Return to Table of Contents

Risk Managers' Forum

The business behind business interruption

A forensic accountant's approach to BI claims

By Scott E. Bushnell, CPA, CFF

One of the most challenging aspects of commercial property and casualty insurance is preparing claims when disaster strikes. Most P-C policies contain straightforward property damage coverage language. Generally, property damage claims are simple in nature, and risk managers often handle many of these claims in-house with some support from their accounting department. However, business interruption (BI) claims often pose a daunting task to risk managers and accounting personnel alike.

Preparing business interruption claims takes thoughtful planning and insightful analysis, clearly communicated to all of the parties involved in the claims process. One of the most important factors is the breadth and depth of analyzing relevant financial information related to interrupted business operations. Although this may seem like an intuitive step, there is often a gap between the internally prepared financial information and the analysis to determine lost profits. Application of due diligence results in a smooth claim process, quicker payment from the insurer and a fair and equitable recovery.

Role of the forensic accountant

Policyholders often hire forensic accountants to prepare BI claims and, in many cases, this makes good business sense. Their work requires a unique mixture of analytics, statistics and accounting. Analysis of this type of economic damage also requires an application of due diligence. Most business professionals recognize due diligence as it applies to business acquisition or combination of companies. An idea of due diligence that likely comes to mind is a detailed verification of accounting information. However, in the context of BI claims, due diligence considers verification of the affected business's historical information as well as analysis of prospective operations and challenging the veracity of information.

Preparing BI claims requires calculating damages on a perspective beyond the empirical analysis of accounting data. This requires understanding the market environment of the industry, business drivers for sales, inputs and outputs of raw materials and finished goods, as well as operational data such as units of production or plant operating rates. Due diligence brings into focus the underlying components of commercial damages and lends veracity to a policyholder's claim.

Business interruption coverage

Business interruption insurance is a very common coverage designed to protect a company's income stream. Most commercial property and casualty policies include some form of this coverage. Although specific policy language will vary from policy to policy, BI generally covers the loss of profits due to damage of a physical asset by a covered cause resulting in an interruption of the operations of a business.

A policyholder should conduct a thorough review of its insurance policy as the first step in any claim situation. Furthermore, many policyholders will consult legal counsel for coverage advice and forensic accountants for quantifying losses during the claim process. Applying due diligence at this stage of the process will reveal deductibles, exclusions and limitations of coverage in relation to the loss, which are necessary elements of any BI claim.

Had no loss occurred

The standard applied to determining lost profits incurred due to an insured event is: expected earnings had no loss occurred, minus the actual earnings incurred during the period of indemnity. Generally, analysis of these types of claims applies the "but for" theory of damages. This assumes the business would have earned profits (or reduced losses) but for the incident interrupting normal operation of the affected business.

Furthermore, a complete cessation of operations due to the event is not necessary as a policyholder has an obligation to take reasonable means to mitigate its damages (including partial production, if possible).

Significant analysis is performed to understand the operational and financial aspects of the business to prepare a reasonable forecast of the results of operations had no loss occurred. This analysis includes lost sales due to the event, fixed/variable costs and the ensuing BI losses.

Determining "but for"

The first step in BI analysis is to develop a strong foundation in the operations business. This will often include site visits, not only to affected locations, but also to unaffected locations as well. Risk managers should conduct interviews with employees and managers at the affected location and with accounting department personnel. Beyond getting a good perspective of the loss incident and plant operations, they can address the following questions:

• How are operations planned or scheduled at the plant?

• Is this schedule based on customer (internal or external) demand or some other factor (such as maintaining inventory)?

• Are plant budgets available? If so, how are they used in evaluating current or future performance?

• Do the budgets tend to be accurate when compared to actual or are they inaccurate?

• How are costs of sales/manufacturing identified, collected and reported in the income statement of the company?

• Are there any unusual characteristics to the costs individually or in a pool of costs?

• What did the marketplace look like for products? And were there any upcoming significant orders or sales that might have had a greater impact to normal operations?

These are just a few of the questions that will begin to open up fruitful conversation with local personnel.

The next step in the process is collecting the financial information necessary for preparing the claim. As one can imagine, the list of information that may be necessary will differ from company to company and from claim to claim. Operational income statements and balance sheets as well as supporting details provide the basic components for preparing the BI claim. Additionally, the adjuster will likely request sales ledgers, forecasts, and analyses. Cost and expense information will be useful in the BI analysis as well.

Beyond the financial information listed above, several different categories of documents may be requested for preparing a BI claim. These would include:

• Copies of the past three- to five-year financial statements, both audited and operational

• Sales ledgers for specific affected products or plants/stores

• Fixed asset ledgers and schedules for equipment maintenance or plant turnarounds

• Details of expenses including depreciation, SG&A (selling, general, and administrative), and out-of-pocket expenses incurred due to the incident

• Industry data and economic analysis performed independently of the policyholder

This information will serve as the foundation of the BI claim, but it is important to keep in mind that this list is not all-inclusive of the population of documents needed in any particular case to prepare a claim.

Connecting the dots from event to lost sales

A connection must be made from the initiating event to damaged covered property to the interruption of operations and lost sales. At its base level, lost sales drive lost profits, even if there is only a partial cessation of operations. However, there is still a causational link from the event to a reduction in operations. A substantial amount of analysis will be directed to lost sales.

Determination of lost sales begins with an analysis of anticipated sales for the period of indemnity, the time from the date of loss to restoration of operations. Several factors should be considered to forecast sales during the interruption such as historical performance of the business, economic environment of the industry, and anticipated movement of the industry as a whole. Additionally, considerations such as strategic business initiatives, sales campaigns, and new product development are other factors to consider as analysis of damages progresses.

There are generally no hard-and-fast rules about how many months of historical data should be reviewed to forecast sales in BI cases. However, there should be enough information analyzed to determine trends, cyclicality and seasonality of sales. This analysis is generally performed on a monthly basis using a company's preceding three- to five-years monthly sales figures. Similar analysis should be considered for units of production and costs of sales as well. This form of analysis may lead to other areas for review such as price volume or sales margin analysis.

Putting the pieces together

This is where due diligence comes to the forefront of preparing the BI claim. After interviews are conducted and basic analysis is performed, additional investigation into historical market and industry trends is performed. The chief aim of this analysis is to test the reasonableness of forecasted sales, gross margin, and profits and their interaction with BI damages.

Economic indicators are available for every standard industry code in the SIC system. As the nation has seen over the last three years, many U.S. companies have had year-over-year decreases in sales due to the slowdown in the economy. Relevant market and economic indicators should be considered and applied when forecasting sales. For example, in the U.S. steel industry over time, steel mills have generally become less profitable due to competition from overseas and reduction of margins due to manufacturing costs. However, one segment of the steel industry that has maintained profitability, and in some cases, increased profitability, is the mini-mill. This is an excellent example of economies of scale. Investing time into this analysis can pay off handsomely when the claim is settled.

Due diligence involves testing out what part of lost sales can be explained solely as an effect of the incident. Not all losses may be explained in the mathematical difference between last year's sales and this year's sales. Additionally, changes in the market conditions may affect costs and expenses. The rising and falling price of oil will directly influence shipping costs. This increase could be seen in freight costs on raw materials or expenses for shipping out finished goods. Year-over-year increases or decreases in costs and expenses need to be investigated enough to provide a realistic picture of what forecasted profits would likely be had no loss occurred.

The author

Scott E. Bushnell, CPA, CFF, is a Certified Public Accountant practicing in forensic accounting for more than 16 years. He assists corporate clients recovering from catastrophic events through claim investigation and quantification of damages. He has testified as an economic damages (business interruption) expert in federal and state court and has prepared numerous contingent BI claims for policyholders. Additionally, he routinely prepares BI, extra expense and property damage claims for corporate clients. He regularly lectures and teaches CPAs and other professionals through continuing education programs. For risk management education, attend the Certified Risk Managers (CRM) program: www.TheNationalAlliance.com.

Return to Table of Contents