

Estimating expected sales





The problem

For the last year, forensic accountants have been grappling with the mechanics of COVID-19 claims and the ongoing impact of the Supreme Court decision re coverage which appears to be open to interpretation by individual insurers and their respective lawyers. However, just when it seems that progress is being made in evaluating and processing the vast quantity of COVID-19 claims, potentially even more serious and longer lasting problems are waiting in the wings which will impact a significant number of business Interruption claims for years to come.

The effect of the pandemic is that a substantial proportion of businesses in the UK as well as in all COVID-19 affected countries will have experienced abnormal sales from at least March 2020 onwards and in some industries and countries, sooner. For the majority of businesses sales will have been adversely affected but for some, the pandemic will have had a positive effect – e.g. online retailers, supermarkets, manufacturers of home gym equipment to name but a few. This period of “abnormal” sales looks set to continue in the UK at least until the middle of 2021 and probably

thereafter for certain industries. Obviously this period of abnormal sales will differ from country to country depending on the severity of the pandemic and lockdown restrictions in individual countries.

Why does this matter from a BI viewpoint? It matters because the standard procedure to estimate a sales loss after a BI loss has been triggered is to compare expected sales with actual sales in the indemnity period. Expected sales are typically estimated by analysing sales in a prolonged period prior to the loss (two or maybe three years) and applying a year on year trend to the prior year sales to estimate expected sales during the indemnity period. Indeed most policies specify that expected sales during the indemnity period should be based on sales in the 12 or 24 months preceding the loss taking into account “all trends and other circumstances” which may affect expected sales. However the effect of the pandemic is that where previously we had a reliable set of actual data which acted as a starting point on which to base our estimate of expected sales in the indemnity period, there is now a gaping hole.

Let's look at some of the alternate ways forensic accountants can estimate expected sales in the absence of meaningful pre loss actual sales:

Budgeted sales

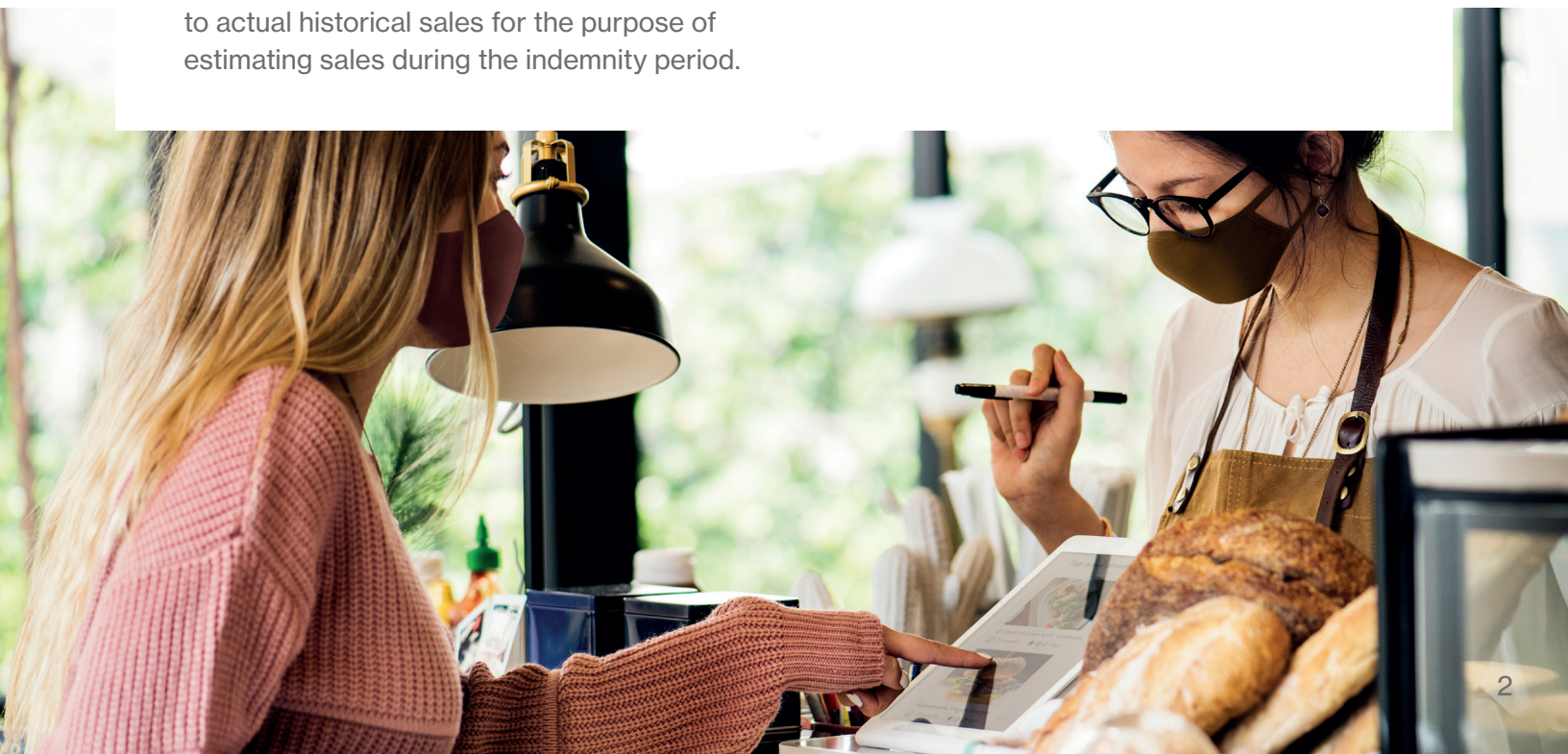
Most small and medium sized businesses are unlikely to produce budgets but larger enterprises will produce annual and monthly budgets as part of their normal financial package.

Even in “normal” times budgets are of limited use because:

- They are subjective and the budgeting philosophy may change from year to year.
- An insured will normally seek to narrow the gap between actual and budgeted sales so a company that has beaten budget by 20 percent in one year is unlikely to repeat the achievement in the following year making estimates based on budget unreliable.
- Policy wordings, while not specifically excluding the use of budgets, usually refer to actual historical sales for the purpose of estimating sales during the indemnity period.

The problems are further complicated in a post pandemic situation as any budgets prepared to cover this period must be viewed with extreme wariness as the authors of such budgets, through no fault of their own, will have little idea about how efficiently or quickly their particular sector will recover. We have already seen examples of companies preparing a specific “post COVID-19” budget in April or May 2020 soon after lockdown. These have proved to be wildly inaccurate as in April or May nobody could have foreseen the devastating effects of the pandemic and the economic effects of multiple lockdowns both in the UK and worldwide.

For the above reasons, budgets will be of very limited use in estimating “expected” sales in the second half of 2021 and beyond.





Industry statistics

There are a number of private specialist agencies that produce industry statistics but they are most common in the property, fashion and retail industries and also in the automotive sector. They produce everything from general industry data to product specific data.

Government agencies also produce statistics on certain industries which may be available to the general public either free or for a fee.

However use of industry statistics has the following drawbacks:

- There is often a significant delay in publishing the relevant statistics.
- The statistics look at the overall performance of an industry or sector and if there are wide variances of performance within the industry may be totally unrepresentative of the likely performance of the insured.
- Statistics provided by private agencies may be extremely expensive.
- The statistics will not take account of the individual bespoke circumstances of the Insured which may be highly relevant to estimating expected sales.
- Statistics only record past performance – they will not forecast the future so if you want to incorporate such statistics into your estimation model, you may have to wait several months after the relevant period.

Industry specialists

These are individuals usually operating as a “one man band” who have spent most of their working life in a particular industry and at some stage set themselves up as an industry “specialist”. Although they can be extremely useful as a sounding board for various statements and assertions of an

Insured, my own experience is they do not really understand the process of estimating sales nor are they able to back up any sales forecasts they make with anything more than “gut feeling”. Consequently they will be of very limited use in the estimation of expected sales.

Post loss period sales

This method may ultimately prove to be one of the more accurate methods of estimating expected sales during a loss period. Basically if after the end of an indemnity period sales were increasing at a rate of, say, three percent per month, one could simply run this “backwards” during the indemnity period. The main problems with such an approach are:

- Sales are unlikely to increase at a steady rate after the indemnity period and may be subject to extreme fluctuations which would render any “backward” projection impossible.

- One will have to wait for several months after the end of the indemnity to finalise calculations of the loss which is not ideal for both the insured and insurers.
- Other factors may come into play post the indemnity period making the post loss results unsuitable for use in any estimation.

“Blue sky” thinking

By “blue sky” thinking I mean using data or an approach that would not normally have been considered pre-pandemic. For example the sales of a London sandwich bar in the second half of 2021 could be estimated based on data from Transport for London showing public transport usage compared with pre-pandemic usage. This would give an indication of the reduction in footfall in London which has a strong correlation with sandwich bar sales.

Part of the key here is to understand what drives the sales of a particular business – clearly for a London sandwich bar it is the number of people requiring food at breakfast or lunch which is directly linked to the footfall in the city.

Similarly companies selling pet food or ancillary products such as clothes or toys will be dependent on the UK pet population which increased hugely under lockdown as people forced to stay at home bought pets for company. If one could ascertain the increase in numbers of dogs/cats in UK households over a given period, such information may be useful in estimating expected sales of companies in the pet products industry. The Kennel Club publishes such data and although this only relates to pure breeds, any increase would be indicative of a general overall increase.

When looking for such sources of data, the internet is a great tool and should be used extensively to try to find the necessary data itself or at least locate such data and ascertain how it can be obtained quickly and cheaply.

Other matters to consider

Forensic accountants also must be aware that the business model of an insured may have changed as a result of the pandemic and that the historic rate of gross profit may no longer be applicable. One should consider using actual rates of gross profit achieved during the indemnity period to estimate the loss of gross profit suffered by the insured.

For the same reason it may be inappropriate to try to estimate increased costs of working or savings during the indemnity period by reference to pre pandemic results.

Given that there may be some fairly imaginative ways of estimating expected sales, it is important that insurers approve any alternative methodology adopted by their appointed forensic accountant and are satisfied that the methodology is in accordance with the policy wording. For this reason, there must be early and regular communication with insurers.



Conclusion

Forensic accountants will need to be creative and open minded about the possible methodologies they use when prior year sales are effectively meaningless. Often they will need to use a combination of different approaches to arrive at a reasonable range of expected sales which is acceptable to both the insured and insurers.

It has often been said that forensic accountancy is a mixture of art and science. It seems certain that faced with the problems outlined above, forensic accountants are going to have to rely more on their creative and artistic abilities and thinking “outside the box” than on their scientific knowledge in the coming years. The trick is going to be ensuring that the artistic side doesn’t become too abstract!



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