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Techniques for Discovering Unreported Income

*By **Mark Kohn,** CPA, CFE, CVA, ABV*

This article discusses relatively simple techniques that can be used to uncover the practice of some business owners of fraudulently reporting less gross receipts than were actually received, thereby reporting less than accurate net income (gross receipts less business expenses equals the net income earned).

The key techniques for uncovering under-reported income are (1) ratio and (2) lifestyle analyses. Private investigators and subpoenas are useful tools for implementing the analyses.

Ratio analysis requires a comparison of the financial numbers reported by the subject business with those reported by similar businesses. A few examples make this easy to understand.

The clothing manufacturer

Assume that sales of $5 million were reported, with reported cost of sales at $4 million. This means that for every garment sold at, for example, $5, it cost the company $4 to actually manufacture it. The cost of labor, overhead, cloth, dyes and cutting, for example, added up to $4 for every garment sold for $5. The ratio of cost to sales is therefore 4 to 5, or 80%.

One would look at the industry ratio. Assume that many manufacturers of similar garments report that it cost them $3.50 for every garment sold for $5 - a 3.5 to 5 ratio, or 70%. One could thus make an initial presumption that the subject business is under-reporting its income by $714,000. This would be calculated by dividing the $4 million of reported costs by the industry standard of 70% to arrive at projected actual gross sales of $5,714,000.

As sales of $5 million were reported, $714,000 presumably went unreported (the mathematics involved is pure algebra: .70x = 4,000,000; solve for x).

The above would be a rebuttable presumption, and the analyst would have to further analyze the case to ensure accuracy. It could be that this particular business is very inefficient, and, therefore, it cost the company 80 cents per dollar of sales. It could be that the company made many garments that simply went out of style and could not be sold, so that the costs were incurred but the sales were not made.

If the business reported the above high expense to sales ratio (which would then typically cause the business to report very low net income), then the owner's lifestyle could be scrutinized to see if the low income corresponds with the lifestyle. Quite often, the owner could be living quite well while the business seems to do poorly. If an owner claims that the lifestyle is funded by gifts, inheritances or loans, one should require evidence.

The coin-operated laundromat

One of the most important costs in this business is utilities - water and power. Assume that the business owner reports gross receipts of $1 million, and provides an income statement that reflects various expenses, including utilities expense, of $350,000. That means that his financial statement reflects utilities expense to be 35% of sales.

The first step would be to obtain statistics from the industry to see if the subject business's numbers seem reasonable. If, in the industry, the typical ratio of utilities expense to sales is 20%, then one could presume that the subject business is under-reporting $750,000 of income. That would be computed by dividing $350,000 by 20% to arrive at expected sales of $1,750,000 – which is $750,000 higher than the amount reported.

The analyst should then validate the conclusion of $750,000 by investigating the personal lifestyle of the owner. An investigation of the actual laundromat machines might also be required. Data from manufacturers regarding how much water and electricity is used per load together with data from recently paid bills from the utility company would allow calculations of the typical water and electricity costs per load. Those costs should then be compared to the amount the laundromat charges to operate the machine per load.

The resulting ratio should be compared to the financial statements. For example, if the data supports a conclusion that it costs 60 cents in utility costs per load and the laundromat charges $3 per load, then the ratio is 20%. On the other hand, if the financial statements reflect a 30% ratio, one could presume that some income is unreported.

The garbage collection company

Assume that the business tax returns reflect low gross receipts and low net income. The family lifestyle, however, reflects significant income. Investigating this situation would require industry statistics, private investigators and subpoenas.

One would first determine, from the tax returns or through a private investigator, the number of the company's collection trucks. From industry statistics, one would estimate the typical gross receipts earned per truck per year. One would then multiply the typical gross receipts per year by the number of trucks and compare that amount with the reported gross receipts.

The shortfall would presumably be unreported income. This could be bolstered by instructing the private investigator to follow various trucks through their daily routes to determine the names of the commercial customers being served. The customers could be subpoenaed to provide all payments made to the company within a certain period. The data on the subpoenaed records could be compared with the cash receipts journals of the subject company; any shortfall would be presumed to be unreported income.

The lawyer

Assume that a certain lawyer has what seems to be a successful practice, but reports low gross receipts and low net income. He also lives a lifestyle that indicates a much higher net income. Gifts, inheritances and loans are excluded as possible sources of income by discussions with the spouse and friends.

The investigation would start by obtaining the lawyer's accounts receivable records together with his cash receipts journals. A subpoena of the law practice's bank would produce the deposit offsets - the deposit slips that accompanied each deposit, together with the client checks that were deposited.

One would then compare all of the activity, as follows. First, one would compare the total collections for the year as reported on the accounts receivable records with the total collections reported on the tax return. (The accounts receivable records would likely be correct, because the lawyer would not want to present false information to his clients.) If the total collected per the accounts receivable records should exceed the total reported, then the difference would be presumed as unreported income.

One would then prepare a more detailed analysis. One would look at the billings for a certain month - for example, January. Assume that the lawyer billed Mr. Smith $5,000 for services rendered that month. One would then review the accounts receivable records for February for evidence of payment of the $5,000. One would then examine the subpoenaed bank records to see if the $5,000 was deposited.

The deposit offset could reflect a deposit of $5,000 less cash withdrawn at the teller's window for $3,000, as an example, for a net deposit of $2,000. It would thus be possible that only the $2,000 would be reported on the lawyer's cash receipts journal. If only $2,000 was reported on the cash receipts journal, sales for the year would be $3,000 less than actual. Perhaps the lawyer might repeat this type of activity many times during the year.

A follow-up step would be to review the lawyer's personal bank records and credit card charges. This might reflect virtually no amounts being spent for groceries, clothing, household supplies, etc. The absence of records of such expenditures, contrasted with a known lavish lifestyle, would mean that the lavish lifestyle is being paid for in cash. That cash might have come from those withdrawals at the teller window. The presentation of the accounts receivable analysis with the business bank records with the personal banking activity would be powerful evidence of unreported income.

It is important to note that in all of the above examples, the amount of unreported income was implied to be a relatively large amount. The above techniques are appropriate in such cases, because the conclusions are necessarily approximations. One could conclude that approximately $500,000 of unreported income exists, and that would be satisfactory in court, because the court would know that it might really be somewhere between $400,000 and $600,000.

If, however, one is looking for unreported income of $10,000 or a similar small amount, the effort would not be warranted by the costs, and the conclusion might be explained sufficiently by the other side to the court as to make the effort inconclusive.

In summary, if the forensic accountant/fraud examiner is provided with sufficient resources, including the use of private investigators and subpoenaed records, unreported income can often be determined to a fairly precise amount.