Forensic Accountants – A Resource for Finding Hidden Funds and Business Value

By Shelley A. Brown, Principal and Shirley Zhao, Supervisor

Conflicts between related parties – whether for divorce, a business break-up, a bankruptcy or an estate challenge – often revolve around finances and a lack of trust between the parties. The disgruntled party often thinks the solution is an audit when they really need a forensic investigation. The purpose of an audit is to opine on the validity of a company's financial statements as a whole and not to identify all possible irregularities. While auditors look for signs of material fraud, they give no assurance that a fraud will be identified. Forensic accountants do employ some audit techniques, but their objectives are different. As a result, their investigative methods and procedures are different.

Based on experience with an audit client, an auditor makes selections of certain transactions within specific accounts for testing. A forensic accountant, having no previous relationship with the company or the individuals involved, will start the engagement based on information provided by an attorney, a regulatory agency, or a complaining party. Forensic accountants focus on financial and operational fraud to discover hidden assets and misappropriated funds.

Forensic accountants analyze the details of a company's financial records and obtain data generated by the company's system of internal controls. They will also observe, interview and research individuals and apply analytical procedures to identify exceptions and make recommendations for improvement. If the exceptions were willful, such as hiding revenues, misappropriation of assets, payment of personal expenses through the business and tax fraud, then company management and perhaps even the appropriate regulatory agency will be notified.

Misappropriated Assets

Forensic accountants are retained to determine when company management suspects a misappropriation of assets. These thefts can go undetected for a significant period of time in instances such as when an employee has created a fictitious vendor or customer, resulting in the company paying or billing for goods or services which were actually for personal use. The forensic accountant's investigation is specifically designed to find the missing assets and cash, often starting with the use of data mining software, artificial intelligence or other specialized programs to identify unusual or suspicious transactions in the accounting records.

Forensic accountants trace these selected transactions from inception to completion, verifying each step with the individuals involved, such as customers, vendors and employees. The procedures may also include an analysis of supporting documentation, like purchase orders, invoices and cancelled checks as well as conducting a physical examination of inventory and company equipment. Based on these procedures, the forensic accountant will then write a report detailing the procedures performed and the resulting conclusions to enable the client or Court to determine the existence or absence of fraud and the client to develop a strategy for recovery.

Litigation Support

Forensic accountants are also retained to assist in commercial litigation involving disputes between shareholders or partners, a challenge between beneficiaries of an estate, a divorce, a fraudulent conveyance in a bankruptcy or other actions in which one party believes they did not receive a fair division of the subject assets or that they were defrauded.

In addition to employing forensic accounting procedures, these engagements require that the forensic accountant be knowledgeable with respect to the applicable federal or state law and statutes. With an estate, for example, life insurance is typically not taxable to the beneficiaries, but is taxable to the estate if the decedent owns the policy. For that reason, when an a business is valued for estate tax purposes, the appraiser must examine the life insurance policies for the decedent business owner to determine whether there is a tax consequence. If so, the tax consequences must be calculated.

Sometimes, the inappropriate transaction is relatively easy to find. In a recent investigation for divorce purposes, the titled spouse claimed checks payable to “cash” were for payroll. Comparing the total of the cash checks to the total payroll reported to the Internal Revenue Service on Form W-3, proved the representation was false and the cash taken for non-business purposes. This was added back as part of the business valuation procedures.

At other times, designing the appropriate procedures requires a little more ingenuity. We were recently involved in a case in which construction contractors were colluding with low-level government employees to defraud a government agency. To obtain construction permits at reduced prices, the contractors requested the employees enter one or two “real transactions” at the prices established by the government. For the remaining transactions, the employees issued “understated” invoices to the contractor with the contractor’s name entered under a slightly different spelling. The “understated” invoices went unnoticed. On the “understated” invoices, the employees charged a reduced price for the permit and the employees were paid cash bribes for issuing them.

A government manager found a wad of cash left by an employee in a drawer. That was the “red flag”. Using a thumb drive, the files containing all invoices for construction permits were entered into “data mining” software. Discrepancies were identified which raised professional skepticism, such as 26 contractors having the same business address for their companies. That procedure enabled the identification of all understated invoices. The investigation resulted in the recovery of $2 million from the contractors and one contractor was prosecuted.

If the litigation involves a business, the forensic accountant must have the necessary training and experience to value the business — and the purpose of the valuation impacts the way it is performed. In cases involving an oppressed shareholder or in a divorce where only one spouse is involved in the business, discounts from the business value for marketability or a minority interest are not permitted in most instances.

Contact Us

The PKF O’Connor Davies Forensic, Litigation and Valuation Group provides forensic investigations and valuation services for litigation, buy/sell agreements, estate planning, tax planning, mergers & acquisitions, sale or purchase of a member or shareholder interest.

If you would like further information on these services, please call Shelley Brown, MBA, CPA/ABV/CVA, CFF, Principal at 201.639.5760 or e-mail her at shelley.brown@pkfod.com.