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DIGGING IN THE DIRT: PERFORMING FORENSIC ANALYSIS OF FINANCIAL RECORDS FOR VALUATION PURPOSES

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When investigating financial records during a valuation, defining the scope, having effective communication with the client, and gathering the necessary records are the foundational components of a successful engagement. Whether the valuation professional is investigating personal activities or potential accounting fraud, it is important to be aware of where red flags might lurk, as well as corrective actions.

Introduction

In many types of business valuations, whether it be for a proposed transaction, shareholder dispute or litigation, economic damages, or marital dissolution, the issue of investigating personal activities or accounting fraud in a business's financial statements often arises. Sometimes, the inquiry arises from an attorney or client who has direct knowledge or reason to suspect fishy behavior in the business records. Other times, this inquiry stems from a preliminary review by the valuation professional who has identified red flags. In any event, valuation professionals should understand various fraudulent situations they can identify and help the client to correct.

Personal Transactions

As it pertains to small-to-medium privately held businesses, the most common inquiry at the beginning of an engagement is with respect to personal transactions on business records. In some respects, it is the low-hanging fruit of a forensic investigation—one or a couple of owners establish the business as a pass-through entity and reduce their tax liability by comingling personal and business expenses. Personal transactions can involve assets on the balance sheet and transactions accounted for in the profit and loss statement. Some examples are included in Table 1; however, the list can be much more substantial.

Table 1
Common Personal Items in Company Financial Statements

ASSETS/LIABILITIES	EXPENSES
Luxury Automobiles	Cash Withdrawals
Boats	Family Vacations
Vacation Homes	Clothing
Planes	Home Repairs
Shareholder Advances/Loans	Club Dues

To counter the effects of personal items paid for by the business, a potential solution can be found in the personal-centric accounts in financial statements, such as shareholder distributions and shareholder loan or advance accounts on the balance sheet and reclassifications to W-2 compensation on the profit and loss statement.

Starting the Investigation

To begin an investigation into personal items in the financial statements, one must identify how the business owner pays for personal items and how the items are recorded in the financial statements. Payment is often by credit card, wire, or check. Therefore, receiving corporate monthly credit card statements and bank statements in addition to the standard financial documents for any valuation is warranted.

HELPFUL TIP #1: When requesting monthly bank statements, try to ensure that check images of deposits and credits on the account are received. Often, a bank statement will show the check number and amount but will not provide the associated check image. This helps identify vendors, the date checks were written versus deposited, and any notes made on check memos.

To address the second issue, arguably the most critical component of an investigation is receiving the general ledger reports from the business. The general ledger, from an investigative perspective, is a tool for confirming where specific transactions have been documented in the accounting records.

However, the general ledger cannot be taken at face value. It must correlate with the financial statements provided. For instance, if a tax return is provided with a general ledger, it is possible to discover that significant changes were made at the time of preparing the tax return that are not actually reflected in the ledger.

The View from Above

But before the valuation professional dives into the general ledger or monthly bank or credit card statements, it is important to review the business from a higher level. From this perspective, the valuation professional can identify possible red flags. Some potential red flags include:

1. A mature business that has consistent losses
2. Frequent break-even performance
3. Underperformance relative to industry benchmarks
4. Unexpected earnings volatility

   Example: The company experienced robust growth from 2019 to 2021, which was consistent with industry benchmarks that indicated the industry had robust growth from 2019 to 2023. In 2022, however, the revenue of the business decreased by 22 percent. Company revenue in 2023 then reverted to normal.

5. Unexpected variability in individual expense account line items

   Example: Accounting and professional fees increased by $100,000 in the year the business owner went through a marital dissolution.

In some situations, a high-level preliminary analysis can diffuse allegations or suspicions from the attorney and/or client. Examples that can sometimes be considered green flags include, but are not limited to, the following:

1. The earnings of the business are at historically high levels.
2. The metrics of the business trend more positively than industry benchmarks.
3. The growth of sales and profitability is positive.

The reason the three “green flag” items mentioned above may only *sometimes* be positive signs is because in situations where an owner seeks a high valuation (e.g., proposed transactions), these green flags might actually be grounds for further inquiry to ensure the owner is not inflating the financial statements to produce a more fruitful outcome.

An initial observation of the financial statements also can identify potential corrective actions to potential red flags—for example, the presence of asset accounts pertaining to shareholders, such as a shareholder loan account (often referred to as “Due from Shareholder” or “Loan to Shareholder”). Rather than a business owner

Figure 1
Scenario 1: Credit Card Transactions Appearing Individually in the General Ledger

April Credit Card Statement

DATE	DESCRIPTION	AMOUNT
4/11/2023	JetBlue	$ 1,500
4/12/2023	John's Italian Restaurant	$ 175
4/13/2023	Bahamas Parasailing	$ 300
4/14/2023	Uber	$ 20
4/15/2023	Beachside Café	$ 45
4/17/2023	Marriott Bahamas	$ 1,750

General Ledger

ACCOUNT	DATE	DESCRIPTION	AMOUNT
Expense - Travel	4/11/2023	JetBlue	$ 1,500
	4/17/2023	Marriott Bahamas	$ 1,750
Expense - Meals & Entertainment	4/12/2023	John's Italian Restaurant	$ 175
	4/13/2023	Bahamas Parasailing	$ 300
	4/15/2023	Beachside Café	$ 45
Expense - Auto	4/14/2023	Uber	$ 20

committing tax fraud by expensing personal kitchen renovations in cost of goods sold under the "materials and purchases" account, the owner moves the personal expense over to a shareholder loan account, indicating that the shareholder now owes the company money for expenses incurred to renovate a personal kitchen.

HELPFUL TIP #2: Always identify the accounting basis for which the financial statements are prepared (cash, accrual, percentage of completion, etc.). Receiving accrual basis financial statements along with cash tax returns may lead to additional questions and, possibly, red flags. In some cases, unexpected observations in the financial data can be due to a change in accounting methods rather than bad deeds.

The level of cleanliness in financial statements can be ascertained by high-level observations of red and green flags. But preliminary analysis cannot determine the outcome of this type of investigation. Rather, it can help the client and attorney decide the next course of action.

A valuation professional can present observations and opinions; however, the valuation professional cannot provide the best course of action. Simply put, detailed investigations are time-consuming and, therefore, costly. Is it worth it for a client to spend a substantial amount of money for a valuation professional to review every ledger account and every monthly credit card statement over a reviewed historical period when the outcome is uncertain? It depends on the client's goals.

Credit Card Investigations

In an ideal situation where a valuation professional is provided with the monthly credit card statements, monthly bank statements, and general ledger, the ability to trace transactions to the financial statements can be more straightforward. A valuation professional has two primary ways to trace a credit card transaction all the way to a financial statement, with the second being a slightly more complicated endeavor:

Each credit card transaction appears individually in a general ledger account. The ledger accounts should tie into the overall financial statements (unless there are unrecorded adjustments that cause a difference between the ledgers and financials).

The payment of a group of credit card transactions traces to a combined expense on the general ledger account. Again, the ledger accounts should tie into the overall financial statements.

Let us take a deeper dive into each scenario:

Scenario 1: Each credit card transaction appears individually in a general ledger account.

Sally Cook, the owner of a business, books a family vacation, including a flight, hotel, and several meals, on the corporate credit card. Each transaction on the credit card statements is categorized directly into expense accounts in the profit and loss statements.

As seen in Figure 1, there does not appear to be any journal entry adjustments that reclassify these

Figure 2
Scenario 2: Credit Card Transactions Not Appearing Individually in General Ledger

April Credit Card Statement

DATE	DESCRIPTION	AMOUNT
4/11/2023	JetBlue	$ 1,500
4/12/2023	John's Italian Restaurant	$ 175
4/13/2023	Bahamas Parasailing	$ 300
4/14/2023	Uber	$ 20
4/15/2023	Beachside Café	$ 45
4/17/2023	Marriott Bahamas	$ 1,750
4/20/2023	Online Payment	$ (3,790)

General Ledger

ACCOUNT	DATE	DESCRIPTION	AMOUNT
Expense - Meals & Entertainment	4/20/2023	Credit Card Payment	$ 520
Expense - Travel	4/20/2023	Credit Card Payment	$ 3,270

transactions out of the expense accounts and instead into shareholder loans and/or distribution accounts.

Table 2
Sally Cook Company Financial Statement

Revenue	$ 750,000
Cost of Sales	230,000
Gross Profit	520,000
Operating Expenses:	
Salaries	330,400
Insurance	43,000
Rent	35,000
Office Supplies	22,000
Dues and Memberships	4,930
Auto	20
Travel	3,250
Meals	520
Miscellaneous	7,520
Total Expenses	446,640
Operating Income	$ 73,360

Additionally, the total amounts listed in the general ledger for travel, meals and entertainment, and auto are consistent with the total amounts appearing in the financial statement, as seen in Table 2. Therefore, it would be reasonable to conclude that the expenses relating to the family vacation are not only incorporated into the financial statements of the company, but also were taken as expenses that reduced company income.

Scenario 2: The payment of a group of credit card transactions traces to an expense of the credit card payment on the general ledger.

In this scenario, Sally Cook does not record individual credit card purchase transactions in the general ledger of the business. Rather, the general ledger captures only the payments from the credit card statement.

On April 20, there was an online payment of the credit card for $3,790, which aligns with the expense records of the general ledger. The detailed transactions do not appear; therefore, the valuation professional would want to ensure that the transactions that appear to be personal are included in the expense records of the general ledger.

In the Scenario 2 example, as seen in Figure 2, the expenses totaling $3,790 are consistent with the payment made of $3,790, which agrees with the split of the credit card payments on the expense records.

As in Scenario 1, the final check is to ensure the totals of each general ledger account tie to the totals reported on the financial statement (or tax return). If the totals are consistent, the analyst could make a reasonable conclusion that the family vacation was included in company financial statements without seeing the detailed transactions in the general ledger.

This is a straightforward example, but, investigations do not often provide straightforward situations.

A few common scenarios that frustrate an investigation can include:

1. The credit card payments do not align with the detailed transactions one identified in the credit card statement.
2. The valuation professional identifies an adjusting journal entry moving expenses to a distribution or shareholder loan account at the end of the year but does not have the detail to decipher what specific expenses were adjusted.
3. The lawyers or client can obtain transactional information via credit card statements and bank statements but cannot produce a general ledger or access to the accounting database. Therefore, the effect on the accounting becomes much more difficult, if not impossible, to investigate.
4. There are multiple credit card holders; however, the lawyers or client cannot provide statements only for the individual involved in the matter.

Handling less-than-ideal situations can be rectified in several ways, whether it is through additional document requests to shore up disagreements between bank or credit card records and the financial statements provided or providing the attorney with potential deposition questions that can help lead to more definitive answers.

HELPFUL TIP #3: Personal expenses are not always incurred on credit cards. It is important to read through the general ledger to identify any checks written (or alternative types of transactions initiated) to entities that do not seem necessary for the business given its purpose and industry. Additionally, recurring cash withdrawals recorded on the general ledger can be a red flag during an investigation.

Financial Statement Investigations

The accounting system of the business also can be used to investigate the underreporting of revenue.

A common scheme to underreport revenue and, thus, drive down the profitability of the business on tax returns starts by deferring sales from late in one year into the beginning of the following year while recording expenses as normal. As a result, the business avoids dealing with the tax implications of the revenue until the following year.

Identifying the situation can come from a couple sources. First, it can be identified by asking the appropriate questions during a management interview. Second, if the valuation professional concludes that the business is not seasonal, a review of monthly financial statements can identify dips in revenue at the end of each year, coupled with heighted revenue at the beginning of the year.

IT IS IMPORTANT TO READ THROUGH THE GENERAL LEDGER TO IDENTIFY ANY CHECKS WRITTEN TO ENTITIES THAT DO NOT SEEM NECESSARY FOR THE BUSINESS.

To appropriately address the situation, it is important to identify which transactions existed during the relevant time frames (e.g., the late or early months of each year), typically focusing on data in the revenue accounts of the company's general ledger.

For example, a service business might have issued invoices in January for services provided in November or December, whereas its traditional practice is to invoice customers at the end of each month. Receiving weekly or monthly reports of revenue accounts may show a significant dip in, or even no, revenue in the months at the end of a year.

In addition to the tax scheme revenue deferral issue, the ledger could reveal suspicious adjustments to revenue. For example, a business's accounting system might track thousands of contemporaneous retail transactions, only to later write off hundreds of thousands of dollars of revenue with one entry at the end of the year.

Another area of potential concern is a cash transaction. Often, cash poses the most difficulty in a forensic investigation of the financial records. In any investigation, particularly as it pertains to cash transactions, the valuation professional must first understand the business operations, including how clients typically are billed and pay for services and who at the company is responsible for collecting payments.

Performing the analysis for a large corporation with several controls in place is quite different from an analysis of a small, privately held business. A few areas to assist in the analysis may include the following:

1. A detailed invoice ledger that provides the invoice number, customer information, billing date, and amount invoiced allows the valuation professional to review invoice numbers to identify any sequential gap (i.e., there are invoices #10029 and #10031 but no #10030). The valuation professional can inquire about the missing invoice to conclude whether it was an accounting or clerical error or paid in cash and removed from the invoice records.

2. In the case of a retail location that uses a point-of-sale ("POS") system, certain POS reports may be used as a comparison with the sales figures in the accounting records.

3. If the valuation professional has access to personal bank records, a review of deposits in addition to known compensation or distribution deposits could pose a red flag that requires further inquiry. It may be the case where the owner takes cash and deposits it directly into a personal account.

4. If a business appears to operate at or around the break-even point yet does not have to take on loans to purchase new vehicles or equipment, the source of the funds to purchase those types of assets may be obscured due to underreported income.

Final Thoughts

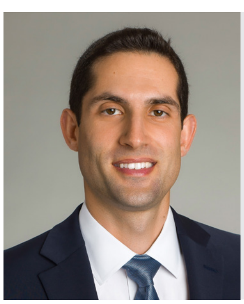
Forensic investigations into the financial records of a business can be a time-consuming endeavor for the valuation professional and costly for clients. Therefore, it is critical to address the process of the analysis at the beginning of the engagement.

Factors such as the potential time horizon to complete such an analysis, estimated costs, required documentation, and a clear indication that the analysis may not lead to any definitive conclusions will go a long way to setting realistic expectations.

To get an engagement started in the right direction, the valuation professional should request foundational documents (e.g., tax returns, financial statements, etc.) prior to any discussion with the client regarding a plan of action, budget, and time line.

Before having such a discussion, it is critical to perform a preliminary review of the documents and highlight areas of potential concern or patterns. Although the review might seem premature, the workload required to complete a thorough forensic investigation warrants the valuation professional to be well prepared.

About the Author



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