MDD

A Claims Management Perspective: Forensic Accountant (BI)

Making Numbers Make Sense

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FORENSIC ACCOUNTANTS

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Practice Areas

- Loss of Profits
- Extra Expense
- Contingent Business Interruption
- Product Liability & Product Recall
- Litigation Support
- Property Damage & Stock Claims

Industries

- Food & Beverage
- Automotive
- Hotels & Resorts
- Retailers & Wholesalers
- Manufacturing
- Petrochemical
- Power generation

Why a Forensic Accountant?

- Losses of large monetary value
- Complex losses
  - Complex industries
  - Complex loss situations
  - Complex accounting issues raised in claim
  - Large amounts of supporting documentation
  - Start-up companies
  - Lack of or inconsistent trading history
- Losses that might lead to litigation – need for Expert Witness
- Adjuster capacity constraint

Large Loss Team Based Approach

- **Loss Adjuster**
  Project Manager
  Communicator
  - **Forensic Accountant**
    BI or other quantum valuation
  - **Engineering Expert**
    Cause of machinery breakdown
  - **Forensic Scientist**
    Cause and origin investigation
  - **Lawyer**
    Coverage and recovery issues
  - **Other Experts**
    Specific to claim scenario

How MDD Typically Operate

1. New Instructions received by Partners or Managers
2. Agree / discuss scope of work
3. Work planning, resource allocation
4. Fact finding via meetings and research
5. Formal / informal interim reporting as necessary
6. Re-evaluation of Scope of works if required
7. Meeting with insured, obtain data and information
8. Evaluation of loss, methodologies, settlement options
9. Meet with Insured and client, settlement negotiations
10. Final reporting

Business Interruption Loss

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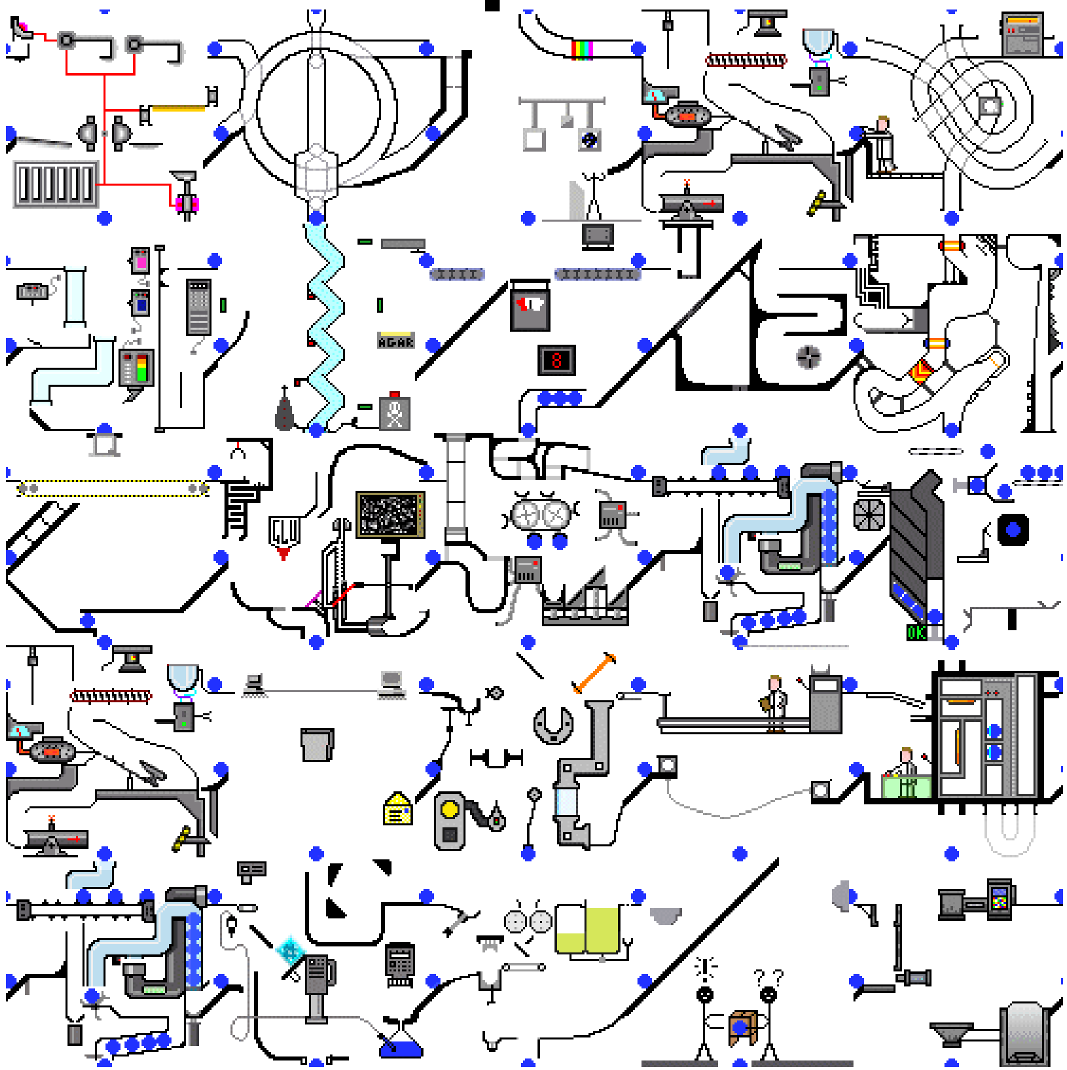
Competition

Supplier



Customer

Legal Framework / Trade Regulations

Other Factors:

Political
Economic
Social
Technological

BI Coverage: Key Components

1. Calculation of Standard Turnover (or projected turnover)
2. Deduction of Actual Turnover to arrive at Reduction in Turnover
3. Application of a Rate of Gross Profit to arrive at Loss of Gross Profit due to Reduction in Turnover
4. Deduct any other Savings that have arisen as a result of the damage;
5. Add Increase in Cost of Working ("ICW") that meet the tests defined;
6. Application of the Average clause to reduce the indemnity if the sum insured is inadequate in comparison with the sum at risk; and
7. Add any Additional Increase in Cost of Working ("AICW") that meet the tests defined.

Loss of Turnover

Standard Turnover Typical Wording:

"The Turnover during the period corresponding with the Indemnity Period in the twelve months immediately before the date of the Damage appropriately adjusted where the Indemnity Period exceeds twelve months…"

Will usually be included with an "other circumstances" or "trends" clause.

"to which such adjustments shall be made as may be necessary to provide for the trend of the Business and for variations in or special circumstances affecting the Business either before or after the Damage or which would have affected the Business had the Damage not occurred, so that the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which but for the Damage would have been obtained during the relative period after the Damage."

"Other Circumstances" Clause

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WE CAN CONSIDER:

- Budgets Adjusted for Normal Variations to Budgets
- Sales By Product / Client
- Forecasts / Rolling Forecasts
- Market Share, Industry Statistics
- Strategic Plans
- Order Book Analysis
- Sales Projection via Regression Analysis, Market Analysis

Rate of Gross Profit

<u>Policy:</u>

Gross Profit is "*the amount by which the sum of the Turnover and the amount of the Closing Stock shall exceed the sum of the amount of the Opening Stock and the amount of the Uninsured Working Expenses*"

WHAT DOES THIS MEAN?

Rate of Gross Profit is "*the Rate of Gross Profit earned on the Turnover during the financial year immediately before the date of the Damage*".

The Special Circumstances Clause also applies to the Rate of Gross Profit.

Uninsured Working Expenses OR Specified Working Expenses

Rate of Gross Profit

WE CAN CONSIDER:

- Monthly Detailed Management Accounts
- Market Pricing Data
- Interrogation of specific cost centres
- Commission Based Contracts / Management Fees
- Material Balance Reports
- Supply Contracts

Savings in Fixed Costs

Policy:

"any sum saved during the Indemnity Period in respect of such of the charges and expenses of the Business payable out of Gross Profit as may cease or be reduced in consequence of the Damage"

Factors to consider when calculating Savings in Fixed Costs

- Any costs that are not deducted in arriving at the Rate of Gross Profit
- Reduction must be due to the damage and not due to other factors
- What other factors could cause the savings?

Why Deduct Savings?

Some fixed costs are deducted in arriving at gross profit in accounts

- Due to mechanics of GP calculation, an Insured will receive payment to cover fixed expenses as if they continued at their ‘normal’ level and a normal net profit margin
- However, fixed expenses may reduce, depending on the circumstances of the loss (particularly in periods of longer downtime and total shutdown scenarios)

Thus: Need to Calculate Savings

Fixed Costs

WE CAN CONSIDER:

- Depreciation
- Maintenance
- Headcount / Wages Analysis
- Duplication between PD and BI
- Inflation (longer interruption period)
- “Stepped” Fixed Costs

Increase in Cost of Working

Typical Policy Wording:

"The additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover which but for that expenditure would have taken place during the Indemnity Period in consequence of the Damage, but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided."

Criteria:

- Additional – i.e. above normal levels
- Reasonable and Necessary
- Sole Purpose of Avoiding or Diminishing the Reduction in Turnover
- Benefit During the Indemnity Period
- Not Exceeding the Economic Limit

ICW - Examples

Importance of Average

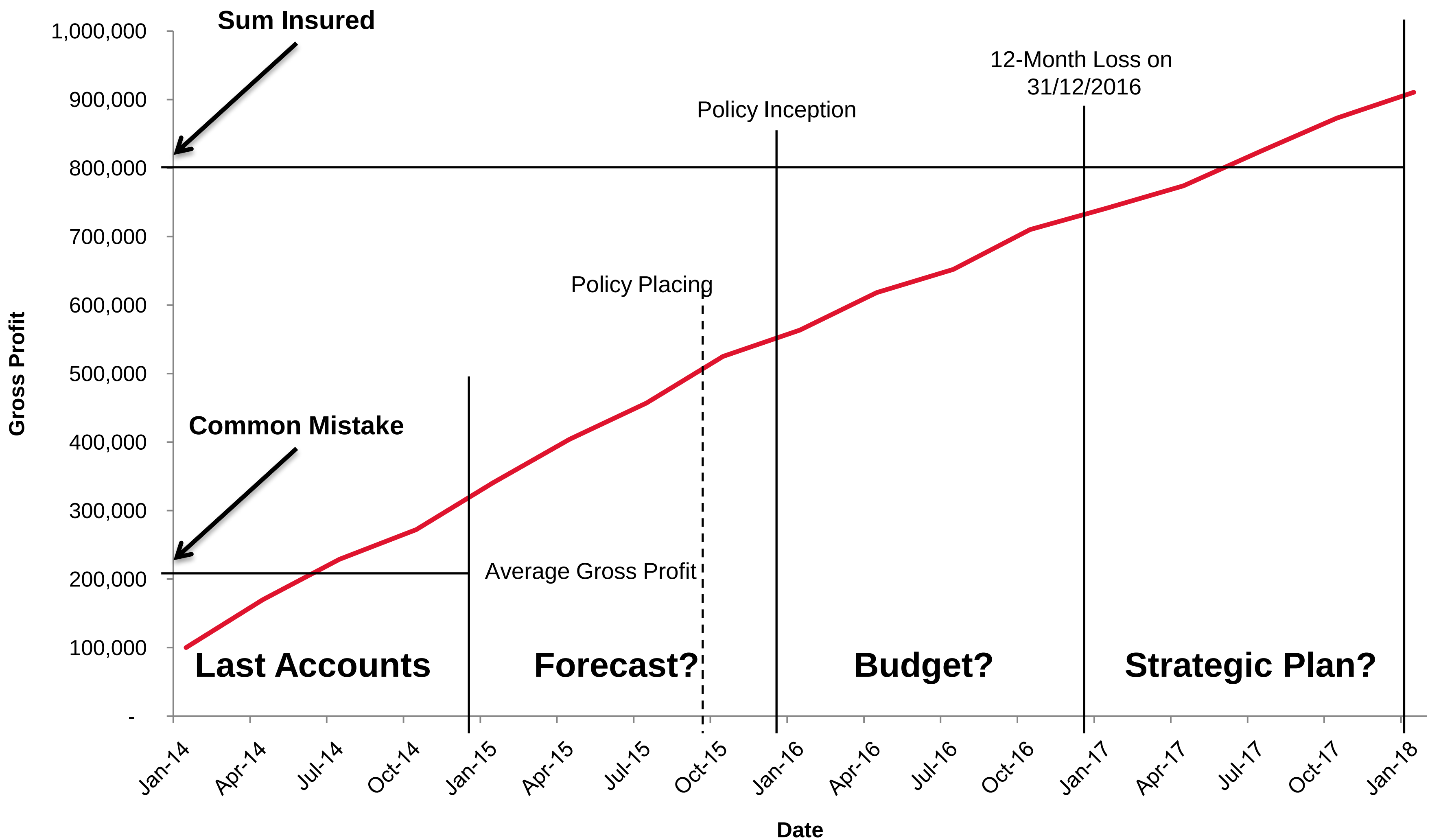
Policy:

"if the Sum Insured by this item be less than the sum produced by applying the Rate of Gross Profit to the Annual Turnover (or to a proportionately increased multiple thereof where the Maximum Indemnity Period exceeds twelve months) the amount payable shall be proportionately reduced."

Factors to consider when calculating Average:

- Must be consistent in assumptions adopted between loss measurement and assessment of adequacy of sum insured
- Adopt same Standard Turnover and Rate of Gross Profit

Average Clause Issues



Setting the Sum Insured

- Forward looking – not based on prior year accounts
- Consider potential maximum indemnity period loss arising at the end of the policy.
- Ensure variable costs excluded (wasted premium).
- Exclude fixed costs only if it is understood that these will not be paid in the event of a loss.
- If uncertain – why not increase sum insured upwards with a return of premium clause?

Other Common BI Issues

- Deductible Application
- Make-Up
- Production vs. Sales
- Accumulated Stocks
- Duplication BI/PD
- Uninsured standing charges
- Depreciation as a Saving
- Maintenance Brought Forward or Saved
- Project “Float” on DSU Claim
- ICW incurred during waiting period

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