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Unreported Income

Unreported income occurs most often in cash based businesses, such as bars, restaurants and other businesses where cash is a significant source of revenue. A sign of unreported income is when a cash based business has low reported profits in comparison to its owner's lifestyle.

Typically a business's unreported income is difficult to quantify with precision because of limited or unreliable information. However, it may be possible to reasonably estimate a business's unreported income using a combination of the following methods.

Bank Statements

A business's revenues may be estimated by totaling its bank statement deposits. However, since bank statements also show transfers between accounts as deposits, transfers should be subtracted in determining a business's revenues. The weakness of the bank statement method is that business owners wishing to hide revenue often do not deposit cash into bank accounts.

Expense Ratios

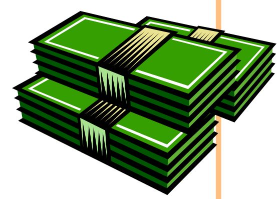
Often business owners will pay all of their expenses through the business's checking account because vendors and employees are reluctant to accept cash for payment. Business owners are also inclined to write checks to support tax deductions. Therefore most, if not all, of a business's expenses are likely to be reported. By knowing a business's expenses, a forensic accountant can estimate a business's true income and profitability based on studies of historical revenue to expense ratios for similar companies in the same industry. The expense ratio method's reliability is dependent upon the similarity between the company and the companies included in the industry studies.

Activity Based Revenue

Some business's revenues are based on the number of customers served or products produced. Therefore, a business's revenues can be determined by multiplying the number of customers served by the average revenue per customer.

Lifestyle Analysis

A forensic accountant can analyze an owner's lifestyle to determine their earnings. Two of the most common ways to perform a lifestyle analysis are to (1) analyze the owner's current lifestyle expenditures or (2) analyze the increase in an owner's wealth over a period of time.



Estimates

As you may already know, the above methods of determining a business's income and profitability are educated guesses of a business's earnings based on the information available. Therefore, these types of analysis should only be relied upon when other more reliable information is unavailable. Using a combination of the above methods to support a conclusion of the business's revenues and profitability is more likely to stand up in court.

Questions or Comments

Please call me with your comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA

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