• The volume of product sold, particularly where that volume can be reliably determined or is tracked by a third party. For instance, the number of gallons of gasoline sold by a gas station.

• The reported gross profit margin in comparison to the industry norm, as well as in comparison to a reconstructed gross profit for the specific business. For instance, if the business is a restaurant, and it is showing cost of food of 50%, and the industry norm is 30%, even allowing for variations in the specific restaurant as contrasted with the industry in general, there is simply too great of a swing – there is probably unreported income.

The preceding provides a brief overview of various ways to address concerns about unreported income. The next part of this article will provide further insight into the process of reconstructing income. We will also provide our readers with a path to deconstructing what was just reconstructed – ways to challenge the determination of unreported income.

Reconstruction of income tends to be done only when we are concerned that there is serious unreported income. The use of the word "serious" in the preceding sentence was intentional. If there is concern that there is, by way of example, $5,000 or $10,000 a year of unreported income, the reality is that it is probably not worth pursuing. Typically, the cost to prove that (or to find out that you are wrong) would exceed the eventual economic benefit derived from such a determination. In addition, unless you are fortunate enough to have absolutely ironclad evidence of the unreported income that supports your specific numerical conclusion, the process of reconstructing income brings with it certain assumptions, and therefore margins of error. In most cases, $5,000 to $10,000 would simply not be enough unreported income to eliminate the concern that it falls within the reasonable margin of error – which could also mean no unreported income. Therefore, in almost all situations, for the process of determining unreported income to be cost effective and supportable, we typically need to be dealing with "serious" unreported income. For the lack of a better definition or explanation, let us assume that the word "serious" means that the magnitude of the unreported income is such that it makes a difference in the parties' standard of living – whether it be spending or savings.

Let us now deal with various approaches to determining unreported income, as well as how we might go about challenging conclusions as to the unreported income.

Use of forms 1099 – this area has some, though generally limited, application and use. First, a brief explanation – form 1099 is, in a rough sense, like a W-2, except that it is issued by payors (customers or clients) to independent, non-employee providers. Common examples would include businesses served by attorneys who provide them with a 1099 for the fees paid to the attorneys; doctors receiving same from insurance carriers for the funds paid to the doctors by those carriers; the general obligation that any business has to provide a 1099 to any person or entity that provides it services (as contrasted with goods). The use of 1099s can at times be helpful in determining unreported income by showing what is not there as contrasted with what is there. For instance, with doctors, if a doctor's reported gross revenues reasonably approximate the forms 1099 issued by the insurance carriers during the year, you have a near certainty that there is unreported income. This is because of the very practical issue of co-pays. Simply put, 1099s never include the co-pays. Thus, if reported revenues equal the 1099s, there is a guarantee that co-pays have not been reported.

A typical reaction might be to the effect that since a co-pay is typically only $10 to $20, we are really not talking about all that much money. That argument is usually fallacious. How many patient visits does this doctor have – how many times was the co-pay paid? It is not unusual for doctors to have thousands of patient visits per year. To illustrate with some simple arithmetic, a doctor with 100 patient visits per week, 5000 per year, at a co-pay of just $10 each, has the potential for $50,000 of co-pay receipts.

Challenge – frankly, there aren't too many credible challenges to a determination of unreported income based on the use of 1099s. One attack might be the determination of the number of patient visits – since that is typically the driver as to the magnitude of unreported income. For instance, were the number of patient visits determined correctly; and was there an assumption that every patient visit equals the payment of a co-pay – which perhaps is not always the case. Also, how about the employees stole the co-pays, not the doctor? Finally, as with so many retail type businesses that make payments for odds and ends out of the register, it might be that many different office expenses (by definition legitimate business expenses) were paid with the cash that was collected from the co-pays. Therefore, to whatever extent there was unreported income, there was also a comparable unreported expense. From an economic point of view,



as well as from a tax point of view, the net result is a wash.

Labor hours or labor capacity – this is an approach that often has many weaknesses, and is used typically when there are no other reasonable alternatives. The concept is that the driver of the revenue of the business is labor – typically the owner or employees or a combination of both working varying numbers of hours at varying rates. Thus, if we were able to determine that the employees (including the owner) of a business generated 10,000 work hours in a year, and if we were also able to determine that the business charged $100 per hour of service, then the gross earnings (caution here – earnings aren't necessarily the same as collections) of this business were $1,000,000. We would typically use an approach like this where the only driver of relevance, the only nexus that we can make with revenues is labor. This might apply for instance to a beauty salon, a skilled trades person (i.e. plumber, electrician, etc.), or even a professional such as a lawyer or accountant.

Challenge – as probably all of our readers have immediately surmised, and in fact probably are jumping all over it, this type of approach is fraught with many weaknesses. It is certainly not an approach of preference when any other suitable alternative exists. Areas of challenge include – how were the number of hours determined; was there adequate allowance for downtime, training and other non-billable time; how was the average hourly rate determined; was it an average versus an actual, an average versus a per person rate; since owners typically do not punch a clock, how were the number of billed owner worked hours determined; how strong is support that the calculations can translate into actual billings; and ultimately, billings do not necessarily equate to collections (something our readers of course can ruefully understand).

Gross profit – this is one of the most popular and usually most effective (when done correctly) approaches to backing into unreported income. For many businesses, what is sold is first purchased, then perhaps modified (i.e. manufactured), and then eventually sold to the customer base; or, is purchased from the manufacturer/distributor (the concept of wholesale), and resold to the general public (typically what we would call retail). Thus, one effective way to determine unreported income (actually to determine what the correct income should have been and, by comparison to the reported income, the amount that is unreported) is to determine what the gross profit margin should be as contrasted to what is being reported. If there is a serious difference, if the reported gross profit is seriously less than the calculated gross profit, there is a strong inference of unreported income.

By way of examples, if a retail clothing store marks up its goods 100% (not unusual in the classic retail arrangement), that means its gross profit is 50% (it sells for $200 what cost $100). If we were then able to determine that in a sample period it purchased $200,000 of saleable product, we know that the sales were (should have been?) $400,000. If reported revenues were only $350,000, then maybe we have $50,000 of unreported income during that time frame. Another example might be a manufacturing operation where we have been able to determine that it takes $100 of raw materials (cost to the manufacturer) to produce $300 resale value of a certain product. Thus, if during a selected period of time this manufacturer purchased $500,000 of raw materials, we know that sales should have been $1,500,000. Again, comparing that to the reported sales may give us a conclusion as to unreported income.

Challenge – as good as this approach is, it does carry with it the potential for some serious miscalculations. For instance, was the calculation of the margin of profit correct – does it allow for differing margins on different types of products; what about waste, what about clearance and unsellable goods? Was the time frame selected adequate – the shorter the time frame the riskier the approach. What about shifts in inventory – this is a little more exotic, but simply manufacturing goods (purchasing the raw material to make product) doesn't mean that it was sold. It is hardly unusual for a business to buy or manufacture product and not sell it during a specific time frame, but rather that product builds up inventory. Built-up inventory is not sold goods. Caution must be exercised in using this approach to make sure that the potential distortions have been removed.

There's more to this saga of the treasures of unreported income. Stay tuned for Part 2 of this article – to be continued in the next issue of Forensic Forum.

## FOCUS ON FUN

# Accountants & Humor
## – A Sociological Fable

1. The IRS issued a special bulletin advising that Form 945 does not exist. This was in response to significant confusion that arose by the reference in Form 8109, the Federal Tax Deposit Coupon Book, to a Form 945, causing various taxpayers to fruitlessly search for that form.

2. As reported in a national newspaper, but with the names changed so as to avoid embarrassment, a California accounting firm provided a specimen financial statement (that is a proforma type statement, with a shell indicating the type of financial statement, and x's in place of numbers) to a business owner who subsequently became a client of that accounting firm. Some months later, that client called a partner in the CPA firm to complain that the financial statement made no sense – the Company's name was missing, and instead there was just all of these x's and no numbers. The partner was perplexed since the firm had not done a financial statement for that client. The client had submitted the specimen statement to its bank – a rather large bank – in applying for a $50,000 loan. The icing on the cake is that with all of its shortcomings - the overwhelming number of x's, and that the specimen financial statement indicated that the Company's business was (and this is a quote) "company is a California corporation engaged in the promotion and sale of xxxx". - the bank gave the Company the requested loan.

3. A taxpayer, who began to exhibit signs of mental illness shortly after his marriage, was advised by his psychiatrist to obtain a divorce in order to regain his mental health. The taxpayer submitted to his wife's demands in order to obtain the divorce as quickly as possible, and subsequently deducted his legal fees, his wife's legal fees and the divorce settlement as expenses for medical care. While I would like to be able to tell our readers that this story had a happy ending, the IRS held, and it was upheld by the Court, that none of those expenses were deductible – despite that indeed all of this did restore the taxpayer's mental health.



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# Calendar

***Recent and Upcoming Speeches Include:***

### May 2006

**18 -** ICLE – Divorce Taxation (Atlantic City)

### September 2006

**12 -** CPA Club – Investigative Accounting Process in Litigation – Part II (Saddle Brook)

**16 -** Family Law Section NJ Bar & NJ Society CPAs – Current Issues in Business Valuation (Iselin)

**20 -** Institute of Management Accountants – Investigative Accounting Process in Litigation (East Hanover)

### Ongoing

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### Recent Media Situations:

- ***Book - Second edition of Investigative Accounting in Divorce*** by Kal Barson, published by John Wiley and Sons
- ***Book - Financial Issues in Divorce Practice*** by the Staff of The BARSON GROUP
- ***Book - Business Valuation: The Basics*** by the Staff of The BARSON GROUP
- ***Book - Divorce Taxation: The Basics*** by the Staff of The BARSON GROUP
- ***Article - Investigative Accounting A Force in Matrimonal Practice*** American Journal of Family Law (winter 2006)
- ***Article - Sampling the Goods*** American Journal of Family Law (fall 2006)

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# The Construction & Deconstruction of Income

In general, the testing of the income area, particularly as to concerns of unreported income, is far more difficult and far more complex than is usually the case with testing the expenses of a business. One of the reasons for same is that when faced with the prospect of unreported income, we are testing to determine what was not in, did not go through, the system. It is much more difficult and complex to test for what is not there than it is to test what is there. Thus, by its inherent nature, testing to determine the correct gross income (revenues, sales, fees) concludes with only an estimate of what additional revenues, if any, need to be reflected. When done correctly, that estimate is a very good one, within a reasonable margin of error, and reliable. This is so not only in various forms of financial litigation including divorce and shareholder/partner disputes, but is also regularly employed by the IRS in its audit function. What that often means as a practical issue is that, by way of example, if we determined that unreported income was $100,000 per year, assuming that we did not have the great second set of books that gave us exact numbers, our conclusion was an estimate. Could the real number be $90,000, could it be $110,000 – the answer would have to be yes. However, if you were to then rephrase the question to the effect of "could the real number be $50,000, could it be $150,000" – assuming that we did our jobs correctly, the answer would be no. And that is because the latter represents simply too great of a variance, too wide of a margin of error. If we did our jobs correctly, that extent of variation would be highly unlikely.

Some of the ways that we test for unreported income include:

- Comparing reported revenues to forms 1099 issued to the business from its customers. This is sometimes an effective way to address whether a doctor has unreported income. If the doctor's reported revenues tie very closely to the forms 1099 the doctor receives, there is almost a guarantee that there is unreported income – in the form of co-pays, which are never included in 1099s.

- The number of labor hours times the hourly rate. Also taking into account (where and if possible) product sales. In a sense, this is a type of capacity test.

..................continued on page 2



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