

# Forensic Accounting, Financial Underwriting & the Claims Impact

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# Forensic Accounting in Insurance

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INVESTMENT · INSURANCE · SUPERANNUATION



# Introduction

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- Forensic Accounting – what is it?



# Why insurance?

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VS



**Chartered  
Accountants**

NUMBER ONE IN NUMBERS



# Evolution of forensic accounting in insurance

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- **Step 1 - Claims**

- Litigation
  - Claimants working?
  - Earnings whilst on claim?
  - Pre-disability or pre-application earnings?
- Day-to-day claims management
  - Interpret financials in terms of policy wording
  - Standardise financial assessment processes
  - Upskill claims assessors through training
- Claims lessons fed back into product development
  - Policy terms & definitions don't leave the back door open
  - More certainty for policyholders

# Evolution of forensic accounting in insurance

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- **Step 2 – Underwriting**

- Learn from claims experience
  - GIGO
- IP Contract Style forced knowledge to front end
  - Guaranteed & Endorsed Agreed Value vs Indemnity
  - Certainty (esp self-employed)
- Impact on underwriting guidelines
  - Link to claims and ensure front end = back end
  - Realistic evaluation of client's risk exposure

# Financial underwriting over time

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Better at assessing financial risk = more relaxed financial underwriting

## Term Life & TPD

- Fin Q - \$2m to \$6m (\$5m TPD)
- Professionals & Homemakers
- Multiples increased
- Business vs Personal exposure

## Income protection

- Relaxed replacement ratios
- No financials in certain circumstances (farmers & professionals)
- New industries (mining)

Transparency promotes relationships and educates industry

# Evolution of forensic accounting in insurance

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- **Step 3 – Distribution**

- BDM
  - Improves service
  - Create financial “field underwriters” – relieves back office
  - Opens new markets – Small to Medium Enterprise

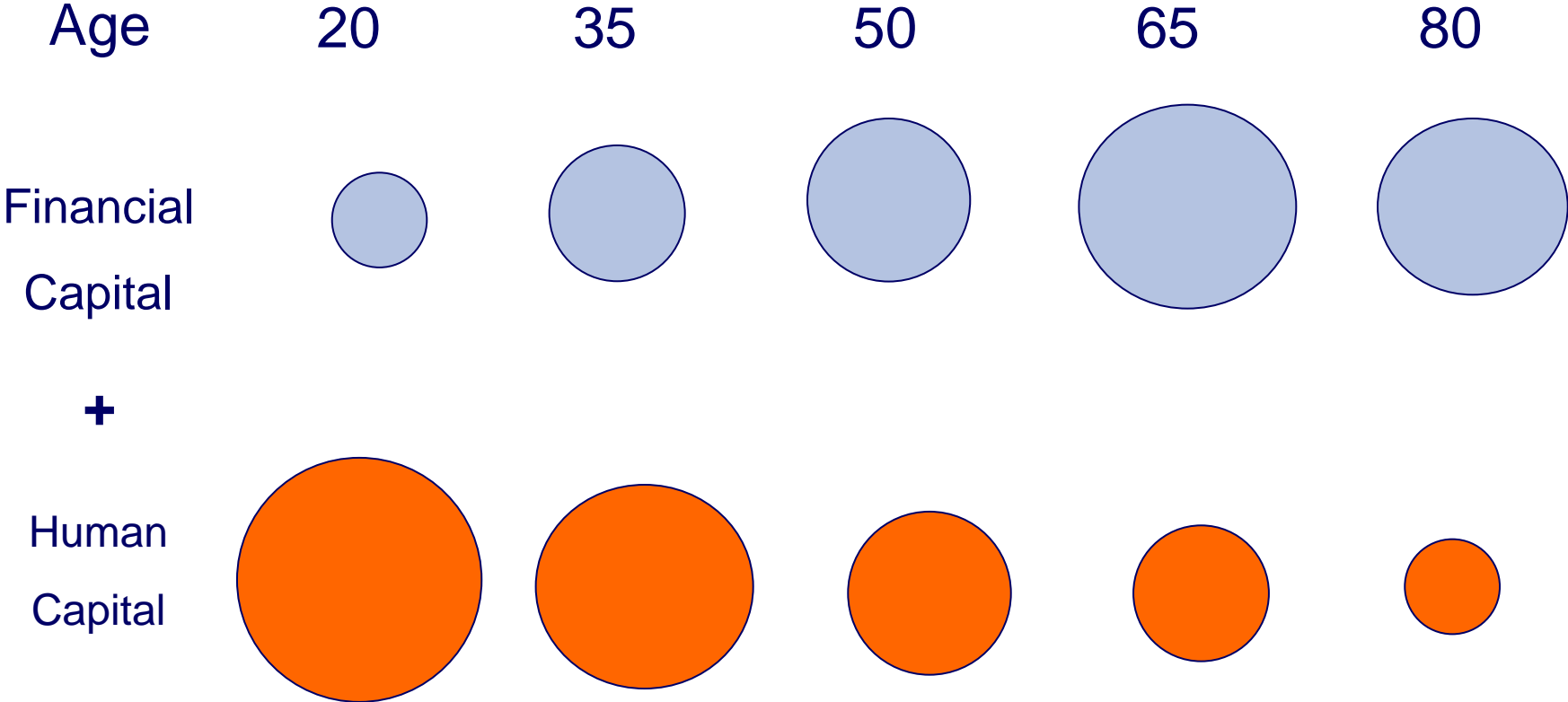
- **Step 4 – Advisers**

- Presentations & Education
  - PD Days & Workshops
- Moving to post Ripoll environment
  - Fee for service
  - Professional environment

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# Earning capacity

# Individual's Personal Balance Sheet



**Protects human capital and ultimately financial capital**

# Human life value / personal capital

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H.L.V. - 35yo - \$125K Earnings pa  
5% C.P.I. and 2% inflation to age 65

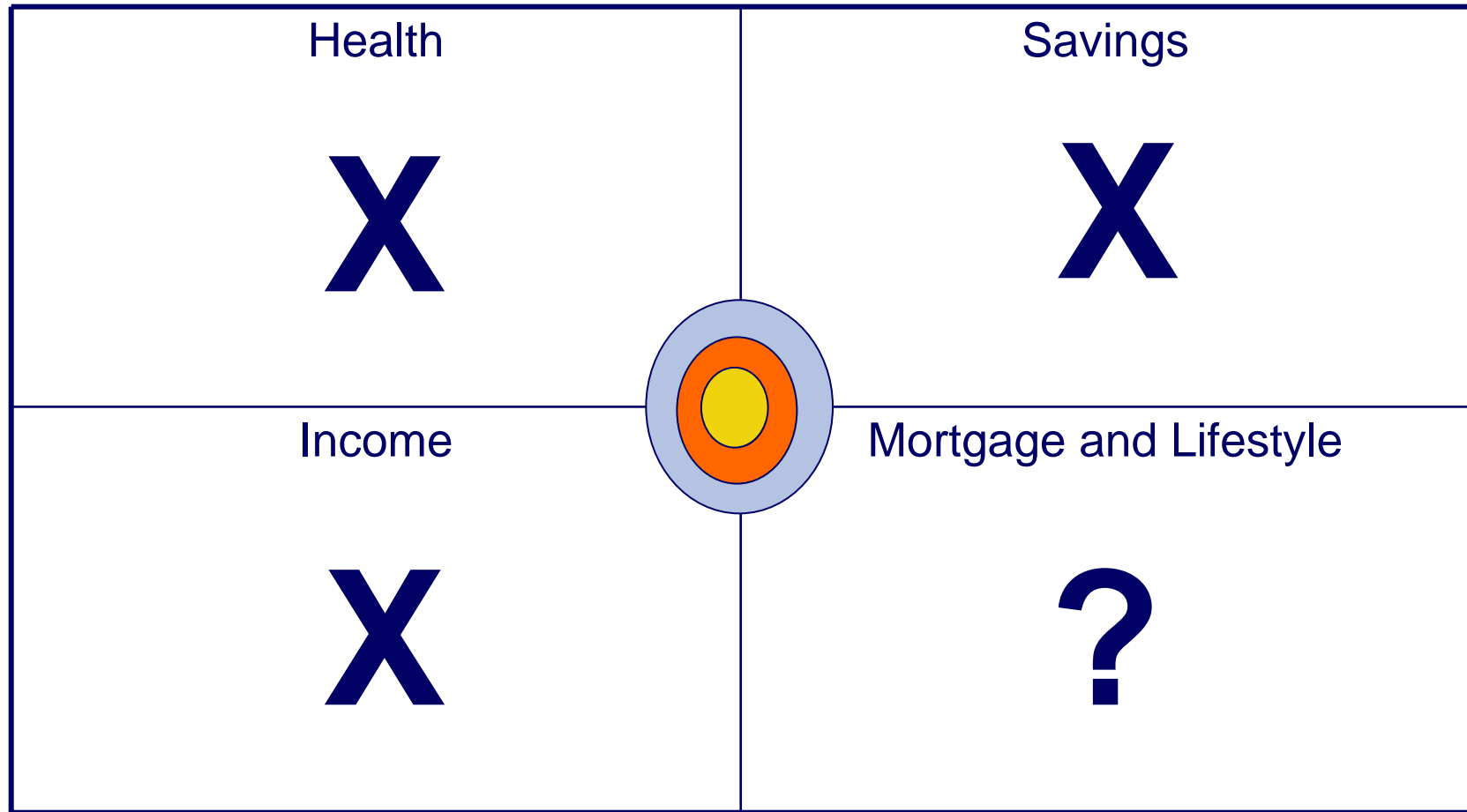
**\$4.2 million in cashflow**

**\$2.5m in today's dollars**

The Most Valuable Asset class on your personal  
balance sheet for most of your working life

# Reality

## Guarantees and Choice



# What is earnings (and what is it not?)

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## Who knows?

- Accountants? NO – historical results and tax
- Banks? NO – free cashflow to repay loans
- Solicitors? NO – distribution of estate proceeds & legal agreements
- Client? NO - driven by accountant or what hits their pocket
- Financial Adviser/Insurance Industry – YES!
- **Who says – Courts!**
  - Principles laid down by Forensic Accountants and tested in Supreme Court
  - Litigated Claims
- **Formula? What is it?**
  - Standardised – calculators
  - Variations per the contract?



# INCOME ISSUES THE CLAIMS PERSPECTIVE

LDG Seminar 18 August 2010

Munich RE 

# Income Issues – the claims perspective

- Majority of applications not financially underwritten



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- Apples to Apples (what we say v what we do?)
- Underwriting/Claims Guidelines (financial)
- Greater onus on underwriting to verify the information provided – regardless of level of cover or Indemnity v Agreed Value
- Reliance on Forensic Accountant reports



# Income Issues – the claims perspective



- Most PDSs/Policy Documents/applications are clear on the definition of ‘income’

*As a general rule: Income earned through own personal exertion before tax but after any expenses incurred in earning that income.*

# RECENT EXAMPLES

- 
1. March 2008 application
    - AV monthly benefit of \$8,000.
    - Annual income \$176,000
    - Income had increased in last 12m months due to increase in contract fees to \$3,400 per week. No expenses were stated.
    - Previous FY(2007) ITRs show total income of \$87,000 – after deduction of expenses.
- What is the basis of \$8,000 MB? Income \$176k supports \$11kMB.
  - Insured stated no expenses. Previous FY ITRs showed expenses. What changed?

## Recent Examples

- 
- UW noted maximum benefit supported \$6,000, but noted advised rate increase.
  - UW Decision: Allow \$8,000 AV “financially unverified”
  - Feb 2010: Claim. 2008 ITR supports MB \$5,600.
  - What is intention of ‘financially unverified’ decision? No remedy at claim.
  - Potential options?
    - Offer Indemnity
    - Offer \$6k AV; \$2k Indem
    - Further clarification
  - Claimant now better off on claim

# Recent Examples

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## 2. App. for \$3,250 MB(indem)

- 50% partner in business. Bus. Income stated as:

*Business Revenue*     \$450,000

*Total Expenses*     \$400,000

*Net Income*     \$50,000

- \$3,250 requires annual income of \$52,000
- 50% of net income = \$25,000 (provides \$1,563MB)

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- Further answers also stated:
    - 0% interest in business
    - \$0 in addbacks
    - Separate subsequent statements of \$52k & \$10k
  - UW decision: *Financially OK (no further questions asked)*
  - Query 0% interest?
  - Is \$52k paid out of \$400k business expenses?
  - What is actual entitlement? \$52k? \$52k + \$25k?
  - What level of responsibility sits with UW to ensure :
    - Adequate cover?
    - Not paying for benefit never likely to receive?

## Recent Examples

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### 3. App. For \$7,200MB

- 100% owner of business
- net profit of \$635,000
- reported addbacks of either \$48,000 or \$96,000 (both provided).
- annual income for himself of \$48,000.
- Tele UW confirmed an annual income of \$50,000. However, benefit of \$7,200 still accepted.

MB therefore of either:

i. \$30,000 (based on income of \$731,000 or \$683,000 (due to UW limits))

ii. \$3,000 based on \$48,000

iii. \$3,125 based on \$50,000.

However, no supporting evidence or basis for MB of \$7,200.



Points to consider:

- Do they understand/have they referred to the relevant policy definitions in their consideration of income and expenses.
- Have you read and thoroughly considered their report?
- Do you agree with the outcome?

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## EXAMPLE:

- forensic accountant review of claimant's post disability earnings resulting in FA's opinion of \$400k overpayment.
- Without review or consultation, assessor wrote to claimant demanding repayment of \$400k overpayment - resulting in a complaint.
- On review – and after further consideration of the policy terms, the overpayment reduced to below \$100k.
- Due to the anxiety caused by the initial overpayment advice and subsequent loss of good will between the insurer and the insured, the overpayment was waived.

# Take Away Points

- Ensure information provided makes sense
- Consistency across and within departments (guidelines etc)
- Refer to policy terms and conditions
- Don't be afraid to question (clients; FAs; each other)
- Be nice



# Determining Income – some considerations

*Paul Hastings*  
*LifeRisk Insurance Solutions*  
*LDG Seminar*  
*18 August 2010*



## What is Income – to an underwriter?

**Income for a self employed person includes -**

- ✓ Salary
- ✓ Profit share
- ✓ Superannuation
- ✓ ‘add backs’ – donations, motor vehicle expenses

## What is income – to the case manager?

**It's all about the policy. Sample definitions include:**

- “income earned by the life insured from **personal exertion** in (her) usual business...less business expenses necessarily incurred in earning that income (but before personal deductions and income tax”
- “if the ...insured owns part, or all, of a business or practice, income is money generated **by the business** due to the person insured's **own activity...**”
- investment earnings may be excluded

## Is it 'apples with apples'?

**Not necessarily.**

- Compliance with policy terms
- Circumstances of each case must be examined:
  - business maintains previous level of profitability
  - business has multiple owners
  - insured owns, or has interest in, a number of business entities
  - insured's business has made a loss pre disability

# FICS determination 13142

## Partnership situation with income splitting

### Panel Determined

- income must be attributable to the insured's 'personal exertion'
- Neither party applied policy to the facts
- Tax returns not determinative of 'income'

### Guiding principles

- apply calculations to relevant periods
- analyse proportion of working time between wife and husband
- analyse actual income earned from personal exertion
- analyse hours worked & quality of function
- income relied on at application irrelevant

## FICS Determination 15755 (April 2008)

### Application (Dec 2001):

- Occupation – concrete cutter; employee of own company
- Income - \$49,000; last year \$45,000; previous year \$42,000

### Claim

- Insured returned to work 2 hours/day doing sedentary work.
- Insurer refused PD benefits as insured's "earnings" exceeded pre-disability earnings
- Income of business generated by insured & 2 employees

### Policy

- 'Income' linked to personal efforts of the life insured'



## FICS Determination - 15755 (cont'd)

- Reviewed structure of insured's business in detail
- What is meant by 'personal efforts of life insured'?
- Noted *FCT v Everett* that profits from ownership of business are not necessarily due to personal exertion if “*..there is little energy being devoted to the practice*”.
- Manner of calculation of income not as crucial as consistency of approach at all relevant stages – underwriting, pre-disability and post-disability

## FOS D15755 – Determining Income

- Member's approach may be seen as a disincentive for a person to rtw
- Considered philosophy behind approach and looked at:
  - PDS
  - Application (language re 'income', employee & s/employed – not defined)
  - Underwriting guidelines
  - Policy (no reference to 'add backs' etc...)
- Key is to determine the “energy being devoted” in terms of profit it is producing. But, not logical to base this merely on hours worked.
- Fair to say profit generated by efforts of life insured.

## Issues for consideration

### Policy Terms

- definition of income (including time periods)?
- linkage to 'personal exertion'
- 10 hours/less than 20% of earnings
- what is 'work' or 'gainful employment'
- Right to reconcile? What are 'add backs'?

### At Underwriting

- Understanding the above
- What is benefit assessed against? Evidence of this?
- merits of 'financial underwriting'? Impact of 'guarantees'?
- Understand how claim would be assessed?

## Take Aways.....?

- **Awareness of real world application of policy terms**
  - link between personal exertion and income received
- **Collaboration between product, u/writing & claims**
- **Limits of the ‘claims fix’**
- **Forensic Accounting**
  - reference to policy & substantiation of assumptions
  - if in doubt, challenge
- **Tax law not determinative of income**