# Advocate'sEDGE

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May/June 2012

*Business interruption claims*

# Provide evidence of lost sales — not just lost production

Whether caused by negligence, breach of contract, terrorism or "acts of God," the temporary interruption of a business can be financially damaging. When a company tries to recoup its losses from its insurer or the responsible party, it needs solid, comprehensive expert testimony — or it risks losing its claim. A recent West Virginia district court decision, *Felman Production, Inc. v. Industrial Risk Insurers*, shows how one business learned that lesson the hard way.

## BOILING AFTER A BREAKDOWN

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

In April 2008, Furnace No. 2 at Felman's West Virginia plant experienced a failure and became inoperable before it could produce salable alloy. The furnace had first come on line in 2007, but had suffered mechanical difficulties over the years.

*Courts have found that unsold inventory undercuts a manufacturer's loss claim.*

Felman filed a claim for losses sustained as a result of the furnace's failure between April 2008 and January 2009. In May 2009, unhappy with the progress of its claim, the company filed a breach of contract lawsuit against its insurer. Industrial Risk filed a motion for partial summary judgment. It argued that Felman had offered no proof of "actual loss," as required under the policy.

## INSUFFICIENT EVIDENCE OF LOSS

The district court began its analysis by noting that, given the company'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." But after closely examining the actual evidence, the court determined that Felman hadn't offered sufficient evidence to survive the insurer's motion.

Felman's expert based his calculation of the loss on the furnace's production capacity and the market price of the alloy during the loss period. But the expert didn't offer an opinion that the company would have sold any (let alone all) of the expected production if it weren't for the plant's failure. That left the company needing to provide other evidence. As the court explained, however, Felman failed to 1) identify existing or potential sales, or 2) produce evidence showing it could sell existing inventory.

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

## UNSOLD INVENTORY UNDERMINES CLAIM

Courts have found that unsold inventory undercuts a manufacturer's loss claim. In this case, the court stated that Felman failed to produce evidence that it could sell the alloy it *did* produce.

Various documents demonstrated Felman's recurring inability to sell what it was producing — before and after the furnace failed. The company claimed it couldn't sell its inventory because it had to maintain a "buffer stock." Yet the documents indicated its leadership "was actively trying — and failing — to sell the supposed buffer stock."

### HOW CPAs CALCULATE LOST SALES

To arrive at an initial estimate of lost sales for purposes of a business interruption claim, CPAs generally use *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, and
- Seasonal and other periodic variations.

Random fluctuations, nonrecurring events, and external variables such as industry trends and competitors' sales also are considered. The qualitative analysis, on the other hand, weighs internal factors such as the business's products and services, competitive advantages and customer profiles.

Certain circumstances can make calculating lost sales difficult. CPAs, for example, will adjust their approaches to calculate lost sales for startups or companies with unpredictable income streams.

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

## PROOF POSITIVE … OR NOT

This case illustrates the importance of solid and comprehensive expert testimony. Felman, for example, 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 who look at the whole picture — not just part of it. ◗

# Why companies need unscheduled fraud audits

Regularly scheduled audits are required of all public companies and are highly recommended for privately owned businesses and nonprofits. But because regular audits provide cheating employees time to hide their crimes, auditors typically don't find occupational fraud schemes. That's where unscheduled fraud audits come in.

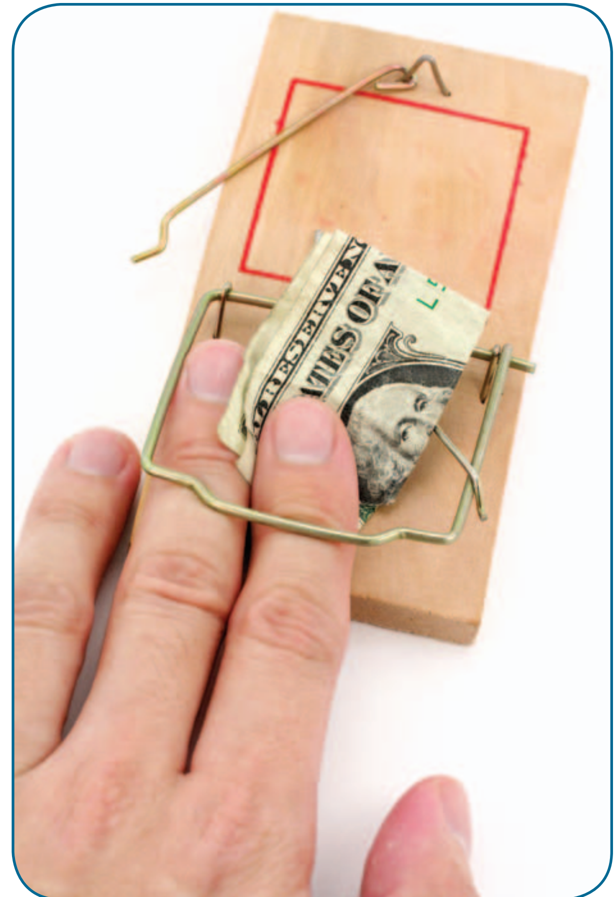
Experts conducting unscheduled audits can use a number of different accounting procedures to detect malfeasance at all levels of an organization. Regardless of the techniques used, the goal is the same: to catch perpetrators red-handed.

## SUSPICIOUS SCENARIO

To understand how surprise audits can be effective, let's look at an example. Suppose a client suspects that his company's CFO is falsifying financial statements. Traditionally, large financial statement frauds revolve around inventory, sales and accounts receivable. In a surprise audit, an outside expert would examine these areas for irregularities.

> *Catching an employee off guard can be all it takes to uncover even a long-running scheme if the guilty party doesn't have time to shred, alter or hide records.*

If anything unusual is detected, the expert might then interview the suspect and other staff members and take a more detailed look at the company's historical financial statements for unusual trends. If fraud is found, the expert's findings can be used to help terminate the employee or as evidence in court.



## "GOTCHA"

The element of surprise is critical. Say a company has multiple inventory locations, and employees know when and where auditors will conduct test counts. They have a chance to conceal shortages at locations not scheduled for a visit that day. When auditors show up without notice, employees have no chance to shift inventory around.

Surprise fraud audits are just as useful in uncovering lower-level theft, such as cash skimming. Catching an employee off guard can be all it takes to uncover even a long-running scheme if the guilty party doesn't have time to shred, alter or hide records and other evidence.

Surprises can include not only when auditors start work, but also how they conduct the audit. If auditors usually start their visits counting cash, a fraud perpetrator is likely to know this. Thus, an auditor could trip up the thief simply by starting with receivables.

In fact, surprise audits can both detect *and* deter fraud. Numerous studies have found that people who perpetrate fraud believe the risk of getting caught is minimal. Seeing other employees taken unawares may discourage potential thieves.

### DETECTION METHODS

The AICPA's Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, recommends that experts conduct surprise audits on test areas, locations and accounts that would otherwise not receive scrutiny. Experts can design tests that employees can't predict or expect, based on the company's internal controls and other standard procedures.

While traditional fraud-busting methods serve fraud auditors well, surprise audits also may include high-tech sampling and computer data analysis techniques. For example, specialized software can examine as many as 1,000 invoices quickly and in detail, including invoice numbers and to whom payments were made.

By isolating suspicious cases, auditors may spotlight schemes where, for example, someone submits phony invoices to the company's accounting department, which then sends payment to a post office box. A technology-aided surprise audit also can help uncover suspicious duplicate invoice amounts and invoice numbers.

### A CANDID SNAPSHOT

If a company is conducting only scheduled audits, it may be giving free rein to all kinds of financially damaging fraud schemes. Even when its owners and auditors are confident its internal control system is effective, surprise audits are still a good tool for testing whether transactions comply with those controls. After all, it doesn't hurt to step back and take a "snapshot" of your company operations — and "candid" shots are almost always better at depicting the true nature of a subject.

# Thumbs up

## *Court takes business valuation guide's advice*

Courts often expect business valuation experts to rely, at least in part, on the value of comparable entities when making their calculations. But in late 2011, the California Court of Appeals allowed a business valuation based on "rules of thumb" multiples, rather than comparables. In fact, the court in *In re Marriage of Bauer* increased the expert's multiplier by more than 100%.

### GETTING PHYSICAL

Randall Bauer is a licensed physical therapist who co-owns a practice that employs several other physical therapists. After 16 years of marriage, Randall's wife Rebecca filed for divorce. The spouses hired a forensic

accountant, S.M. Zamucen, to prepare a written valuation of the physical therapy business.

At trial, the court heard testimony from Randall's former partner in the physical therapy practice and Rebecca's accounting expert. The court valued the business at about $1 million. As a result, it awarded Rebecca $256,484, half of Randall's share. But Randall appealed, contesting, among other things, the valuation of his business. He pointed out that Zamucen valued the practice at between $450,000 and $547,000.

## TRIAL COURT GIVES 100%

The trial court supported its valuation decision with a two-page report. It cited a publication quoted in Zamucen's report, *Business Reference Guide: The Essential Guide to Pricing a Business*. The guide provides a rule of thumb for valuing physical therapy businesses: a multiplier of 60% to 100% of annual collected fees.

Zamucen had applied a 42% multiplier. But the trial court applied a multiplier of 100% to the business's average gross profit of about $1 million for the four years preceding the dissolution. It noted that the business had several factors in its favor, including:

- A good location,
- A long existence,
- A reputable name in the medical community — meaning a broad referral base,
- An established core of professional employees,
- "Hands-on" owners,
- Recurring business, and
- A history of income growth.

Based on these positive attributes, the trial court determined that a 100% multiplier was appropriate.

## APPELLATE COURT AGREES

When the case went to the court of appeals, it agreed that the trial court had used a legitimate valuation method. It pointed out that Randall's former partner (who had purchased five physical therapy practices) had testified that the value of a practice ranges from 1 to 2.5 times its gross annual sales. The partner also

testified that the higher multiple is used if the business has existed for a long time. The appellate court found that his methodology mirrored the one described in the *Business Reference Guide* and used by the trial court.

Rebecca's expert witness, an accountant, also provided testimony supporting the court's valuation. He used a market comparables approach which considered 31 other physical therapy practices that were for sale. The average listing price for these practices was 106% of their gross income. The expert testified that the appropriate multiplier for Randall's business would be 1 times its gross income.

The appellate court concluded that the trial court could calculate the value of Randall's practice using the guide's rule of thumb. All of the relevant witnesses supported a 100% multiplier, citing various marketability factors and the business's health. Thus, the court's use was "well within the range of evidence presented."

## BEYOND COMPARABLES

Although the court here referred to the market comparables approach, it was only to support the value derived from applying the *Business Reference Guide*'s rule of thumb. When similar supporting evidence is offered, it's possible that more courts will accept valuations based on multiples rather than comparables.

# When is ESI production an undue burden?

Electronically stored information (ESI) has moved to the forefront of discovery. Yet some attorneys still struggle with ESI production, including the rules for opposing a request. A recent federal district court case, *Linnebur v. United Telephone Ass'n, Inc.*, illustrates just how high the hurdle can be to prove undue burden.

## DISCOVERY DISAGREEMENTS

Evelyn Linnebur worked for United Telephone Association (UTA) for more than 33 years. After she was terminated, Linnebur sued UTA for age discrimination. UTA claimed she was fired for cause because she'd failed to notice a significant accounting error made by an employee she oversaw. It also alleged that she'd repeatedly refused help in managing the accounting department and had given her granddaughter, also employed by UTA, preferential treatment.

Following a joint planning conference, the two parties prepared a report that indicated disagreement over the production of ESI. The court entered a scheduling order noting the parties agreed that UTA must produce copies of e-mails in paper format or on a computer-readable disc. The order also stated that Linnebur reserved the right to seek production of ESI in its native format.

When Linnebur served her first request for production of documents, she asked UTA to produce ESI — including organizational charts, e-mail, payroll files and performance evaluations — in its native format. UTA didn't assert any specific objection but produced the requested ESI in PDF format. Linnebur challenged the production.

## COURT FAVORS NATIVE FORMAT

The court noted that, under Federal Rule of Civil Procedure 26(b)(2)(B), the producing party must show that ESI isn't reasonably accessible because of undue burden or cost. But UTA maintained that Linnebur was responsible for explaining why she requested the native format.

The court found that Linnebur had already done so. She contended that the timing of her termination was a key issue and that the metadata in the requested documents contained information about the author, creation date and history of each. Linnebur claimed this information was central to establishing the timeline of events that led to her termination — and wasn't accessible in PDF formatted documents.

UTA, on the other hand, failed to show that undue burden or cost meant the information wasn't reasonably accessible. As a result, the court ordered it to produce the responsive ESI in native format.

## THE BURDEN OF BURDEN

So how can you show undue burden? Most likely, you'll need to address the various generators of ESI (such as desktop computers, laptops and smart phones) and their location, the methodology used to retrieve it, and the associated costs. Make sure you get the input of a qualified forensic expert. It's a critical step to successfully collecting and presenting this information to a judge.

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