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Warning Signs of Fraud in Divorce

By Martin Mathias

Divorce cases involving closely held businesses can present unique challenges. Determining business value and income available for support are often the primary considerations that need to be addressed. However, in some cases, it may be prudent to consider if a spouse is using the closely held business to either hide marital assets or fraudulently deflate the business value.

Financial fraud can be difficult to detect. It can also be a time-consuming and costly effort to go on a "fishing expedition" just based on a hunch that some malfeasance may be taking place. However, there are certain warning signs that should be considered.

Sudden changes in profitability. Does a business that was historically profitable begin to experience a downturn that coincides with problems in the marriage? It's not unusual for a business to experience periods of lower profitability. These cycles can be caused by any number of factors including a loss of a key customer, tight labor markets, or in recent times, a global pandemic.

A business owner should be able to provide meaningful explanations to substantiate the reasoning for the decreased profitability. However, when the downturn coincides with problems in the marriage, further scrutiny of the explanations should be considered. Ronald Reagan was famous for using the phrase, "trust, but verify." His advice is appropriate when confronted with these situations.

Control and secrecy over business affairs. Does the spouse who is most involved in the business withhold financial information from the other spouse? Information and knowledge are very powerful. While it is generally good practice to keep a business's financial affairs guarded, any business owner should be given access to, and be able to make inquiries about, their own company's financial records. If a spouse is unwilling to share financial information or is vague in their responses to inquires about the business, it could be an indication that they have something to hide.

Owner distributions. In flow-through entities (partnerships, LLC's, S-corporations), equity distributions made to owners are not typically reported as taxable income on the couple's individual income tax return. Since these distributions are not reported as taxable income, they can sometimes be overlooked as a source of income.

The equity distributions are, however, presented on the owner's Schedule K-1, which are issued by the company. Equity distributions should be traced to corresponding deposits in the couples' personal bank accounts. If the distributions from the company do not match the personal deposits, it could be an indication that assets are being concealed.

Unexplained business loans. Has the business recently started to loan money to others or borrow money for unknown reasons? Unusual lending and borrowing activity could be an indication of hidden assets. It is very common practice to focus measures of financial performance on just the income statement. The income statement presents the net profitability of the company.

However, the income statement only tells part of the story. A company's balance sheet includes amounts due to and from a company. If an owner decided to loan $100,000 from the business to a friend, this transaction would never appear on the company's income statement. However, a review of the balance sheet should reveal that $100,000 was borrowed from a spousal asset (i.e., the business) for personal reasons.

Use of business credit cards. Does the spouse most involved in the business have access to business credit cards? When a business issues a payment, there is typically an accompanying detailed invoice that lists the products or services being purchased. Therefore, one should be able to use these invoices to determine the nature of the payment.

However, credit card statements generally only indicate the date of purchase, the vendor's name, and the payment amount. This lack of detail creates an opportunity for potential malfeasance. Access to business credit cards could provide an owner the means to make personal expenditures under the guise of it being for business purposes. This type of activity could result in not only hidden marital assets but also a lower business valuation.

If a business owner uses a company credit card regularly, the credit card statements should be reviewed for indication of personal use. In addition to the credit card statements, business owners should keep the underlying detailed receipts to substantiate the nature of the expense.

Condition of business records. Are the business financial statements regularly reconciled and reviewed by either independent employees or by an outside accountant? Sloppy business records by their nature can be both an indicator of, and means to conceal, financial fraud.

Look for the Warning Signs

In many divorces, emotions are "running high" and there can be trust issues between the spouses. A suspicion of financial fraud can be a natural result of these factors. These suspicions should be tempered before beginning a complete forensic analysis of the company.

However, if one or more of the above "warning signs" exist, further investigation may be warranted. In these cases, consider engaging an expert, such as a Certified Fraud Examiner (CFE), early in the process. These experts can help define the scope of the project and provide meaningful investigation, analysis, and testimony.

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