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A Case History

Submitted by Sterling & Tucker, Inc., FASNA Member Firm in Honolulu, Hawaii

Our firm was retained by an insurance adjuster to review the claim of an automobile dealership. The dealership experienced a business interruption when a fire destroyed the parts and service departments of the building, and smoke and water resulting from the fire damaged the sales department. While the sales department was only closed for three business days, the parts and service departments, suffering an almost complete loss of inventory and tools and equipment, were down entirely for approximately one week. Determination of an exact restoration period was complicated because the insured continued operating in the damaged location by way of trailers and tents until construction of a new facility was completed several weeks later. The goal of our calculations was to determine when and if the impact of the fire on gross profit was noticeable.

The insured rallied its employees and set up operations in the parking lot, and actually did one heck of a job in recovering from the loss. Therein lays the first predicament encountered by the claimant. Did the insured do too good a job in recovering from the loss? The second quandary the insured ran into revolved around the co-insurance clause contained in the insurance policy and a resulting deficiency in coverage. Was the claimant properly informed of the co-insurance requirement when the policy was purchased?

The insured's claim consisted of lost gross profit of $130,000 company-wide over a period of approximately one month. In addition, the insured claimed extra expenses for temporary accommodations erected in an attempt to minimize lost revenues. In order to verify lost gross profit, we examined the monthly financial statements for the three years

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CASEWORK EXPERIENCE

FASNA member casework includes, but is not limited to, cases involving:

- Inventory/property loss
- Employee dishonesty
- Business income loss
- Personal injury or wrongful death claims
- Truth in lending/truth in leasing
- Post judgement matters/ calculations
- Loss of income/earnings
- Divorce and fidelity claims
- Business valuation
- Expert testimony
- Fraud

INDUSTRY EXPERIENCE

FASNA member experience includes, but is not limited to cases involving:

- Auto dealerships and transportation
- Colleges and universities
- Construction, contracting, and engineering
- Financial/money management, trust, and estate
- Healthcare
- State and Indian tribal government
- Insurance claims
- Manufacturing
- Real estate
- Restaurant and hotel industries
- Retailing/wholesale

preceding the loss. This analysis revealed a consistent increase in revenues and related costs of goods sold. The trend percentage was reasonably applied in an effort to project gross profits for the restoration period. Consequently, a comparison of actual activity to this projection seemed to indicate that no loss of gross profits had actually occurred. In fact actual gross profits exceeded our projections. And while we were not engaged to verify the extra expense portion of the claim, it would appear that the insured incurred said expenses as were necessary to reduce or eliminate the business income loss that otherwise would have been incurred.

A thorough calculation of the required coverage should be done before a policy is purchased and should be revisited on policy anniversary dates to ensure adequate coverage is in place at all times.

We extended our calculations further to consider only the loss experienced by the parts and service department. Analysis of actual activity compared to our projections for the parts and service department did in fact reveal a loss of gross profits amounting to $43,000. So while the sales department recovered fully from the fire by setting up temporary operations and even achieved gross profits significant enough to cover the loss incurred by the parts and service department, it stands to reason that a loss still occurred.

As mentioned previously, a co-insurance clause existed in this particular insurance policy. The insured was required to be 90% co-insured, meaning their limit of insurance needed to fall below 90% of the net income plus operating expenses that would have occurred if but for the fire during the 12-month policy period. A calculation of the required coverage indicated the claimant was underinsured by $525,000 and could only recover 30% of the loss incurred by the parts and service department. Thus, of the original claimed loss of $130,000, only $43,000 in lost gross profits was deemed to be actually lost and further still only $13,000 was actually recoverable by the insured. Presumably, the insured was also able to recover a portion, if not all, of the extra expense loss.

Two important points can be gleaned from this particular case. It is vital that the insured have a thorough understanding of the insurance policy and its requirements. In this situation, the insured fell far below the limit of coverage needed for their level of business activity. A thorough calculation of the required coverage should be done before a policy is purchased and should be revisited on policy anniversary dates to ensure adequate coverage is in place at all times. Secondly, it makes good business sense for a claimant to forge ahead in the face of a business interruption loss. The insured could have complacently stood by as business suffered waiting for the insurance proceeds. The policy in this case stated that "if you intend to continue your business, you must resume all or part of your 'operations' as quickly as possible." The insured did just that. One might envision the goodwill created from witnessing the dedication a company has toward its customers; the drive of a company to continue servicing customers despite the obstacles presented by fire damage.

Using the Clues to Solve a Business Mystery

By Mike Pivoz, CPA, JD, Mellen, Smith & Pivoz PLC, FASNA Member

"It was a dark and stormy night. The patron thought he heard a gunshot, but he couldn't be sure; at least, not until the body came crashing through the door."

Unlike in the world of fiction, not all mysteries begin this dramatically. Sometimes they start when a business owner gets a call from his banker telling him that his account is overdrawn or when he notices his bookkeeper suddenly driving to work in an expensive new sports car.

The mystery novel is designed to entertain us, while the business mystery threatens to bankrupt us. However, there are some similarities between the two. The mystery writer uses his skilled pen to lead us through a series of facts and clues, sometimes using deception to keep us off the trail of the killer, but in the end, as we review the information provided, the conclusion becomes obvious. Similarly, when employees try to perpetrate fraud, there are facts, clues and other information that should raise our suspicions.

The necessary information to solve these mysteries lies in an appropriately designed accounting/bookkeeping system. Cash receipts and revenue don't just disappear; there will be a trail left in the books and records that show just how cash left a bank account. Accounts receivable statements won't agree with what your customer feels is owed. Expense accounts will be unusually large. Inventory write-downs will be of a different magnitude than what has occurred in the past. This information will allow business owners to stop employee fraud, but they have to look for the clues.

Unfortunately, many business owners overlook these clues. Some are too busy running their business to have the time to personally review records. Others have no background in finance and accounting and rely on others to review records for them. In many instances, these business owners don't hire outside accountants to do anything more than prepare a year-end tax return.

More vigilance is needed now than ever before as more and more businesses become the victims of fraud. Having a forensic accountant review your records at least once a year may cost a bit more than what a business owner would like, but potential benefits could outweigh the costs. First, forensic accountants may find instances of fraud on a more timely basis so the perpetrator can be caught and the business can be made whole. In addition, they could stop fraudulent activity before it happens, deterring employees from committing fraud when they become aware that the business is using a forensic accountant.

Although forensic accountants are strong deterrents to fraudulent activity, the first line of defense against fraud is still the business owner, who needs to establish procedures that make fraud more difficult. In accounting lingo, this is referred to as internal control, and one of the basic concepts of internal control is the segregation of duties. When duties are segregated, there must be a conspiracy among employees to perpetrate fraud. The more people involved, the less likely a conspiracy is to succeed, and this is why accountants discourage systems where only one person opens the mail, prepares bank deposits, takes deposits to the bank, records activity in accounting records or prepares the bank reconciliation. It would be a recipe for employee theft.

However, accountants understand that in small businesses there may not be enough employees to properly segregate these duties. In that case, the business owner has to take upon himself a supervisory role, reviewing activity on a regular basis. In order to have a deterrent effect, this review must be obvious to employees.

Business owners must also use their eyes and ears to monitor what goes on in their business. Pay attention to situations where an employee seems to be living beyond their means. Listen to employees as they complain about heavy financial burdens with which they suddenly find themselves confronted. Maintain enough regular contact with employees that they would find it difficult to hide a substance abuse problem. Have a sympathetic ear for employees who are going through marital difficulties.

These are all situations where an employee's perceived need for extra funds may outweigh their normal moral outrage at stealing. Many rationalize it as "borrowing," but this would probably be a "loan" that would never be repaid. If the business owner becomes suspicious of an employee, he should contact a forensic accountant to do a clandestine analysis.

A skilled mystery writer weaves a tale for us that keeps readers glued to their seats, anticipating the end of the story, using the clues provided to solve the mystery before the writer reveals the resolution. An employee who steals from a business also weaves a tale, leaving clues behind. A business owner must be attuned to the information laid out before him and sometimes call upon forensic accountants to help him unravel this information. If not, fraud might not be discovered until it is too late.

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