

Forensic Accounting: Building an Evidential Case for a Business Interruption Claim

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Executive Summary

Business interruption claims require solid testimony to make the case for lost sales.

- The temporary interruption of a business can be financially damaging whether it's caused by negligence, breach of contract, terrorism or "acts of God."
- To recoup its losses from its insurer or the responsible party, a company needs solid, comprehensive expert testimony — or it risks losing its claim.
- Felman Production offered weak expert testimony — and paid the price
- Valuable lessons can be garnered from Felman's lost claim:
 - The burden of evidence with business interruption claims is with the policy holder
 - It is not enough to prove interruption in production or any other singular component of the business.
 - Claims must include solid, data-backed evidence that the interruption was a primary factor in lost sales or revenue.
- One of the best ways to ensure success with business interruption claims is to hire a forensic accounting firm to build a case using balance sheets, trends and projections.

Introduction

The temporary interruption of a business can be financially damaging whether it's caused by negligence, breach of contract, terrorism or "acts of God." To recoup its losses from its insurer or the responsible party, a company needs solid, comprehensive expert testimony — or it risks losing its claim.

Recently, a West Virginia district court made this lesson clear. In *Felman Production, Inc. v. Industrial Risk Insurers*, one business offered weak expert testimony — and paid the price.

The Lesson from Felman

WHERE'S THE PROOF?

Felman Production produced an alloy used in steel production and sold it through an exclusive contract with a commodities broker. In March 2008, the company bought a business interruption insurance policy from Industrial Risk Insurers. The policy covered up to \$25 million worth of property damage and business interruption losses resulting from, among other things, equipment failure.

Furnace No. 2 at Felman's West Virginia plant experienced a failure in April 2008 and became inoperable before it could produce salable alloy. Felman filed a claim for losses sustained as a result of the furnace's failure during a period of April 2008 to January 2009. Unhappy with the progress of its claim, the company filed a breach of contract lawsuit against its insurer in May 2009. Industrial Risk filed a motion for partial summary judgment, arguing that Felman had offered no proof of "actual loss," as required under the policy.

NO SALES, NO LOSS

The district court agreed. It began its analysis by noting that, given Felman's proven sales record and a broker who operated internationally, "one would expect [Felman] to easily demonstrate to a reasonable likelihood that it would have sold at least some of

Furnace No. 2's expected production during the loss period." After examining the evidence, the court determined that Felman had not offered sufficient evidence to survive the insurer's motion.

To calculate losses, Felman's expert looked at the furnace's production capacity and the market price of the alloy during the loss period. However, the expert didn't testify about whether the company would have sold any — let alone all — of the expected production if the plant hadn't failed. As the court reasoned, Felman failed to identify existing or potential sales, or produce evidence showing it could sell existing inventory.

Felman didn't have any sales contracts for Furnace No. 2 before it failed. Its exclusive broker confirmed that the company's capacity during 2008 was sufficient to meet demand for actual purchases and that lost sales were driven by price competition, not lost production. Felman's primary customers also confirmed that the company had enough product to meet their requirements and that the loss of Furnace No. 2 didn't affect their long-term agreements. Felman provided no evidence that anyone would have bought more alloy, even if the company had produced it.

LACK OF CREDIBLE ALTERNATIVES

Unsold inventory has undercut manufacturers' loss claims in many courts. In Felman, the court stated that the company failed to produce evidence that it could sell the alloy it did produce.

Documents showed Felman's recurring inability to sell what it was producing — before and after its furnace failed. The company claimed it couldn't sell its inventory because it had to maintain a "buffer stock," yet the documents indicated that it was trying — and failing — to sell this stock.

LOST SALES: Quantitative & qualitative approaches

When developing an initial estimate of lost sales for purposes of a business interruption claim, CPAs generally start with quantitative methods. They then apply qualitative analyses to adjust the initial estimate.

The quantitative aspect considers the business' sales history, including trends, growth, product and market shifts, seasonal and other periodic variations, random fluctuations, nonrecurring events, and external variables such as industry trends and competitors' sales.

The qualitative analysis, on the other hand, weighs internal factors such as the business's products and services, competitive advantages and customer profiles. CPAs will also adjust their approaches to calculate lost sales for startups or companies with unpredictable income streams.

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The court also dismissed Felman's argument that it could provide alternative means of proving its actual loss. Even if some other proof could be sufficient to show actual loss, the court found that Felman had failed to provide any such credible alternative means of proof.

MAKE A STRONGER CASE

In Felman, the company would have had a stronger case if it had provided evidence of lost sales as well as lost production. When representing a client in a business interruption case, be sure to retain experts capable of providing solid and comprehensive testimony.

The Lessons of Felman's Lost Claim

Valuable lessons can be garnered from Felman's lost claim. The burden of evidence with business interruption claims is with the policy holder, and it is not enough to prove interruption in production or any other singular component of the business.

Claims must include solid, data-backed evidence that the interruption was a primary factor in lost sales or revenue.

In Felman's case, the business clearly demonstrated the loss of their furnace. The physical evidence could not be denied: Felman produced less than it would have if the furnace were operational. However, the statistics produced by the company did not provide overwhelming evidence that the company could have or would have sold additional stock, making it hard to prove that the company lost revenue.

Employ a Winning Strategy

One of the best ways to ensure success with business interruption claims is to hire a forensic accounting firm.

Just as a forensic expert in a criminal case can extract specific information from DNA and crime scene pictures, a CPA trained in forensic accounting can build a case using balance sheets, trends and projections.

CPA firms that are familiar with this type of work bring a specific group of skills to the table, including:

- A thorough understanding of business interruption insurance policies;
- Experience with BIC cases;
- Experience dealing with insurance companies, legal counsel and corporations; and
- The ability to create comprehensive claim documents that pass scrutiny in a court.

WHY WORK WITH A FORENSIC ACCOUNTING FIRM?

One of the key elements in a forensic reconstruction of any type is a critical, third-party view. Executives and in-house accounting staff may understand the balance sheets and details of the business. However, it is not likely they have experience with insurance claims and court procedures. It is also likely someone so close to the issue will miss critical components of a claim.

An outside forensic accounting expert takes a comprehensive approach to the claim. They are not limited by ties to certain divisions or processes and can see the entire problem. Steps a CPA takes in compiling evidence for business interruption claims include:

- Identifying sales, accounts or customers lost to the interruption event;
- Identifying potential business income that was tied to the event or to physical damage;
- Building a case for the likelihood revenue would have been realized had the event not occurred;
- Analyzing future and ongoing implications of the event on sales; and
- Documenting abnormal business expenses associated with the event.

Forensic accounting specialists work with in-house resources and the insurance company to resolve business interruption claims in a manner that benefits the business. If resolution cannot be had with the insurance company, as in the Felman case, the expert's claim usually has a better chance at holding up in court.

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About Freed Maxick and Our Forensic Accounting Capabilities

Freed Maxick advises public and private companies in Western New York on ways to enhance profitability, save taxes, improve accountability and preserve wealth. We specialize in helping our clients discover and achieve their bottom-line potential and we provide sound business advice based upon our vast experience in a broad array of industry groups.

Our premier group of forensic accountants provides the winning edge in investigative, civil, and criminal matters areas including:

- Business interruption claims
- Forensic audits
- Damage calculations
- Due diligence and compliance audits
- Investigation of fraud, money laundering, or embezzlement
- Analysis of accounting issues in complex commercial litigation
- Bankruptcy or business proposal analysis
- Reconstruction of accounting records
- Preparation or analysis of insurance claims
- Participation in settlement negotiations
- Identification of departures from customary business practices or professional standards
- Expert witness testimony for demonstration / communication purposes.

For more information on our business interruption and other forensic accounting services, call us at 716.847.2651 or visit FREEDMAXICK.COM.

