PERSPECTIVES

The Difference Between Lost Wages and Lost Income Analyses From a Forensic Accountant's Viewpoint

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INTRODUCTION

Forensic accountants are frequently retained to evaluate economic damages arising from a multitude of circumstances. These engagements require a set of specialized knowledge unique to the facts of the particular case. In many cases a forensic accountant will be retained to evaluate lost income arising from a business interruption loss.

This article compares a forensic accountant's involvement in a lost income analysis to that of a lost wage analysis. The expertise required for these analyses can be both very similar and very different, so it is important to retain a forensic accountant who is well versed in the specific type of damages being evaluated.

Basic Analysis of Lost Income & Lost Wages

The formula for evaluating lost income can be simplified to just a few components. It can be described as ***Projected Revenues less Actual Revenues equals Lost Revenues.*** From the calculated lost revenues, you then subtract variable operating costs, which often include components such as cost of goods sold, repairs and maintenance, etc., to arrive at a net business income loss.

Projected Revenues – Actual Revenues = Lost Revenue – Variable Operating Costs = Net Business Income Loss

While the intricacies of these calculations can be quite complicated, the above formula is the general roadmap to all lost income measurements.

When evaluating lost wages, the general formula for measurement is relatively similar to that of lost income, in that, instead of lost revenues we are measuring lost wages / earnings. In addition, instead of variable operating costs, we are considering other types of unincurred expenses.

Projected Wages/Earnings – Actual Wages/Earnings = Lost Wages/Earnings – Unincurred Expenses = Net Lost Wages/Earnings

Despite the surface level similarities there are several meaningful differences between these two types of analyses that need to be thoroughly examined.

Duration of Measurement

First, the duration of measurement in a lost income calculation is often in hindsight and / or for a limited duration into the future. In other words, when evaluating business income losses, we are often reviewing what happened while the business, which has since reopened, was closed. Alternatively, in a lost wage measurement the calculation is often measured in perpetuity ending only with the impacted individual's life or work-life expectancy. In many cases, this could involve projecting wage loss for some future timeframe in excess of 20 years. As a result, lost wage analyses often require the forensic accountant to determine the appropriate timeframe of measurement (i.e. what is the individual's actual remaining work life and / or life expectancy) whereas business income may not involve this component. Under either assignment, projections into the future will likely require additional considerations such as the net present value of future losses.

Sources of Income

Another noteworthy difference between evaluating a business income loss and an individual's wage loss is that wages can come from multiple avenues whereas lost business income is typically from one source which is frequently customer sales. In the context of a lost wage analysis, due consideration should be given to the fact that a single individual could have multiple sources of income that could be affected by the relevant incident in vastly different ways. Detailed review of each income source would need to be considered to properly evaluate impacts on the individual's true earning capacity before and after the incident.

Additionally, a lost wage measurement could include losses stemming from various triggers such as base wage, overtime wages, and / or benefits. The continuity of each of these factors could also vary tremendously and would need to be independently evaluated when determining lost wages.

Finally, when projecting an individual's earning capacity into the future it is important to remember that an individual's earning capacity has limitations which need to be considered. For example, if the injured individual had been working 80-hour weeks leading up to the injury, is it reasonable to expect they would have continued to do so for the duration of their work life or is there some timeframe in which would be more probable for an individual to sustain that level of work? In the instance of lost income analyses, however, a business may have opportunities to expand their capacities via additional payroll, etc.

Mitigation Opportunities

Perhaps the most distinctive difference between a lost income and a lost wage analysis is the opportunity for mitigation. With regard to business income losses, the business is often limited in its opportunities to mitigate. These opportunities could include things such as utilizing a sister location and / or making up losses upon reopening. In the scenario of a lost wage analysis, however, the mitigation opportunities are limited by the individual's capabilities. In other words, an individual's industry, line of work, type of services, etc., could be flexible in certain circumstances to allow for mitigation of lost wages. Given the lost wage projections are often into the future, the evaluation of future mitigation can often involve a level of hypothetical considerations and evaluations as to the reasonableness of such.

In the case of a very young, injured individual, it may be reasonable to expect the individual to go back to school and obtain another degree in a different area of study. However, if the injured party is nearing retirement, then this alternative is less likely to be reasonable or feasible for purposes of mitigating future losses.

Saved Costs

With regard to saved costs, lost income analyses are often a bit more straightforward in that there is often only one source from which saved costs are determined (often the income statement). With regard to lost wage analyses, especially those involving a business owner, there may be multiple sources from which saved costs are being evaluated such as both the business and personal tax returns. The thought process and analysis of determining which costs would or did cease during the relevant period is consistent in that we are looking to determine costs that would have been incurred but were not due to the specific cause of loss.

Case Study

In this example, we were retained by the defense to evaluate lost wages arising from an incident that involved a gymnastics studio that was owner-operated. This studio was fully closed for six months because the owner was injured and unable to teach the classes. Pre-incident, the studio was consistently bringing in $20,000 in monthly revenues with $5,000 in variable expenses every month. We were engaged to evaluate the wage losses arising from the owner's injury. The owner had presented her claim on a lost income basis rather than a lost wage basis. The below shows the outcome of each approach.

The claim was presented as follows:

Lost Revenue $120,000 ($20,000 X 6 months) less Variable Operating Expenses $30,000 ($5,000 X 6 months) = Business Income Loss (aka Claim) <u>$90,000</u>.

In this instance, the claim failed to acknowledge that the business itself was not the injured / impacted party but rather the owner was. The proper analysis, in this case, was to evaluate the individual's wage / earnings loss rather than the business. In some cases, these two analyses may be the same or very similar. However, in this case they were not. Through our review of local news outlets, we were able to find that the owner recently opened a new business. This new business was a seasonal crawfish food truck that was operated during the six-month closure of the gymnastic studio and was set up in response to the owner's injuries from this incident. The owner failed to report the existence of and the financial results of this business. However, when we were able to obtain the necessary documentation, we determined the losses were substantially less than claimed because the crawfish business had in fact yielded profits which offset those that were incurred due to the gymnastic studio's closure.

It's worth noting that not every example will be as flagrant as the above wherein the injured party is a business owner who embarks on a completely new venture which serves to mitigate the loss. Nevertheless, when that does occur, it is important to acknowledge and consider any costs associated with getting the new venture up and running, including but not limited to, costs to obtain additional schooling and / or credentials to operate the new business. In our example, these costs included obtaining the proper food service licenses, fuel costs, and advertising costs, among others.

Alternatively, in some cases it may be more advantageous for the injured party to invest additional expenses into the original business to maintain operations. These types of expenses, while allowing for business continuity, would in fact impact the owner's personal income and should be considered. For example, the owner in the above example could hire temporary help to mitigate the losses during the injury. In this case, this could include hiring a temporary coach to teach the sessions while the injured individual was unable to do so.

CONCLUSION

While lost income and lost wage analyses are often very similar conceptually, they each require a unique set of investigation and analyses. Retaining the proper expert with experience in the specific circumstances at issue in a given case will yield the most accurate analyses.

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