avoid making statements or expressing opinions regarding the guilt or innocence of parties to the investigation. Guilt and innocence are legal judgments arrived at by a trier of fact. The investigator's role is to gather, analyze, and present the evidence in a manner sufficient to assist the trier of fact in reaching his or her conclusion.

A common finding in cases involving hidden income or assets in professional practices is that the subject being investigated may have committed tax fraud. It is unethical to threaten criminal prosecution to achieve a settlement in a civil matter such as divorce. On the other hand, demonstrable tax fraud hurts the subject's credibility in whatever they testify about, and many states require judges to report tax fraud that comes to light in their courtrooms. Even further piling on the potential trouble to the professional, this type of ethical lapse, if exposed in court, can jeopardize their professional license and livelihood. Typically, these cases reach some kind of settlement before the written report is ever completed and presented.