BUSINESS INCOME MADE SIMPLE

Business Income (BI) insurance is the most complicated and misunderstood insurance product. As a result, seventy-five percent of businesses suffering major property damage are out of business within three years because they did not have a tested contingency plan or the proper financing to see them through the period of recovery. Each year businesses and insurance companies are losing millions of dollars and litigation becomes an ugly factor.

There are three areas of concern: since businesses are in denial, the underwriter is not receiving the proper premium for the total exposure; agents and brokers are losing income and being sued because the insured did not read their policy; and the insured is not getting paid what they expected.

Agents, underwriters, and insureds need to do their part to produce a policy that is properly valued and accurately protects the organization's real exposure. Since adequate protection is the goal, thorough preparation is key.

At the same time, everyone is confused and irritated by the required business income worksheet. Underwriters do not receive one, agents get caught in the middle and sometimes must complete one, and insureds complain the worksheet is cumbersome and does not fit their business. The result: no BI worksheet in file. We want to resolve these problems by identifying the most common problem areas in the policy and provide solutions to consider.

Let us begin with the semantics. While the two terms, business income and business interruption are often used interchangeably, they really mean different things. Business interruption is what happens to a business (fire) while business income is the insurance coverage organizations buy to replace their lost income and pay their additional expenses during their period of recovery.

Insurance Contract: Commercial Property and Business Income

First of all, there must be direct physical damage to the described property which impairs operations and causes a loss of income. The period of restoration (recovery) is the claim payment period and stops when income reaches its expected level. However, some polices say that the period of restoration ceases when you are able to resume operations (turn on your machines or pick up the telephone). This latter type of policy wording does not factor into the recovery period the time it takes to reach projected sales.

Business Income coverage pays for **actual lost business income** (lost **FUTURE** sales during the recovery period). However, many of the insurance company accountants deny there is ever lost future sales because they say businesses will make it up. WRONG! However, the business must be able to substantiate their loss using sales forecasts with historical accuracy, specific lost contracts, expected sales, etc. You must be very careful to differentiate between deferred sales and lost sales. Also, there is a clause in the policy that limits the amount of loss payable for multi-year sales contracts that are cancelled within the recovery period. For example, if you have a three year contract with Ford Motor and a fire interrupts your business, when Ford Motor cancels the contract, you may only claim the amount of income lost during the recovery period (one of three years). This really catches a lot of businesses by surprise and costs them millions of dollars.

It is important to emphasize to insurance buyers that they should carefully read the entire insurance policy to determine rights, duties, and what is, and is not covered. This places the responsibility on the insured and forces them to determine their own proper risk management.

Let us review the **ISO BUSINESS INCOME (AND EXTRA EXPENSE) COVERAGE FORM.**

Rents may be included, excluded, or by itself. This coverage protects income from a third party who has an "arm's length" relationship with the insured. For example, the jewelry counter or shoe department in a department store is owned by another company and they lease space from the department store and pay a percentage of their sales as rent. If the department store burns down, the store loses this rental income.

Rents are an area of confusion because quite a few organizations have separate entities for their operations and for their realty ownership. For example, the president owns the real estate and the operating company pays him rent through his realty company. This is simply two pockets of the same suit and not considered rent protection as long as both entities are named insureds on the policy. The business income policy pays the rental expense as a continuing expense of the operating company, so it does not have to be added as additional income.

Business Income is defined in the policy to be net profit or loss, and continuing normal operating expenses including payroll.

For example: sales minus cost of sales = gross margin or gross profit (and is approximately the 100% B.I. amount).

Net sales:	$10,000,000	
Cost of sales:	- 7,000000	
Gross profit:	$3,000,000	approximate annual business income amount

As a rule of thumb, combined BI and extra expenses should be approximately:

Manufacturers:	100% of their gross profit
Wholesalers:	50% of their gross margin
Retailers:	30% of their gross margin
Service:	15% of their revenues

Do not use this to determine insurance limits, but this will help prioritize your accounts so you are able to spend time on those needing the most attention.

Ordinary Payroll causes a lot of problems for everybody. Businesses think it is direct labor, cash labor, warehouse, or temporary help, so they exclude this coverage from their policy. However, it is defined in the policy to be everybody below the department manager level.

When this is explained to the insured, their usual comment is that they cannot afford to lose those people and want them included.
At the same time, if they do lay off their employees after a disaster, their unemployment tax rate increases, they have less qualified people in the job pool when they recover, and they have lost their reputation in the community. After working with several companies following Hurricane Katrina, the business owners discovered that after they had rebuilt their facilities and contacted their employees to come back to work, very few of the employees returned because they had found other jobs. Consequently, these businesses folded because they had no experienced employees to produce their product.

Law and Order: Remember to endorse "building ordinance" and increased cost of construction because while waiting for the property to be repaired, you could be losing a significant amount of sales.

Common Areas: If there is no physical damage to the premises, there is no business income coverage. There have been several high rise office buildings damaged by fire, hurricanes, tornadoes, etc., but because a specific suite was not damaged, their claim was denied even though there was no access to it. The ISO policy includes common areas as part of the premises definition, but many policies currently in the market do not. It should be part of the premises description so that a tenant's premises include all internal access routes (hallways, stairs, elevators, etc.).

Deductible: Most business income policies have a twenty-four to seventy-two hour deductible for lost income with no deductible for extra expenses. Some policies define it to be "normal business hours" which means a company working nine to five with a seventy-two hour deductible would subtract nine days from their claim.

Extra Expenses: Do not confuse expediting expenses with extra expenses even though some policies mistakenly call expediting expenses "extra expenses". The difference is that extra expenses pays ALL the expenses above normal operating expenses incurred to recover from a disaster. However, expediting expenses only pay the expenses that directly reduce lost income.
For example:
Extra Expenses is all the necessary money spent to avoid or minimize the suspension of business. $ 750,000 reduces the loss $ 500,000, but it pays all $750,000.
Expediting Expenses are the monies spent that actually reduce the loss. $750,000 spent reduces the loss $500,000 so it only pays the $500,000

Civil Authority: Access to premises denied by civil authority due to adjacent property damage, commonly has a twenty-four to seventy-two hour deductible with coverage for a three week period. There is no coverage for evacuation prior to the flood or hurricane, only for denied access after the disaster strikes because it is the physical damage that triggers the coverage.
For example, three days prior to the hurricane, the city is evacuated. Three days after the hurricane makes landfall, the access denial is lifted. However, your landlord denies you accessibility while they check the building for damage. Three days later they say there is no

damage and allows entrance to your premises. What is the civil authority period of claim? The three days from hurricane landfall to access denial lifted by the city. This causes a tremendous amount of confusion for the insured and is even more reason for them to have a well-planned contingency plan that includes conversations with the landlord about how quickly they will open the building or find other space for you.

Extended Period of Indemnity: There is an automatic extended period of indemnity of thirty days in most policies, but this may not be enough to allow the business to reach their projected sales once they have resumed operations. The business usually needs at least ninety, one hundred eighty, or even three hundred sixty days if there is any seasonality to the business. Once again, the contingency plan identifies this need for the business.

Loss Conditions fosters several areas of concern:

1. **Loss settlement fees**: Endorse "claim preparation" or "loss settlement fees" of $25,000 to $100,000 to pay for "experienced" help calculating the loss.

2. **Duties in the event of loss**: Educate the insured so they know what to expect and what their responsibilities are as well as how to submit their claim. A business owner stated he lost $10 million because of the hurricane, but when pressed, he was just submitting his policy limit.

3. **Loss Determination:** Excludes community-wide disaster impact. For example, a hotel could have had 125% occupancy because all the hotels in the city were destroyed but their historical occupancy was 85%. Their claim will be based upon that 85% number, not the 125%. They cannot make money from the disaster.

4. **The Loss Payment Clause:** Also causes a lot of frustration because the insured misread this statement. It says the insurance company will pay thirty days after <u>agreement on the amount of loss</u> has been reached, NOT thirty days after claim submission. Since even minor business income claims take a long time to come to agreement, it is imperative that the insured have alternative financing available for their cash flow while they are working on their claim amount.

Coinsurance: Really causes problems at the time of the claim and states that if the insured's business income limit is mathematically incorrect at the time of loss, then the insured will pay that error percentage of the claim.

For example, the policy says there is a $1million limit with a 50% coinsurance clause. This means the 100% amount would be $2 million. If, at the time of loss, the 100% amount was $3 million, then the limit should be $ 1.5 million (which is 50% of the $3 million) and the insured would be penalized 33% of their claim. ($1million versus
$1.5 million).

One client was penalized 85% of their $750,000 loss because they had not revised their insurance limits or coinsurance amounts in several years. The coinsurance penalty is cause for a lot of lawsuits and a lot of unpaid claims. Put agreed amount on the policy and eliminate this problem. However, to do so, requires a signed worksheet in file showing future projections of income. No worksheet, then coinsurance applies.

Since most ISO companies have only filed rates to go down to fifty percent or six month coverage, there are two other options available for businesses that want less than six months protection.

Maximum Period of Indemnity Actual loss sustained for 120 days. No coinsurance applies, but this pre-settles the loss period and will not pay for a partial loss that exceeds the one hundred twenty days.

Monthly Limit of Indemnity: Is a commonly used endorsement that provides a chosen monthly percentage of the limit. 33% provides one third of the limit for three months, 25% gives one fourth of the limit each month for four months, etc. No coinsurance, but the problem is that this endorsement also limits the loss period and the amounts are not additive. In other words, use it or lose it.

For example, a $100,000 limit with 33% monthly limits would be

Month 1 lost	45,000	Policy pays	33,000
Month 2 lost	27,000		27,000
Month 3 lost	38, 000		33,000
Total lost	$110,000		$ 93,000

Now let's discuss the infamous worksheets. They are an integral part of the insurance selection process because they easily determine an organization's financial risk/exposure to loss. If "agreed amount" coverage is requested, insurance companies must have a signed worksheet in file from the insured per state regulations. Additionally, the worksheet ensures that the underwriter will receive proper pricing on the policy and completing it is also "good practice" for the insured so they know how to calculate their loss.

We have completed over a thousand worksheets for all types of organizations and the issues are always the same. “This worksheet does not fit our business.” “We calculated a negative amount.” “Where is payroll covered?” “What about spread of risk?”, etc. In response, we have simplified the worksheet completion process by developing sixteen industry-specific electronic worksheets on our website that calculate the totals for you.

The intent of the Business Income worksheet is to allow an organization to estimate the financial impact of a disaster. It also helps the underwriter understand the insured's logic and feel comfortable that the numbers used "make sense". For example, if the sales number doubles next year, then the number for payroll and inventory should also almost double.

Several scenarios may be used for the worksheets to see what the financial impact would be. Then, choose the scenario that best suits the organization. A worksheet may also be completed for each location to see how they affect the organization. The worksheet is almost never used at the time of loss, partly because hardly anyone completes them, so the only penalty for worksheet error is either over or under-insurance.

Most insureds do not realize that they can change their business income limits in the policy period. I always suggest that they review their calculations at least quarterly to see if there have been any material changes and with an electronic form, it takes them only a couple of minutes to see how the changes impact their exposure. That way, they will make sure their insurance protection is keeping up with their business.

WARNING: Since only the business owner has a thorough understanding of their business operations, it is **their** responsibility to complete and sign the worksheet. Insurance professionals should not attempt to fill out the worksheet, as it becomes an E&O liability if the improper amount of insurance is purchased.

So let's take a look at the ISO business income worksheet. Since this is a one-size-fits- all form, you cannot choose the appropriate worksheet for your business. However, there are several other sources for worksheets that may be accessed for a more appropriate worksheet. For this explanation, we will use the ISO form as it is the most common. It has four columns, the first two are for the current fiscal period and the second two are for the projected fiscal period. It is the calculation in the right hand column that determines the exposure, as it is future income that needs to be protected.

Keep in mind that the loss may not occur until the last month of the policy period and then continue for a year into the future. This means if the policy period is 9/30/08 to 9/30/09, you must project the loss into 2010. In most cases, this is a very large number so start with a 2009 loss projection and then check the calculations quarterly. It may be June 30, 2008 before we project our loss into 2010, and then endorse the policy accordingly.

INCOME

Page one, is the cover sheet that indicates who completed the form.

Page two is where the **total annual business income amount** is calculated. This is the amount of **income** that will be lost while the operations are interrupted. Use the most recent fiscal year-to-date Profit and Loss statement for the calculations. The intent of the worksheet is to develop the income, (**revenue or sales**), from operations. If the business does not actually receive the money: returns, discounts, etc., it is not included in the amount at risk. Also, subtract income not at risk, such as royalties, license, or rental income from the amount at risk. Disregard continuing income, such as bank interest received, investment income (**financial institutions will include this**), and income from sale of assets, because these monies are not generated from operations. Finally, do add items to income that may be found "below the line," such as sale of scrap, commission income, and third party rental income. **You now have total income.**

On page three, **cost of sales** (materials and supplies), is subtracted because if you cannot manufacture or sell your product, you do not need to purchase raw materials. Do not automatically subtract "cost of goods sold" as there may be payroll included in this amount that you do not want to subtract. Only subtract cost of materials and supplies.

Manufacturers also need to adjust their **net sales** for "production value". If production is increasing, future sales should also be increasing. This means you subtract the beginning finished goods inventory at sales price because that was last year's production. Then add the ending year finished goods inventory at sales price because that reflects your production activity for the current year. You now have the value of manufacturers finished stock for the property policy.

Finally, subtract the **expenses that discontinue** directly with the loss of sales. ISO does not have this line so you would have to include this amount with “Cost of Sales”. For example: subcontractor costs, rental equipment, or temporary help that would discontinue if the operations were shut down. These amounts need to be accurately identified, or you will be misrepresenting your income at risk. When in doubt, omit (do not subtract) it. A shortcut is to take Net Sales minus Cost of Sales. This is the **100% annual business income amount**.

Page four is the **summary** section that puts everything together. The ISO form does not provide for dividing total income by **spread of risk**, or the number of locations, so a separate worksheet must be completed for each of the largest locations. For example, if there are three, widely separated locations with redundant operations, prepare three worksheets and keep in mind the largest location when looking at the exposure. Then get blanket insurance for the largest value. If the majority of income is from one location, use that one for the blanket limit. However, if you have seven facilities of various sizes and locations (some close to others), divide by three because two locations may go down at the same time.

Now determine if you are excluding **ordinary payroll**. Be very careful! This is a common cause for undue distress and increased loss. Keep in mind, you may not exclude more months of payroll than the recovery period. For example, for a six month recovery period, you may not exclude twelve months of payroll. Also, if you are choosing a recovery period of less than five months, you cannot exclude ordinary payroll at all. In any event, the worksheet requires a subtraction of all payroll (do not forget to include taxes, benefits, WC premium, union dues, etc.) and then add back the largest amount of payroll to be insured for either ninety or one hundred eighty days. Remember, you are pre-settling the loss and there will be no coverage for the excluded payroll outside the chosen period. For example, if ninety days payroll coverage is chosen, a loss that goes beyond the ninety days will have no coverage for payroll expenses. Without sounding like a broken record, the Business Contingency Plan will determine how much payroll coverage is needed.

After subtracting ordinary payroll, we add the extra expenses to get the **combined business income and extra expense** value for the total disaster financing need.

Missing from the ISO form is the last calculation to determine the coinsurance rating factor. It is necessary to take the annual Business Income Basis on page four and apply the estimated recovery period as a percentage of a year. For example six months = 50%. Then select 50% of our annual business income basis and add the extra expenses to determine the total business income and extra expense policy limits.
For example:
$5,000,000 is the 100% Business Income X 6 month recovery period = $2,500,000 (50%)
Add $3,000,000 extra expenses needed for the recovery period = <u>$3,000,000</u>
For a total of: $5,500,000

EXTRA EXPENSES

As noted, there is no extra expense worksheet with the ISO form, although ISO is coming out with a buyer beware template that may be used. We have automated the extra expense worksheet on our website and other sources have a form that can be completed manually. In these non-ISO forms, the extra expense worksheet calculates the amounts necessary to reduce the recovery period to the shortest possible time which would then be identified by the coinsurance percentage selected (six months recovery = 50%). A Business Contingency Plan is crucial to ensure accuracy in estimating these extra costs, as well as estimating the duration of the recovery period. **Note: Determine that the policy coverage is for extra expenses, not expediting expenses.**

For example, if normal rent is $10,000 per month and the temporary rent is $12,000 per month, then the extra expense is $2,000. However, the insured may be contractually obligated to continue making rent payments for three months before they can stop, so then the first three months of temporary rent would all be extra expense. Finally, estimate how long it will take to fully recover normal operations (**number of months for complete recovery**) and multiply the total monthly extra expenses by that number.
For example $500,000 per month X 6 months = $3,000,000.

Reaching the projected sales level after restoring operations is the **extended period** for business income and **must be endorsed on most insurance policies. Also, extra expenses may not be covered during this extended period, so make certain to check the policy.**

Finally, we come to the claims component. We have been asked to help with a large number of claims and always end up spending quite a bit a time educating everyone on what the policy says and how the claim should be calculated. This has become such a repetitive situation that we finally automated the claims submission process on our website which allows concentration on the relevant issues of recovery period and lost sales amount.

Insurance companies unnecessarily spend approximately $2,500 per claim in LAE expenses hiring forensic accountants to show the insured what their realistic claim amount should be. Also, agents and brokers spend many hours of non-billable time hand-holding, talking to the adjuster, and explaining the policy to the insured. This unnecessary time and expense could be better used getting the insured properly prepared and adequately protected up front.

The insured is responsible for calculating and submitting their claim to the insurance company and, to protect their interests, should hire their own specialist to do so. There is usually coverage to pay some of this expert’s fees in the loss settlement fees section of the insurance policy. That way, the business owner retains control over the claim process and any business considerations that should be included. Remember, it is the insured’s responsibility to tell the insurance company what they lost and how much they expect to be paid. This is not a whimsical or unsubstantiated number, but a well-documented, calculated amount. It seems incongruous that the insurance company will send an accountant to the insured to tell them how much the insurance company should pay.

The biggest problem with business income claims is an unrealistic projection of lost sales and an inaccurate recovery period. Discontinuing expenses to be subtracted are another area of confusion. Most forensic accountants use a computer model to calculate all expenses as a percentage of sales and then arbitrarily subtract some of each line item. For example, utilities are 4% of sales so a 1 month interruption would be 4% divided by 12 or 0.33%. This amount would then be subtracted from lost sales as a discontinuing expense regardless of the actual utility costs during this period. We will save further detailed business income claim discussions for another article. Suffice it to say, a little forewarning goes a long way in reducing the negative impact of a business income loss
and insurance companies would be better served spending their money educating the insured instead of defending lawsuits.

In summary, prudent people plan for the worst case scenario. Make certain the financial impact has been carefully assessed and financed. Review both the commercial property and business income insurance policies to ensure full protection and make certain to use the combined form with agreed amount. Do not exclude ordinary payroll and make sure it is the business owner who completes and signs the worksheet. Being prepared offers the best protection.