

## By-Lined Article

### THE ROLE OF FORENSIC ACCOUNTANTS IN DIVORCE ENGAGEMENTS

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It is no surprise that financial issues are among the most contentious in divorce actions. The financial aspects associated with marital disputes and dissolution are often complex and consume most of the effort and attention of the parties. Forensic accountants (most often CPAs) possess unique skills that allow them to provide valuable support to divorcing spouses and their attorneys. While attorneys have traditionally engaged accountants to assist with general financial issues related to divorce, attorneys are increasingly relying upon forensic accountants to provide more in-depth forensic services beyond alimony and child support calculations. The stakes are rising in today's volatile economic climate and employing the expertise of a qualified forensic accountant can make a considerable difference in the outcome for your client.

#### When to Hire a Forensic Accountant (or Two)

It is typical for one spouse to assume the money management role during the life of a marriage and seldom do both spouses have equal knowledge of the couple's financial affairs. Consequently, in a divorce proceeding, the money manager spouse holds an unfair advantage that is frequently utilized to achieve a more favorable settlement. In some cases, capitalizing on this advantage may escalate to the level of fraud by the money manager spouse. Emotions often inhibit sound decision-making during the course of a divorce and the higher-earning spouse has strong financial incentive to understate income in order to reduce alimony or child support payments. Additionally, one or both of the spouses may attempt to hide assets they wish to retain post-divorce.

Through an examination of financial records, a forensic accountant plays a vital role in uncovering hidden or transferred assets and income that directly impact both support and equitable distribution. Forensic accountants are uniquely qualified for this role because of their knowledge and experience in financial document analysis, accounting principles and auditing techniques.

A forensic investigation is advisable and should be considered in situations where one spouse is suspected of concealing income or assets or when it is the only means for procuring financial information. It may also be beneficial when there is a

closely held business or a highly compensated spouse. However, it is prudent to perform a cost-benefit analysis to ensure that the projected cost of the desired level of services will not exceed the expected benefit from a forensic examination.

Additionally, some lawyers engage the services of more than one accountant. For example, one CPA may be hired as an expert to perform business valuations services subject to discovery while a second forensic CPA may be engaged as a consultant under the Kovel rule, which is based on the case of *United States v. Kovel*. When a forensic CPA is placed under the attorney-client privilege, findings and analysis of the *Kovel* accountant are generally protected, an advantage for the hiring spouse.

### Uncovering Hidden Income and Assets

The road leading to divorce is often long and rocky and the spouse with the higher income may attempt to hide, transfer or defer income or assets in anticipation of the formal decision to divorce. The spouse may accomplish this by withdrawing unreported cash from a closely held business, manipulating receipts and expenses of a closely held business, transferring cash to other individuals or entities, or by deferring the receipt of a bonus or other compensation until after the divorce is settled.

Detecting hidden, transferred or deferred income is complicated, however forensic accountants have several effective techniques for uncovering such income. These techniques include the analysis of the family's lifestyle to determine if the level of reported income is sufficient to support the family's expenditures, an examination of the couple's net worth at two or more points in time to determine whether the reported income during the period is consistent with the change in net worth, and an analysis of bank deposits.

Uncovering hidden assets is also difficult but again there are multiple methods available to forensic accountants. These methods include the analysis of individual, fiduciary and business tax returns, the examination of personal and business financial statements or loan applications and public records searches. Detailed forensic review of disbursements made from bank and brokerage accounts can prove valuable in identifying situations where one spouse has attempted to dissipate marital assets in anticipation of the separation. Subject to the limitations of the Gramm-Leach-Bliley Act, some forensic accountants can even employ asset locator techniques to identify hidden accounts established by one spouse. Even if this level of service is not required, a forensic accountant can be extremely helpful in identifying and tracing separate, marital and commingled property.

The various methods for uncovering hidden income and assets have limitations and are not appropriate in all circumstances. A forensic accountant will typically evaluate the circumstances of the case to develop a customized work plan. While the discovery of unreported income can be extremely beneficial to the dependent spouse, it can also lead to serious adverse tax consequences, which should be considered when deciding how to utilize the information obtained through the investigation. In many situations, counsel may find that the identification of unreported income can be a very effective tool in negotiating a favorable settlement.

### **Investigating Closely Held Businesses**

A closely held business is often a prime vehicle for hiding assets or income. A forensic examination of the business can be worthwhile where the opposing spouse is actively involved in the day-to-day operations and is suspected of using business assets or income for his or her personal benefit in excess of reported income. Often, the owner of a closely held business will take advantage of his position of control over the company's finances in order to extract additional compensation by either the payment of personal obligations using corporate funds, engaging in non-arm's length transactions with related entities, or through the payment of excessive perquisites such as homes, cars, airplanes, etc.

When examining a closely held business, a forensic accountant will employ many of the methods discussed above to determine whether hidden income or assets exist, whether business funds have been used to purchase personal assets and pay personal expenses, whether the owner-spouse has been intentionally reducing the profitability of the business and whether there have been inappropriate related party transactions. The examination will include a detailed review of business records and practices, including internal controls, as well as issues unique to the industry of the owner spouse's business. The investigation typically yields a financial road map to the hidden value of the business. Undertaking such an investigation on the client's behalf can also protect the attorney from a future malpractice claim.

Since a closely held business is often the largest asset subject to equitable distribution in a marital dissolution, obtaining an accurate business valuation is essential. The business appraiser typically prepares a valuation for the entity based upon the "normalized" income for the business. That is, the appraiser's valuation should be based upon the earnings that a third-party purchaser could theoretically expect to receive upon acquiring the business. However, an accurate valuation is unattainable if the income and expenses of the business are misstated and commingled with personal business activity. The work-product prepared by the forensic accountant can be provided to the appraiser and prove invaluable for obtaining a realistic value for the business.

## Conclusion

Forensic accountants are an invaluable resource to attorneys in divorce litigation, and, when utilized appropriately, their examinations can facilitate a more equitable settlement. While the need for a forensic accountant depends upon a variety of circumstances of each case, including the size of the marital estate, the extent of actual or perceived marital misconduct, the financial needs of the dependent spouse post-dissolution, etc., the reward will generally exceed the money invested in fees and costs.

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