

Davis & Company, CPA's, CVA's

Financial Fraud in Divorce Matters

Some of the most elaborate frauds that I have investigated involve divorce matters.

For a fraud occur, there has to be opportunity, need and rationalization. In a divorce matter that involves a sole shareholder, the elements of the fraud triangle are typically present. The opportunity to commit the fraud exists since the business owner is in control of all aspects of the business finances. The need is driven by the property settlement or the marital support issues. The rationalization is often supported by the emotional circumstances that led to the divorce, or by the result of the divorce action.

The difficulty with fraud committed in a divorce case is the fraud mastermind's ability to create the cover-up. Since the fraud is being perpetrated by the person in control, records that normally would leave clues for the fraud investigator can easily be doctored or destroyed.

In many forensic accounting cases, the fraudulent activity was uncovered by accident, often by the business owner or accountant. The focus of the forensic investigation then becomes who did it, how did they do it, and how much did they get. Common forensic accounting techniques usually lead to exposing the perpetrator.

In many divorce cases, however, the fraud is uncovered unconventionally by studying the business during the period before the divorce filing. This type of analysis will help identify what is missing from the current business, or help identify mysterious activity in the current business operation.

How does fraud affect the outcome?

Siphoning off business profits has several effects on the value of the company. First, reduced income can directly lead to a lower business value since many of the valuation methods consider the earnings or cash flows of the business. The results can be staggering depending on the multiple of cash flow that is determined when valuing the business. Second, the reduction of cash or other assets maintained in the business will directly reduce the asset value of the business. Third, the risk assumptions of the business may increase due to erosion of working capital. Higher the risk assumptions can result in a lower value of the business.

And just because it's legitimate tax deductible expense does not mean that it is necessary for the operation of the business. A review of the nature, occurrence and necessity of the expense is important to determining the real cash flow and profit of a business.