When do you Need a Forensic Review in a Divorce Case?

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 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") owns a business, 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 adjusting for unusual items or owner quirks. For example, expensive gifts for an illicit lover, paid for by the business, should be added back to profit in order to get a fair representation of the business’ true results.

Weigh costs, benefits of an investigation

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 valuation, a business investigation that specifically searches for hidden assets and income, a personal lifestyle investigation, or a full and complete business valuation.

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 is being hidden
- The in-spouse has significant control over the management of the business
- A valuation is needed
- The benefit will outweigh the cost.

Who knows what evil lurks…

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. This spouse may know quite a bit about the family's lifestyle, personal assets, and spending patterns that so often point to fraud.

Most business owners receive perks from their businesses. Some of these include payment of personal expenses, travel and entertainment, automobiles, telephones, computers, repairs, club memberships, etc. The likelihood that there will be abuses usually correlates to the percentage of business done in cash and the strength of the company’s controls. Single-owner businesses often have more opportunity for abuse than when there are multiple shareholders 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 anxious to follow a “scorched-earth” approach that she insisted on turning over significant evidence of intentional tax fraud to the IRS, even though she was not eligible for innocent-spouse protection -- and the most likely outcome was 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.

Legal strategies for hiding assets, 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 customers
- Accelerating expense payments
- Accelerating expansion plans
- Increasing investments in advertising or research and development
- Buying market share through lower pricing
- Accelerating maintenance or equipment replacement
- Pre-funding benefit plans
- Paying advance deposits

Those (and others) are common ways of making a business 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 companies, with an understanding that they can buy them back after the divorce case has settled. Companies 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.

High income, but not an owner

In certain cases, a forensic review may be warranted even if neither spouse owns a business. If at least one spouse is 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?

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

- Determine total family disposable income when there are items such as tax-free 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.

The criteria for determining whether a forensic examination is needed in non-business cases are:

- Whether one of the spouses is likely to be hiding significant assets or income
- Whether there is a disputable claim to the ownership of separate property.

In either case, the benefits of the examination must exceed the cost of the engagement. Spouses should be discouraged from using forensic reviews merely for revenge or emotional gratification. But when warranted, a forensic review can bring about a much more equitable settlement than the underdog spouse could have hoped to achieve.