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FVS Eye on Fraud

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Consideration of fraud in business interruption claims

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Although business interruption (BI) insurance typically covers losses resulting from disaster-related damage and other perils, events, hazards, incidents or losses, during these difficult times many insurance carriers are denying COVID-19-related claims. Some businesses have filed lawsuits against their carriers, and state legislatures are fighting to mandate certain coverage. To date, several states have introduced legislation that would require insurance companies to cover claims for business interruptions due to COVID-19. These litigated and legislated matters are likely to remain in the courts well beyond the publication date of this writing.

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Most business owners regard insurance coverage as a cost of doing business, an expense incurred in the hope that it is never used. On the other hand, risk managers consider a well-structured insurance portfolio to be a proactive approach to doing business in an uncertain world, thereby allowing the company to embrace risk to expand operations and grow the enterprise. Because insurers are often viewed as having deep pockets, business owners may consider filing an insurance claim as a way to recoup the premiums paid over the years or as a return on their investment. The problem with this view is that business insurance is not an investment with a perceived payback but rather an ongoing service.

When an insured event occurs and the business sustains a loss that causes the business to cease operations for a period, the owner or management looks to the insurance carrier to make them whole for the amount of loss to which they are entitled under the policy. Nevertheless, business owners often look at insured losses as an opportunity to replenish their bank account, pay for long-needed improvements or provide themselves with otherwise unaffordable benefits. Filing an insurance claim for lost business income that is more than actual losses is insurance fraud. This is an unnecessary expense to the insurer, which drives up the cost of insurance and can result in higher premiums being charged to all insureds. Policyholders who attempt to file inflated BI claims risk having their coverage canceled, criminal prosecution, and other repercussions.

Background on BI[1]

Business interruption insurance typically covers the insured policyholder for losses resulting from disaster-related damage such as fires, theft or flooding that affects the business's ability to continue operating in the manner it had before the event. The BI insurance policy is derived from the standard fire policy and sets forth the definitions, terms, and coverages under the policy, as well as items that are excluded from coverage. Most importantly, the policy lays out the procedures for filing a claim, including the roles of the parties to the policy, and their respective responsibilities and limitations:

- The **insured** (business owner or other party with an insurable interest in the business, such as a significant investor or business partner) will retain a **public adjuster** to quantify the amount of business income that was lost as a result of the insurable event that affected the property, or otherwise prevented the business from continuing operations as it had prior to the event. Under the terms of the policy, there is normally a requirement for the insured to **mitigate** the loss being suffered by taking reasonable steps to minimize losses incurred. In circumstances where the insurer and insured party hold vastly different opinions about the extent and timing of loss mitigation strategies, it is more likely that the insurer will dispute the amount of the loss claimed. This risk can be lessened by clear communication between the insurer and insured party during the indemnity period.
- The **public adjuster** will prepare, or cause to have prepared, a claim that details, with a high level of specificity and supported by business records, the results of operations of the business prior and after the event and a calculation of the event's impact on the business's operating results. The adjuster will retain an appraiser (such as a forensic accountant) to prepare the related loss claim due to the temporary closure or diminution of the business, for submission to the insurance carrier.
- The **insurer** will review the claim for the business interruption loss, pursuant to the policy language and claims management guidelines. Frequently, the insurer will use the services of a general adjuster or appraiser to prepare a rebuttal calculation of the loss in accordance with the insurer's interpretation of the policy coverages, in response to the calculation presented by the insured.

The calculations of the parties' BI claims and the underlying data will be examined and debated. The proceedings are administered, and decided, by a neutral appraiser, called an umpire. In the event the dispute between the insured and the insurer remains unresolved, counsel will be retained, and the matter will go to state court for disposition. Depending on the jurisdiction, the same forensic accountant may provide testimony in the matter. Forensic accountants may also serve as consulting/expert witnesses in coverage and subrogation litigation subsequent to the appraisal proceeding.

[1] Tiffany Couch, "Detecting and preventing fraudulent business interruption claims," NU Property Casualty360, June 22, 2018, https://www.propertycasualty360.com/2018/06/22/detecting-and-preventing-fraudulent-business-inter/?slreturn=20200922140756 (accessed April 23, 2021); "Business Interruption Insurance: Business interruption lawsuit seek to recover lost income for businesses denied business interruption insurance coverage related to COVID-19 closures," Beasley Allen Law Firm, https://www.beasleyallen.com/matter/business-interruption-insurance/ (accessed April 23, 2021).

It should be noted that preparing a BI claim does not always result in an insurance appraisal or arbitration proceeding, and even fewer are the subject of insurance coverage litigation. Because claim preparation by itself does not anticipate a dispute or litigated matter, such an engagement should be performed in accordance with the AICPA Statement on Standards for Consulting Standards (SSCS) No. 1. Only when the circumstances progress to the point that an appraisal or other dispute proceeding is anticipated will the AICPA Statement on Standards for Forensic Services (SSFS) No. 1 apply. Based on the roles described, being retained by the insurer has the greater likelihood of proceeding into a dispute situation, and in that circumstance the forensic accountant should consider being retained through counsel.

Types of losses and related coverages and exclusions

Companies purchase business interruption insurance to manage their risk of losing income, and to cover ordinarily recurring bills and payroll if a disaster forces the business to temporarily close.

Insurance claims for property damage itself are typically covered under separate commercial property insurance. However, physical damage is an important element of business interruption claims because physical damage to the premises is a predicate requirement for an insurable loss under BI coverage. An interruption of a business that is not the result of physical damage, such as interruption resulting from a worker strike, would not be a covered event. Typically, to be a covered claim, the interruption must be associated with physical damage, such as

- fire, smoke and related water damage;
- hail damage to building or vehicles;
- hurricane, tornado or wind damage; or
- interior plumbing water leakage.

Business interruption insurance can cover the following:

- Profits that would have been earned, based on prior periods' financial statements
- Fixed costs like operating expenses, based on historical costs
- Moving expenses, if the business must be moved to a temporary location
- Employee's sales and commission and, the training costs for operators of machinery that is replaced by the insurer
- Reimbursement for reasonable expenses beyond fixed costs
- Civil authority ingress/egress, meaning coverage is provided if direct loss of revenue is caused when a government authority orders the closure of business, such as in the event of a curfew
- Off-premises service interruption, including overhead transmission lines or gas supply, resulting in an inability to operate or creating a hazard to occupants or visitors

For example, if a fire breaks out in a restaurant, commercial property insurance will pay to replace inventory damaged in the fire as well as any damage to the building. BI insurance helps pay bills, replace lost income and cover payroll while the restaurant is temporarily closed for those repairs. Other events covered by BI insurance include wind, hail, vandalism, or damage to your building or equipment. However, damage caused by flood, earthquakes, or broken glass is typically not covered.

Business interruption insurance is calculated based on a formula that takes into account the time that the operations are shut down (the "Loss Period"); the quantity of goods or services normally produced or sold per unit of time used during the shutdown; and the "but-for" profit that would have been earned during the loss period. This formula is subject to change by the specific policy language.

There are often exclusions to the policy, defining what types of perils are not covered, unless additional coverage is purchased (referred to as a rider to the policy). It is important to read the policy carefully to i) determine if the event is covered by the policy and ii) determine what elements of loss are covered. Common exclusions include these:

- Earthquakes — If an earthquake causes property damage to your business, your standard commercial property insurance policy generally does not cover the damage. In most cases, you must have a separate policy or addendum that provides earthquake coverage.
- Acts of war — Commercial property insurance typically does not cover any act of war that causes damage to a business. It might cover aircraft and missile damage, but not if they occur as a result of war.

- Strikes, riots and civil unrest — Starting in May 2020, protesters filled the streets of Minneapolis, MN, to demonstrate against social injustice. These protests spread to more than 600 cities throughout the United States, sometimes accompanied by acts of violence and destruction. This included arson, vandalism, and the destruction of many businesses. In response to past cases of unrest elsewhere in the world, many commercial insurance carriers have introduced an exclusion for civil unrest.
- Terrorism and political violence — Damage to a business due to domestic terrorism or political violence is typically not covered under commercial property insurance unless a business owner purchases a separate policy.
- Smoke damage — Commercial property damage insurance rarely covers smoke damage, especially in industrial or agricultural settings. However, some specific accidental circumstances trigger insurance coverage.
- Broken glass — Commercial property damage insurance often covers vandalism, but rarely covers broken glass. However, the coverage typically does apply to secondary damage that occurs as a result of the broken glass.
- Weather — Any damage caused by dust, sand or rain is not typically covered under commercial property insurance; however, most policies cover wind and hail damage.
- Biological agents/viruses — Many commercial property insurance carriers do not cover damage caused by biological agents, viruses, or communicable diseases.

The economic consequences of the COVID-19 pandemic on businesses have yet to be fully comprehended or quantified by the business community. With many businesses being forced to close either due to government shutdown orders, unavailability of their workforce, or simply due to a lack or diminution of their customer base in light of quarantines, the effects can be long-term and detrimental to businesses that simply cannot afford to shut their doors.

Opportunity for fraudulent claims

Insurance fraud is estimated to be a billion-dollar problem, and BI policies are not immune to it. Whenever a natural disaster hits, commercial carriers are inundated with claims from business owners pursuant to their BI policy provision. Business interruption coverage is intended to provide the insured's business with the amount of profit it would have earned had there been no interruption of the business or suspension of operations, but it may not be used to put the insured in a better position than it would have occupied without the interruption, as confirmed in *Dictiomatic Inc. v. U.S. Fid. & Guar. Co.* [2]

Dealing with business interruptions can be traumatic and may present challenges to businesses, requiring accurate records, considerable paperwork and correspondence with the insurance carrier for the business to be made whole with respect to lost business income that resulted from the event.

Forensic accountants, working with either the insured in preparing the claim or the insurer in reviewing it, need to focus on key areas that form the basis of the business interruption calculation and are routinely susceptible to fraud. These are i) period of loss, ii) base period, iii) mitigation of loss, and iv) books and records.

Period of loss

The period of loss is measured from the date of the event until the time that the physical condition of the business has been corrected, allowing the company to resume pre-event levels operations (including repairs of damaged facilities or replenishment of damaged inventory). In many instances, such as a fire, machine failure or natural disaster, the event date and time can be firmly established, either by system records or outside sources. Fire and police records, weather services, security videos or building control systems can provide evidence of when a facility was shut down from a storm, flood, or mechanical failure.

[2] David W. Grossman and Dennis Medica, "Fraud and Business Interruption Claims: How to Identify and Combat Blatant Inaccuracies," CLM Magazine, October 2018, https://www.medicacpa.com/files/Fraud-and-business-claims.pdf (accessed April 23, 2021).

For other events, there may be a more subjective measurement date, which provides an opportunity to manipulate the ongoing loss amount. For example, if a manufacturing machine is experiencing periods of reduced output or frequent repairs for two weeks before a total failure, the business owner may try to claim that the loss period includes those weeks of diminished capacity as part of the damages. Accounting and financial records may help clarify the measurement date. These may include, machine maintenance records, production records, and related job cost reports which can establish when the machine broke down, possibly narrowing the insurable loss to an amount significantly different from what might otherwise be reported.

Inflated loss claims

Business interruption claims are based on the theory that, all things remaining equal, the operating results of an enterprise will continue in a manner consistent with how they performed in prior periods. If the profits in the prior period are overstated, that would result in a larger loss of "but-for" income in the loss period. Operating results can be manipulated by various revenue cutoff schemes that involve recognizing sales prematurely or moving expenses into subsequent periods. Because these insurance claims also compensate for continued ordinary expenses (such as payroll) incurred during the loss period, overstating them will cause the claim amount to be inflated. Detailed comparisons of pre- and post-event sales revenues and expenses will provide insights into the comparability of the two periods and to the existence of red flags, and better inform the forensic accountant regarding how to proceed with the analysis.

Insured's books and records

To prepare a reliable calculation of lost business income, the books and records of the company must be true and accurate, and comparable between pre- and post-loss periods. The forensic accountant will need to work with the insured's accountants, to understand how the records are maintained, and learn about the business. If the books are not true and accurate, then a lost-income calculation may not be possible without significant additional work.

If the company's business is seasonal or has periodic peaks and troughs in activity, a period-to-period comparison may not be meaningful. Depending on the factors affecting the business, consider using trending or averaging of sales and expenses for projections. Depending on seasonality of the business, use

- same period from prior years,
- imputed growth rates (such as compound annual growth rate, or linear regression), or
- rolling averages (weekly, monthly, or quarterly, depending on the nature of the business and the duration of the loss period).

Types of claims and potential fraud issues

As with any business, there are accounts with higher risks of misstatement than others. Depending on the industry (but particularly with restaurants, service industries, and any business with large cash sales), unreported cash income will be problematic for the insured because it will reduce the amount of their claimed loss. If there are dubious explanations why "sales are really higher than they appear" with respect to historical sales or expenses, it should be considered a red flag for fraud.

Similarly, off-the-books employees will reduce the amount of recorded expenses, and if these employees are paid in cash, there is no way to reconstruct the actual operating results. If the expenses are understated, it will increase the operating profit, but the reimbursement of ongoing business expenses will be reduced.

Business projections

Business owners routinely prepare business projections for a variety of purposes. They may be part of a required quarterly reporting package for their bank, or an internal planning document for budgeting. Business projections may be included among the documents supporting a BI claim. However, such financial projections may be exaggerated, presenting unrealistic sales and operating performance scenarios. When analyzing forward-looking business records, they should be considered in terms of i) historical perspective (Are the growth patterns consistent with past performance?), ii) any other changes in the local or overall economy or the industry, and iii) when the projection was prepared (before or after the event that caused the business interruption).

Retail businesses

Retail operations bring an additional set of risks to the forensic accountant when evaluating a BI claim. Sales projections are susceptible to manipulation and being overly aggressive. Additionally, whether the company records sales returns in their BI claim in a manner consistent with pre-event practice can have a material effect on the proposed damages.

Another issue with retail BI claims is the valuation of inventory, especially if it is susceptible to spoilage, theft, or other damage. Slow-moving inventory that would have otherwise been marked down can be reflected at inflated costs. Similarly, purchases should be scrutinized to identify possible "inventory padding" before the insured event.

Restaurants

Restaurants and bars present challenges when preparing BI claims. Because of the nature of their business, they have significant cash receipts, which may go unrecorded, and employees may be paid off the books or under the table. These represent misstatements in financial records that would distort the results of a BI claim. The unrecorded income will reduce the amount of the claim, and the off-book payment of employees will increase the net income claimed. Similarly, if a restaurant can provide catering services and not use their indoor dining facilities, this may be a means for mitigating the BI loss that may not be reflected in income.

Bar and restaurant owners may be inclined to furlough or dismiss their kitchen and wait staff during the loss period and retain only key employees. How these employees are compensated during the loss period may warrant closer examination, because they may receive inflated compensation, especially if the restaurant is family-owned.

Valuation of self-constructed improvements and betterments

Another area of concern is self-constructed assets and betterments. These are usually custom-made furniture and fixtures that the insured event may have been destroyed or damaged, and the business owner is claiming excessive amounts for the damage. To support the amount of the damage, there have to be receipts for the materials and labor to construct these assets, otherwise there is no basis for the amount claimed.

Potential fraud issues — general ledger vs. tax returns

Based on these areas of concern, forensic accountants working on behalf of companies filing claims for lost business income may face a variety of risks. If there is a suspicion that the insured is attempting to submit a claim for a fraudulently inflated amount, or is knowingly maintaining incorrect business records, these concerns must be discussed with counsel. Additionally, if the books that form the basis for the claim present lost income significantly greater than what the tax returns would have presented, there is a high probability that the insurer will raise this issue as a basis for either dismissing the claim or, if this is in the course of insurance coverage litigation, move for the court to impose sanctions.

Furthermore, if there is sufficient basis to do so, the court may refer the matter to local, state or federal taxing authorities for criminal investigation. The insured then transitions from being a plaintiff in an insurance coverage case to being a defendant in a tax fraud case.

Mechanics of the calculation

A BI claim is conceptually similar to preparing a damage claim, subject to the terms of the insurance policy. The first and most important step is to read the insurance policy and discuss the covered losses and exclusions with the insured, the broker, and counsel. This will provide the framework for preparing and presenting the calculation to the insurance carrier for payment.

Basic Business Interruption Calculation Framework

Add	Net sales projected
Less	Cost of goods sold (COGS)
Equals	Gross profit
Less	Selling, general and administrative (SG&A) or Operating expenses (OpEx)
Less	Interest and taxes
Equals	Net income
Add	Continuing expenses and Expenses incurred for loss mitigation
Equals	Total estimated business interruption amount

As is the case with any damage claim, documents will be identified and requested to serve as the basis for the calculation. Depending on the business, and the nature of the loss to be claimed, three to five years of books and records are typically required to present a history of earnings, expenses and profits to support a BI claim. At a minimum, the following documents are necessary:

- Policy documents and all riders and amendments
- General ledger
- Cash receipts and disbursements ledgers
- Tax returns
- In the event of property damage:
  1. fixed asset registers and depreciation schedules
  2. invoices for purchase of assets
  3. service records and service agreements
  4. for self-constructed assets, receipts for materials and labor
- Inventory records — typical for retail operations, restaurants, manufacturing and distribution entities
- Purchase records for raw materials, machine supplies (lubricants, cleaning and maintenance products) — typical for manufacturing, vehicle service companies, and fleet operators
- Open purchase orders, sales commitments, and service contracts
- Cash flow forecasts, budgets, income and sales projections
- Invoices supporting expenses incurred to mitigate further losses
- Bank statements
- Credit card statements

Analyze the income statement accounts to identify continuing vs. discontinued expenses for the business during the period of restoration. Continuing expenses are those that will occur regardless of the level or activity occurring at the business, such as:

- salaries of key employees,
- utilities
- insurance

It is important to identify expenses incurred in mitigating additional losses, which i) is required under the policy and ii) may be reimbursable. These include refrigerated storage units to prevent the loss of perishable inventory, construction of outside dining facilities, construction of temporary structures to protect inventory, or to provide access/egress, and other actions to minimize the disruption and loss to the business.

Discontinued expenses are those that cease when the business stops or limits its operations due to the insured event:

- Employee payroll costs, typically for production staff, unskilled or semi-skilled labor, retail and restaurant staff
- Raw materials purchases
- Freight and delivery costs

Conclusion

Like damage calculations involving a breach of contract or other claim, a BI claim has similar elements that are familiar to forensic accountants:

- There is the insurance policy and its riders and exclusions, which is an agreement or contract that controls the rights and obligations of the respective parties.
- There are specific reporting requirements that are necessary for the agreement to operate according to its terms (the BI claim).
- There is a damage formula that applies to claims made under the terms of the agreement. Forensic accountants have strong accounting, auditing, and financial analysis skills to fully identify the relevant losses and to assess those that might be recoverable through insurance claims.
- Forensic accountants can help gather evidential matter to support a claim, and to identify and address the need for supporting documentation.
- There is a dispute resolution mechanism: the appraisal and arbitration process. Forensic accountants have the litigation experience and skills to understand how claims may work through a dispute resolution process. Accordingly, they can help prepare the claim, or an analysis of a claim, that fully explores all covered losses and clearly articulates a defensible position in the dispute. The forensic accountant can also prepare supporting documentation so that the claim is ready to be challenged and to withstand critique in the dispute resolution process.
- Forensic accountants have a keen understanding of the risks of potential fraud, both in the underlying books and records and fraudulent assertions within the insurance claim. Forensic accountants have the investigation expertise to identify potential fraud risks or predicates for further investigation, to ferret out evidential matter that will help evaluate such fraud predicates, and can, when necessary, quantify potentially fraudulent claims.

Notwithstanding these similarities, there are numerous technical differences between the BI claim and damage calculation processes that need to be observed to prepare and support a successful claim to an insurer, or to successfully rebut a fraudulent claim. A forensic accountant needs to be familiar with the policy language, case law, and industry practices (both the insured's industry and the insurance business) to prepare a defensible case.

Red flags to spot fraudulent business interruption claims[3]

1. The policyholder is overly aggressive about settling the claim quickly.
2. The insured's federal tax returns show the company had been suffering financial loss or generating little revenue, yet the claim reports an excessive loss.
3. The claim's losses include large, expensive items, yet the insured cannot produce hard evidence, or produces receipts with no store logo, no sales tax figures, or no date.
4. The claim is made shortly after the policy is activated, after an increase in the amount of coverage is added, or shortly before the policy is scheduled to end.
5. The policyholder previously posed hypothetical questions to the agent about losses similar to the one being investigated.
6. The claimant's financial records contain irregular or questionable information, such as out-of-sequence receipts and checks, and no source documents.
7. The claimant refuses to provide substantive evidence to support the claim (copies of their accounting database or general ledger, bank statements, customer invoices, or vendor bills).

[3] Tiffany Couch, "7 Red Flags to Spot Fraudulent Business Interruption Claims," Insurance Journal, October 1, 2018, https://www.insurancejournal.com/magazines/mag-ideaexchange/2018/10/01/502420.htm (accessed April 23, 2021).

Case studies

Gold Mining Company v. Extractive Equipment Manufacturer Subrogation

A publicly traded gold mining company purchased a piece of equipment necessary for separating the gold from the excavated rock. After the equipment was delivered, installed, and tested, it was placed into operation. Due to a manufacturing defect, the equipment exploded on the first day of operation. Because it was an integral part of the gold extraction process, the mining operation was stopped until the equipment could be dismantled, removed, and a new unit shipped from overseas and installed. The expected delay was between six months and a year, and the mine operator filed an insurance claim against the manufacturer for lost business income over $20 million.

In preparing the claim, there was a question regarding the basis for the amount of the loss being claimed. The mine operator presented data about the amount of rock excavated, the gold extracted daily, and the yield per ton of rock, based on the current and forward price of gold. There were detailed budgets and projections prepared as the mine was shut down, reflecting the mitigating expenses and how the mine operation was losing money.

The forensic accountants reviewing the claim noted that the mine operator was claiming lost income based on lost sales; however, there was no loss of inventory or resources. In fact, the gold was still in the ground, and the only reasonable loss that could be determined was the time value for the delay in production. The final claim paid was $4 million.

New York City Financial District Pub

A large bar and restaurant in the Financial District (FiDi) neighborhood of New York City shared a common supporting wall with the 150-year-old building behind it. The older building suffered a catastrophic collapse, which resulted in severe structural damage to the restaurant. The building was condemned and was closed to the public on Dec. 21. The bar and restaurant were closed for the next three months, missing the holiday season, the Super Bowl, the World Cup and St. Patrick’s Day, and showed no signs of reopening.

The owners filed a claim, which was disputed by their insurance carrier. The owners retained counsel and were prepared to file suit against their insurer for failure to i) provide coverage and ii) pay their claim. Counsel retained forensic accountants to prepare the business interruption claim for lost income.

Based on the books and records provided, the forensic accountants noted that the general ledger account descriptions changed every year, and the amount of the payroll tax payments were inconsistent and did not occur at regular intervals. Furthermore, the owners stated that the furniture in the restaurant, and the bar itself, were custom made. When asked for supporting documents for the construction costs, the owners stated that the bar was built by the employees and the owners’ family and there were no records of material or labor costs.

There were other red flags in the financial records that indicated the owners were not recording cash receipts, and that there were employees being paid off the books. When confronted with these issues and told about the likelihood of the matter being referred to the IRS, Counsel and the forensic accountant declined to pursue the insurance claim.

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