

Factors to consider when calculating lost earnings: A forensic accounting case

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ABSTRACT

One aspect a forensic accountant performs is to use financial data to make calculations of losses and business valuations. Insurance companies use forensic accountants to request the verification of potential lost earnings when a business owner gets into an accident. This case provides a practical example for students to learn the documentation necessary to verify earnings and also calculate a loss. In the field of fraud examination and forensic accounting, there are relatively few proactive cases written which allow students to be actively engaged in the case and use their thought processes to request the applicable needed books and financial records, analyze the data, and make a calculation of a potential loss based on the facts and circumstances. It is important for students to understand the alternative circumstances, including in this case the COVID-19 pandemic, could influence the calculation of the loss during the period of disability. In addition, students need to learn the skills to communicate with attorneys to request the necessary documentation needed to verify the earnings in the periods prior to and subsequent to the date of accident. This case offers an opportunity for the students and professor to role play on the communication between the forensic accountant and the attorney.

Keywords: Forensic Accounting, Loss Calculation, Insurance Loss, Investigation

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INTRODUCTION

Fraud embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations (Albrecht, Albrecht, Albrecht & Zimbelman, 2016). Fraud examination is a methodology for resolving fraud allegations from inception to disposition. Fraud examination involves obtaining evidence and taking statements, writing reports, testifying to findings, and assisting in the prevention and detection of fraud (ACFE, 2013).

The word forensic is defined as used in or suitable to courts of law or public debate (Black's Law Dictionary, 2009). Forensic accounting is the use of accounting theories, principles, or analyses in a legal action, often through expert witness testimony (Rufus, Miller, & Hahn, 2015). Another definition of forensic accounting is a discipline that deals with the relationship and application of financial facts to business problems, conducted in a legal setting (Bologna, Lindquist, & Wells, 1992). Forensic accounting is not auditing. It is a subset of fraud examination where the forensic accountant investigates and reviews the financial records and draws a conclusion based on examination of the financial documentation.

Accordingly, fraud examinations involve forensic accounting but not all forensic accounting is fraud examination. As in the case provided in this paper, valuing lost earnings due to an accident would be included under forensic accounting, but may not necessarily involve fraud. Fraud examinations will generally fall under the category of forensic accounting because the majority of examinations, investigations, and reports regarding fraud are performed with the end result in some form of legal proceeding. Fraud examiners and forensic accountants are taught to conduct their examination with the assumption that the case may end in litigation (ACFE, 2013).

BACKGROUND

Mr. Tony Jones, a self-employed barbershop owner, was involved in an accident on March 11, 2020. Mr. Jones (hereinafter referred to as the Claimant) has alleged that he was unable to work full-time as a result of the accident from March 12, 2020 through October 30, 2020 and has further alleged a net loss of earnings in the amount of \$17,171.14 during the claimed period. Based on the documentation provided, the Claimant's business was "shutdown for COVID" during the period March 21, 2020 through May 31, 2020.

As the forensic accountant, you have been requested by ACME Insurance Company (hereinafter referred to as ACME) to investigate all relevant books and records in order to obtain information that would be useful to you in processing the Claimant's allegation of lost earnings.

At the time of this assignment from ACME, the claims representative provided you with the following records:

1. Copy of the Claimant's personal income tax return (Form 1040) for the year 2019.
2. Copy of the Claimant's business tax return (Schedule C) for the year 2019.
3. Copy of a U.S. Return of Partnership Income (Form 1065) prepared for King LLC Barber Shop for Men for the year 2018. We were further provided with copies of the Schedules K-1 of the business indicating that the Claimant maintained a 50% interest in the business in the year provided.

4. Copy of a comparative Income Statement for the Claimant's business, Barber Shop for Men, for the 12 months ended August 31, 2019 and August 31, 2020.
5. Copies of the Claimant's bank statements for a business operating account he maintained under the name of Barber Shop for Men at USA Bank during the period of March 1, 2020 through September 30, 2020.
6. Copy of Insurance Verification of Self-Employment Income Form signed by the Claimant and dated October 8, 2020.
7. Copy of Insurance Law Verification of Self-Employment Income Form signed by the Claimant and dated November 3, 2020. This copy of the No-fault form included an addendum with the Claimant's net loss of earnings.
8. Other miscellaneous records.

Correspondence

On November 16, 2020, a letter was written to the Claimant's attorney, Mr. Andrew Garden at the Law Offices of Red, White & Blue, LLP. The letter provided him with a detailed list of records required by us in connection with the investigation of his client's lost earnings claim. A copy of this letter was sent to ACME at that time.

On December 8, 2020, Mr. Garden phoned and left a message indicating that he was following up on the documents sent to us.

On December 10, 2020, you phoned Mr. Garden. He questioned you about the documentation he emailed to you. You stated that we had not received any additional documents from him or his office. He stated that his client was a barber and a small business and did not maintain a lot of the records that you were requesting. You stated we were not asking for them to create the documentation for your review, but the records that would support his client's income and expenses that would be reported on his client's tax returns and the Internal Revenue Service would require for an audit. You asked Mr. Garden if his client had business bank statements. He affirmed. He requested your email address so that he could email you the documentation received from his client. He also stated that his client needed the money due to the accident and COVID.

Subsequently you received an email from Mr. Garden with the following records:

1. Copy of the Claimant's personal income tax return (Form 1040) for the year 2018.
2. Duplicate copy of a U.S. Return of Partnership Income (Form 1065) prepared for King LLC Barber Shop for Men for the year 2018. We were further provided with copies of the Schedules K-1 of the business indicating that the Claimant maintained a 50% interest in the business in the year provided.
3. A letter from Mr. Andrew Garden dated December 4, 2020.
4. Copies of the Claimant's bank statements for a business operating account he maintained under the name of Barber Shop for Men at USA Bank during the period of December 31, 2017 through December 31, 2018.
5. Copies of Income Statements for Barber Shop for Men for the years 2018, 2019, and the eleven months ending November 30, 2020.

Investigation and Analysis

During the course of this assignment, you were provided with a copies of the Claimant's personal income tax returns (Forms 1040) for the years 2018 and 2019. The returns were prepared on a head of household basis and declared no additional dependents. Upon examination of the return provided, we noted that the Claimant's address was listed as 123 Main Street, Anytown, NY 12345. We further noted that the Claimant indicated his profession on the returns provided was "Barber".

Income information taken from these returns is indicated in Table 1.

Upon inspection of the personal income tax return (Form 1040) provided, the Claimant reported Schedule C net business income in the amount of \$75,119 in the year 2019. Schedule C is completed when there are profits (losses) from self-employed business activities.

Business income is reported by the owner of a sole proprietorship. In a sole proprietorship, the owner generally does not receive wages from their company. Instead, the owner reports this earned income or loss on a Schedule C form, which is attached to their personal income tax return each year. The Schedule C form itemizes the sales, costs, expenses, and the net profit or loss from operating the business. In the case of a net profit, this represents the owner's earned income comparable to wages received by an employee of a company.

In a sole proprietorship, there is no required interim government tax reporting of earnings such as on a weekly, monthly, or quarterly basis. Instead, the owner reports their income once a year when filing a personal income tax return and the accompanying Schedule C form listing business transactions for the entire year. Therefore, in order to determine when the Claimant worked during the year, an investigation must be made of the underlying books and records depicting the timing and amount of income and expenses prior to, during, and subsequent to the claimed loss period.

Upon inspection of the Schedule C form provided, we noted that the Claimant indicated the principal business to be "Barber", and the name of the business as "Barber Shop for Men LLC". The address of the business was listed as 123 Main Street, Anytown, NY 12345.

The method of accounting chosen on the Schedule C form was the cash method of accounting. In the cash method of accounting, income is recognized as cash received, and expenses are recognized as paid. Furthermore, the Claimant did not indicate that he started or acquired his business in the year 2019.

Additionally, the Claimant reported net partnership income as a result of his ownership interest in King LLC Barber Shop for Men in the amount of \$19,673 (Ordinary business income, \$20,274 less Section 179 deduction, \$601) in the year 2018.

During the course of this assignment, you were provided with a copy of the Claimant's business tax returns (Forms 1065) prepared for King LLC Barber Shop for Men for the year 2018. You were further provided with copies of the Schedules K-1 of the business indicating the Claimant to be a 50%% partner of the business in the year provided.

A partnership is the formation of two or more individuals (principals) for a common business purpose. In a partnership, the principals do not receive wages from the company. Each year the partnership files an income tax return (Form 1065), which reports the sales, costs, expenses, and net income (loss) from operating the partnership. The net income (loss) amounts are then allocated to each partner, based upon their percentage of profit (loss) sharing as specified in the partnership agreement. The share of the partnership income (loss) amount is reported on a K-1 form issued to each partner. The individual partners then report on their

personal income tax returns the income (expense/loss) items from the K-1 form issued to them by the partnership. The ordinary income (loss) amount picked up by the partner from the K-1 is reported on the Schedule E form attached to the partner's personal income tax return (Form 1040), and this amount is considered to be the individual's earned income from the partnership.

In the case of a partnership, the principals can decide to allocate compensation to individual partners, and such compensation is designated as guaranteed payments to partners. These payments are deducted as an expense on the partnership income tax return (Form 1065) in arriving at the amount of net income (loss) reported by the partnership. The allocation of guaranteed payments between partners does not have to follow the percentage allocation of the partnership's net income (loss) to the individual partners. Generally, the amount of guaranteed payments to a partner is determined by the amount of services rendered by the partner during the year. Thus, a partner's earned income consists of the combined total of guaranteed payments to the partner as well as their share of the partnership's net income (loss).

Upon inspection of the business tax return provided, the business address was 123 Main Street, Suite 100, Anytown, NY 12345. The partnership was started on January 1, 2017. The principal business listed on the return was "Barbershop" and the principal service was listed as "Men's Haircare". It is important to note, the box on the tax return, "Final return" was not checked; therefore, you are unable to verify if the partnership was dissolved at the end of 2018 and the Claimant continued to operate the business as a sole proprietorship in the year 2019.

The method of accounting chosen on the Form 1065 was the cash method of accounting. In the cash method of accounting, income is recognized as cash received, and expenses are recognized as paid.

Information taken from the Claimant's Schedule C form for the year 2019 and the Claimant's partnership tax return (Form 1065) for the year 2018 is indicated in Table 2.

Gross Receipts

Upon examination of the business tax returns provided, it was noted the Claimant reported gross receipts in the amount of \$187,350 and \$245,340 in the years 2018 and 2019, respectively.

In an attempt to independently quantify the gross receipts and business expenses in the periods prior to and subsequent to the date of the accident, you requested all monthly bank statements and canceled checks for all bank accounts that reflect business income and expense transactions, as well as information showing the source of all funds deposited into the accounts the claimed loss period.

Since the Claimant's business utilized the cash method of accounting, gross receipts would be recognized as cash received. When a business utilizes the cash method of accounting, the cash deposited into the business account should represent gross receipts as reported on the business tax returns. Similarly, disbursements should reflect business expenses reported on the Schedule C forms.

During the course of this assignment, you were provided with copies of the Claimant's bank statements for a business operation account he maintained under the name of Barber Shop for Men at USA Bank during the periods of December 31, 2017 through December 31, 2018 and March 1, 2020 through September 30, 2020. We were also provided with copies of the Claimant's Income Statements for his business, Barber Shop for Men, for the years 2018, 2019, and the eleven months ending November 30, 2020. To date, we have not been provided with

copies of the Claimant's business bank statements for the year 2019, January and February 2020, and October and November 2020. If all of the requested bank statements are not readily available, duplicate copies can be obtained.

The deposits and transfers into the Claimant's bank account for the periods of December 31, 2017 through December 31, 2018 and March 1, 2020 through September 30, 2020 is indicated in Tables 3 and 4.

We have not been provided with copies of the Claimant's business bank statements for 2019; therefore, we were unable to verify the deposits into the bank account in the year 2019.

The monthly sales revenue as provided on the Claimant's Income Statement for the period January 2020 through November 2020 is indicated in Table 5.

The Claimant reported on the Income Statement, Sales Revenue in March 2020 in the amount of \$11,918.60. It is important to note, the Claimant's business generated no revenue during the months of April 2020 and May 2020. It appears that the Claimant's business generated no revenue in these months.

Business Expenses

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in a given trade or business. A necessary expense is one that is helpful and appropriate for a given trade or business.

Based on the information provided, the Claimant's business continued in some capacity during the claimed loss period. Any loss of earnings benefit the Claimant may be entitled to receive as a result of the accident would be offset by any benefit he may have derived from his business during the claimed loss period.

We have not been provided with documentation to quantify and substantiate the expenses of the business in the years 2018, 2019 and 2020 through the claimed loss period. It is important to note that business expenses represent a key component in the calculation of net business income (loss).

Insurance Verification of Self-Employment Income Form

During the course of this assignment, you were provided with two (2) copies of the Insurance Verification of Self-Employment Income Forms signed by the Claimant. The first form was dated October 8, 2020.

Upon examination of both these forms provided, the Claimant indicated he was a "Barber/Business Owner". He provided his business address as 123 Main St., Ste 100, Anytown, NY 12345. The Claimant did specify that the nature of his business was "Barber". The Claimant did not indicate the dates that he was unable to attend his business due to the accident. The Claimant specified that he did not retain the services of a substitute while he was absent, but he did suffer a net loss of earnings during his claimed period of disability in the amount of "\$538/week = \$10,222".

Upon examination of the second form dated November 3, 2020, the Claimant indicated the dates that he was unable to attend his business due to the accident beginning from the date of accident through "Present *See addendum". The Claimant indicated he suffered a net loss of earnings during his claimed period of disability in the amount of \$17,171.14 through October 30, 2020.

Below we have summarized the addendum as provided on the form dated November 3, 2020:

- 3/12/20 – out of work - \$128.14 (lost wages)
- 3/21/20 - 5/31/20 – shutdown for COVID (no wages claimed)
- 6/1/20 – 8/17/20 – out of work \$897 x 12 weeks = \$10,764 (lost wages)
- 8/17/20 – 9/1/20 – partial disability (worked 40%) = $\$897 \times .60 \times 3 \text{ weeks} = \$1,614.60$ (lost wages)
- 9/2/20 – 9/14/20 – missed work following surgery $\$897 \times 1 \text{ week} = \897 (lost wages)
- 9/14/20 – 10/30/20 – partial disability (worked 40%) = $\$897 \times .60 \times 7 \text{ weeks} = \$3,767.40$ (lost wages).

Average Weekly Earnings

The Claimant's earned income would be equal to his net business income that theoretically would have continued during the claimed loss period had the accident not occurred.

Based on the documentation provided, the Claimant's business continued in some capacity during the claimed loss period. Any loss of earnings benefit the Claimant may be entitled to receive as a result of the accident will be offset by any benefit he may have derived from his business during the claimed loss period. If the Claimant's business continued during the claimed loss period at a level equal to, or higher than, in the period preceding the date of the accident, he would not have experienced a loss of earnings as a result of the accident.

Because the Claimant's business continued during the claimed loss period, in order to demonstrate a loss of net business earnings as a result of the accident, his average weekly net earnings during the claimed loss period must be lower than his average weekly net earnings in the period preceding the claimed loss period.

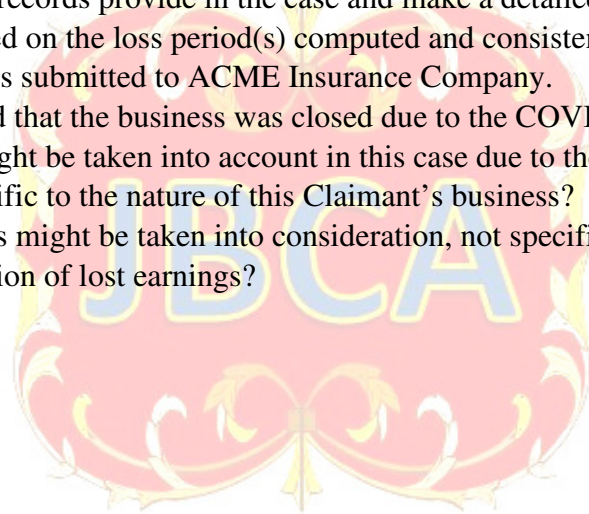
Records Request

It is the Claimant's responsibility to prove his claim of lost earnings. The Internal Revenue Service (IRS) requires individuals to maintain books, records, and supporting documentation, which could be used to verify his business income and expenses. Accordingly, all of the records requested should be readily available, and the Claimant should have no objection to providing these records to you in support of his claim.

You have not requested that the Claimant and/or his accountant prepare any records specifically for your examination. We only need to see those records that are already in existence and are kept in the day-to-day course of doing business to document the income and expenses of the Claimant's business. The records we request are the ones an accountant would use to prepare any financial statements and business tax returns required by the IRS. When evaluating a claim submitted, these records are needed to verify the business income and expenses of a Claimant before and after the date of accident.

DISCUSSION POINTS AND QUESTIONS

1. After you have received the assignment from ACME Insurance Company, write a letter to Claimant's attorney requesting the additional documentation needed to verify the Claimant's earnings in the periods prior to and subsequent to the date of accident. This letter should include the time period for which you are requesting the documentation based on the date of accident (March 11, 2020).
2. Are the records provided (bank statements, Income Statements, tax returns) consistent with each other?
3. Was the Claimant's generation of no revenue in April and May 2020 the result of the accident?
4. Calculate the Claimant's earnings in the periods prior to the date of accident in order to determine if the Claimant incurred a loss during the claimed loss period.
5. What is the claimed loss period?
6. Calculate the average business expense percentage.
7. Use the pertinent records provide in the case and make a detailed calculation of the loss, if applicable, based on the loss period(s) computed and consistent with the information the Claimant in his submitted to ACME Insurance Company.
8. Besides the period that the business was closed due to the COVID pandemic, what factors, if any, might be taken into account in this case due to the COVID pandemic? Are these factors specific to the nature of this Claimant's business?
9. What other factors might be taken into consideration, not specific to this case, when making a calculation of lost earnings?



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APPENDIX*Table 1. Personal income tax returns for the years 2018 and 2019.*

	<u>2019</u>	<u>2018</u>
Net business income - Schedule C	\$75,119	-
Partnership income - Schedule E	-	<u>\$19,673</u>
Total income	<u>\$75,119</u>	<u>\$19,673</u>

Table 2. Business tax returns, Schedule C form for the year 2019 and partnership tax return (Form 1065) for the year 2018.

	<u>2019</u>		<u>2018</u>
Gross receipts (net of returns)	<u>\$245,340</u>	Gross receipts (net of returns)	\$187,350
Cost of goods sold:		Cost of Goods Sold - Other	
Cost of labor	127,380	Costs	<u>3,301</u>
Other costs	<u>3,243</u>	Gross profit	184,049
Total cost of goods sold	<u>130,623</u>	Other income	<u>198</u>
Gross profit	114,717	Total income	<u>\$184,247</u>
Other income	<u>1,317</u>	Less Business expenses	
Gross income	<u>\$116,034</u>	Repairs and maintenance	130
Less: Business expenses		Rent	16,404
Advertising	2,463	Interest	381
Depreciation	1,449	Depreciation	1,449
Legal and professional services	1,669	Square fees	3,616
Office expense	330	Advertising	9,694
Rent: Other business property	16,404	Utilities - Electric	3,600
Repairs and maintenance	138	Commissions	78,587
Supplies	974	Bank service charges	2,888
Travel	298	Consulting and accounting	85
Deductible meals	324	Postage and delivery	382
Utilities	3,600	General expenses	348
Square fees	7,151	Insurance	2,521
Bank service charges	1,549	Utilities	593
Dues and subscriptions	768	Automobile expense	5,946
Miscellaneous expense	1,148	Office expense	7,172
Postage	581	Dues and subscriptions	466
Telephone and internet	2,069	Telephone and internet	3,972
Total expenses	<u>40,915</u>	Meals	<u>5,464</u>
Net business income	<u>\$75,119</u>	Total expenses	<u>143,698</u>
		Net business income	<u>\$40,549</u>
		Claimant's share (50%)	\$20,275

Table 3. The Claimant's deposits into bank account for the periods of December 31, 2017 through December 31, 2018 and March 1, 2020 through September 30, 2020.

	<u>2020</u>	<u>2019*</u>	<u>2018</u>
January			\$10,517.61
February			8,254.30
March	\$15,019.36		9,028.32
April	1,431.58		13,018.33
May	3,528.12		14,656.97
June	15,016.66		14,477.54
July	12,283.61		17,122.52
August	10,522.83		18,901.59
September	16,036.44		17,269.93
October			19,929.43
November			19,913.14
December			<u>18,896.82</u>
Total deposits	<u>\$73,838.60</u>		<u>\$181,986.50</u>

*Not provided

Table 4. Transfers into bank account as part of the deposits into the Claimant's business account.

<u>Transfers:</u>	<u>2020</u>
March	\$1,685.00
April	1,348.00
May	3,465.66
June	
July	2,080.00
August	500.00
September	4,800.00

Table 5. Monthly sales revenue as provided on the Claimant's Income Statement for the period January 2020 through November 2020.

Total Revenue	<u>2020</u>
January	\$21,136.90
February	19,858.81
March	11,918.60
April	0.00
May	0.00
June	16,245.47
July	9,715.94
August	11,169.53
September	12,265.10
October	13,138.38

November	8,237.64
December	<u>\$123,686.37</u>

