

Hidden Income

By Sheila May, CPA

The question which I am asked most often about is hidden income. And I am asked most often asked about it by attorneys that have little money or time to investigate the issue. Below is an outline of suggestions for looking for hidden income using just the documents provided to the court and those that may be obtained with basic investigation.

These suggestions are not for clients who have complex compensation issues, a lot of assets, or offshore accounts. The guidance is most effectively used on clients who are sole proprietors or operate small businesses.

First, when approaching the issue remember two important equations:

Income – Expenses = Net Income

Not only can income be under-reported, expenses can be inflated to result in a lower net income.

Assets – Liabilities = Net Worth

If assets increase, there should be a commensurate increase in liabilities or decrease in assets. For example, to pay for a piece of machinery, a loan must be generated or cash should be depleted or a mix of both should occur.

Technique One: Comparing like-kind Items

Set up a spreadsheet that compares Financial Statement, Tax Returns, and (if available and applicable) Financial Planning information (on a home computer or from statements), and Profit and Loss statements.

A. Examine income by comparing to bank account deposits

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B. Examine expenses by looking at the payee of checks written to, whether personal amounts are included expense line items, where expense items spent, debits for cash, and anomalies of purchases

Verify information: Collecting other forms where income is reported.

A. Verify accuracy of tax returns with tax transcripts (Form 4506-T and can be sent to 3rd party),

B. Verify accuracy of tax returns by scrutinizing W2, 1099's.

C. Look at Schedule B – Interest and dividends reported should match to the accounts listed on the financial statement.

Verify Information by using information found on loans.

People are likely to disclose more assets and income to qualify for a loan.

A. Mortgage loans can lead to applications which contain income information. If the lending institution is not known, a search in the Registry of Deeds will reveal this information.

B. Car loans can lead to applications which contain income information.

C. Small business loans which require loan application and personal financial statements.

D. Loans that fall under the UCC.

E. Lines of Credit.

Verify Income:

A. The specific item method

Take a source document like an invoice from a contracting business or an insurance payment for a doctor and search the business bank statements to see if that deposit shows up. It's spot checking.

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B. The aggregate data method

You can also total (aggregate) the income data from source documents such as invoices and see if it matches the income shown on the financial statement. For example you could add all the completed invoices of a contractor and see how it compares to the income claimed on the financial statement.

C. Verifying Income: Look at historical cash/credit ratios or the like

If historically the cash/credit sales ratio was 50/50 and the cash portion drops, there may be cash income being hidden.

Verify Expenses:

A. Scrutinize certain line items

Look at line items that are typical places to hide Inflated expenses including travel costs, meals, cars, phones, wages, entertainment, recruiting, and business use of the home.

B. Looking at expenses over multiple years

The biggest mistake that is made is that income is understated and expenses stay the same.

B1. Notice if expenses stay the same, income goes down and no debts are incurred. This is a sign income is possibly coming from some source.

B2. If income goes down, some expenses (variable costs) should go down.

You could use historical data and argue that at the level of expenses shown, income was at x amount.

C. Look for recent, large outlays of cash

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Look specifically for increased inventory or a large capital improvement as a way to hide income.