Forensic Accounting:
Financial Reporting Distortions

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FINANCIAL REPORTING DISTORTIONS

When reviewing financial statements, always make sure the financial statements correlate with the underlying books and records of the business. There are certain general financial abuses you should be looking for such as the duplicate processing of income or expenses; the recording and reporting of transactions before they occur; the shifting of current income or expenses to a later or earlier period; whether profits or losses are the results of non-recurring transactions; whether income is being assigned to business partners, family members and/or close, personal friends; and whether there are income timing differences due to accrual versus cash basis of accounting.

There are also some common financial abuses that will not be recorded in the financial statements, underlying books and/or records of the business. These include; unrecorded promises and commitments; unrecorded or pending legal liabilities; unrecorded sales, receipts and disbursements in separate, unrecorded accounts; inadequate or incomplete disclosures; use of funds for illegal payments and transfers; hidden interests in joint ventures; transfers at other than fair value; and insider trading.

In addition, the following specific areas should be examined to protect your client's rights: (1) Cash versus Accrual accounting method, (2) Compensation, (3) Interest income, (4) Dividend income, (5) Tax-free exchanges, (6) Rents, (7) Pension income, (8)Personal injury damages, (9) Illegal or unreported income, (10) Depreciating assets and (11) Other non-reported income

Accounts receivables are the primary cash versus accrual accounting method that can dramatically affect the amount of revenue reported. Watch for unreasonable write-off of accounts receivable as uncollectible. View aged accounts receivables. Determine if orders are booked as accounts receivables when an order is placed or shipped. Depending on the jurisdiction accounts receivables can create a double dipping issue whether they are an asset or next month's income

In trying to calculate income there are many ways a person can be compensated for services. The predominant method is salary or wages, which includes overtime, holiday pay, vacation pay and sick days. Other forms of compensation include tips, bonuses, restricted stock units, stock options, incentive stock options, commissions, severance pay, golden parachutes, cash payments, side jobs, cash register type businesses, petty cash, travel and entertainment reimbursements, property payments, barter, and deferred compensation.

There are employee benefits which should be scrutinized including accident and health plan, medical reimbursement plan, meals and lodging, dependent, commuter passes, parking, tuition reimbursement, moving expense reimbursement, VITA program, professor family tuition waiver, employee achievement awards, employee discount, group term life insurance, cafeteria plans, health spending accounts, flexible spending accounts, group legal service, group life insurance, disability insurance, accident and health benefits, and dependent care benefits

Pensions can be another form of compensation that is overlooked. Some employer plans include profit sharing plans, money purchase plans, defined benefit state, federal plans; union and private employer plans. Look closely at the W-2 to see if a box is checked identifying an employer plan. Also, watch for employer matching in some defined contribution plans like401(k)s and 403(b)s. Annuities are not reported on tax return when purchased. Lump-sum distributions can be rolled over to IRA or another qualified plan

Some Interest income does not immediately appear on tax returns. EE Savings Bonds are tax deferred until the bonds mature or are redeemed. They are often part of contents of safe deposit box. Federal obligations are not subject to state tax. State and local bonds are not subject to federal tax.

A type of dividend income that can go undetected are constructive dividends. These types of dividends can arise from shareholders paying personal expenses through their business; such as home or cellular phone, company car used for personal use, personal meals & entertainment, reimbursing commuting expenses, withdrawals or shareholder loans above salary without obligation of repayment, personal vacations tacked on to business trips, and household expenses. It's strongly recommended to complete a yearly comparative analysis of the businesses expenses to find irregularities that may be disguised constructive dividends.

Rents can be manipulated to distort income. Examine leases for back loaded rental leases which may give free rent up front for higher payments at the end of the least. Alternatively, the free rent can be straddle around a divorce. Tenant's improvements can be stipulated in a lease that then affect the rent paid. Determine if a tenant is bartering services for lower rent. Are relatives or friends not paying fair market value? Have you accounted for security deposits in escrow?

Personal injury damages are usually tax-free, but the interest on the tax-free amount is still taxable and will be reported on tax return. Look for a sudden increase in interest

Some other non-reported income include life insurance proceeds, withdrawals and loans, gifts and bequests, scholarships and fellowships, parsonage housing allowance and of course, illegal or unreported income. Ask a simple question, does cash flow match lifestyle.

On corporate returns look closely at schedules M-1 and M-2 on Form 1120, page 4 provide for book versus tax income (i.e., tax exempt interest, key man insurance, cash v accrual adjustments etc.). On the schedule M-1 you need to add back book adjustments for federal income tax to net income per book to equal taxable income on Form 1120. Look to add back capital losses in excess of capital gains. Adjust for income subject to tax though not recorded on books. Adjust for expenses reported on books though not deductible such as adjusting for meals and entertainment (50% differentia), key person life insurance premiums, excess depreciation, contributions carryover, and foreign tax credits. Conversely, on the M-1, adjust for income recorded on books though not included on tax return such as tax-exempt interest, key person life insurance proceeds. Adjust for deductions not charged against book income including Depreciation (Straight Line vs. Accelerated), contribution carryover and capital loss carryover.

On schedule M-2 -- Unappropriated retained earnings review opening and end of year balance figured on Schedule M-2 and entered on Schedule l, distributions and other columns, pending lawsuits, declines in inventory values, sinking fund for capital expenses, purchase of treasury stock, appropriations with bond holders or creditors and prior period adjustments for change in accounting principles

Examine all partnership and S corporation K-1s for amount distributed to partner which may not be the same amount as that reported as income

Expenses, Liabilities and Tax Credits That May Identify Undisclosed Assets

When reviewing a party's tax returns, be aware of certain items that can help you identify undisclosed assets. For example, retirement, Keogh and SEP contributions, which can be found in the adjusted gross income section on IRS Form 1040 and on the face of business tax returns, may be used as a vehicle to divert compensation into retirement investment activities. This is particularly important if the compensation would have otherwise been included in calculations for child support and maintenance or if the retirement account in question is a non-marital asset.

Pay close attention to IRS Forms and Schedules. Form 1040 – Schedule A may have state tax deductions that may identify undisclosed income from another state, real estate tax deductions that identify undisclosed real assets, and investment and interests expenses that may identify undisclosed investment assets. The inventory reported on IRS Form 1040 - Schedule C, Part III "Costs of Goods Sold" is often approximated, which impacts the business income reported. General business credits reported on IRS Form 3800 may identify undisclosed assets and foreign tax credits reported on IRS Form 1116 may identify undisclosed foreign assets.

Some specific Income/expense distortions include shipping goods before a sale is finalized, reporting revenue when important uncertainties exist, recording revenue when future services are still due, recording income on the exchange of similar assets, recording funds from suppliers as revenue, using bogus estimates on interim financial reports, boosting profits by selling undervalued assets, boosting profits by retiring debt, failing to segregate unusual and non-recurring gains or losses, improperly capitalizing costs, depreciating or amortizing costs too slowly, failing to write off worthless assets, reporting revenue rather than a liability when cash is received, failing to accrue expected or contingent liabilities, failing to disclose commitment and contingencies, engaging in transactions to keep debt off the books, accelerating discretionary expenses into the current period, writing off depreciation or amortization for future years, do inventory or supply purchases make sense in light of revenue reported?