Considerations in Setting Business Interruption Values

Business interruption insurance (BI) is vital for almost every business. Property insurance will pay to repair or replace damaged property, but without BI coverage, companies might fail before their facilities are restored. BI helps businesses retain their net profits and continuing expenses for a period of time following a loss. The concept is simple enough, but estimating how much coverage is necessary can be complicated. This is especially true for rapidly growing companies and companies undergoing significant changes, but even stable companies need to take into consideration an array of economic, industry and company-specific factors when determining how much coverage is appropriate.

Standardized worksheets to calculate business interruption values are available, and in fact may be required by insurers as part of the application for coverage. Insurance buyers for smaller companies, with the help of their broker, will likely complete the worksheets themselves. Larger companies may use a CPA to be sure all contingencies are addressed. But whether a company uses an accountant or relies on assistance from its broker, the insurance buyer should understand how current financial information translates into adequate BI values for future losses. An informed buyer can provide more meaningful input to advisors in the estimation process, will be better prepared to make decisions based on the recommendations of a broker or accountant, and will be armed with information for day-to-day risk management purposes. Additionally, understanding how BI values are calculated, and how they relate to the terms of the policy, can help ensure a smooth transition in the event of a claim.

Understanding business interruption insurance

Business interruption coverage, which also is known as business income coverage, is the most common of several so-called time element coverages designed to respond to a disruption of business activities. Other popular types of time element coverages include extra expense coverage, which covers the additional costs of operating a business at the same or different location during the period of recovery, and contingent business interruption coverage, which responds to losses caused by damage to associated businesses such as key suppliers or customers. Most companies are well advised to purchase a package of time element coverages appropriate to their needs, but almost every business needs, at the very minimum, business interruption coverage.

BI is provided as part of a commercial property policy or a business owner’s policy (BOP). BI coverage is triggered by an insured property loss. Recoveries are subject to a separate BI deductible, and may be further subject to so-called coinsurance, which essentially is a penalty for underinsuring. Recoveries are calculated in one of two ways; either net income plus continuing expenses (net income method) or net sales minus non-continuing expenses (gross earnings method). The final amount should be the same under both methods.
Determining appropriate BI values

Since BI covers lost net profits and continuing expenses after a major fire, a natural catastrophe, or another insured event, the goal in setting BI values is to conservatively estimate a company’s future revenues and expenses. The process can be relatively straightforward for small, stable companies, though all companies need to take into account the impact of macroeconomic, legal and regulatory factors. Larger or more complex companies, and all companies that are growing or experiencing material changes in structure or strategy, need to consider a wide array of variables to be certain that the calculated BI value is the best estimate of the company’s future financial state.

The following questions will help buyers to understand some of the key considerations in setting BI values. They highlight common issues with both the information used in business income worksheets and the process of transforming that information to the values used to determine the amount insured and the BI premium.

Business income worksheet calculations

Almost all business income worksheets include current revenues and expenses, forecast changes in those revenues and expenses during the following 12 months, and adjust for certain non-continuing expenses. The following considerations should be kept in mind when completing these worksheets.

- Is the financial information complete, accurate, and up to date?

  The starting point for calculating BI values is revenues for the most recently completed twelve month financial period. Most worksheets take a top-down or deductive approach to calculating this value: annual net sales plus other earnings from business operations minus certain non-continuing expenses. Often the insurance buyer will need to solicit the help of the accounting or finance department to get all the required information. To smooth the process and to assure all the necessary information is as complete and timely as possible, insurance buyers should identify the data elements needed to complete the worksheet and assemble the information well in advance of applying for coverage. More complex companies may require input from a number of different business units.

  Using current information is important, especially as the economy recovers from the worst downturn since the Great Depression. However, companies vary in their ability (and willingness) to produce complete, accurate and timely financial information on demand. If insurance buyers and their advisors need to use older or incomplete information, it is important that they understand where gaps exist or where more current information, if it were available, would likely differ.

  Insurance buyers should keep in mind that rapidly growing businesses may need to update BI values more frequently than once a year as.

- Have all the factors potentially influencing changes in the business over the next 12 months been taken into account and properly quantified?

  A critical factor in establishing adequate BI values is a realistic assessment of how revenues and expenses will change over the coming year. Most companies have budgets that can be referenced to adjust revenues and expenses. However, if budgets are more than a few months old, changing conditions may already have diminished their relevance. Additionally, budgets may not take into account important changes such as a proposed acquisition. Budgets also may discount the value of future events that could have significant impact on revenues, such as the likelihood of closing large deals still in the pipeline.

  In addition to changes within the company itself, external factors need to be taken into consideration. These include economic changes, the competitive landscape, factors that could impact suppliers or customers, and regulatory developments.
• Have expenses been properly identified and incorporated in the calculated BI value?

BI covers net profits and continuing expenses. Expenses that would not continue as the company rebuilds, and therefore are not included in the settlement of a BI claim, could include:

- Materials and supplies,
- Services that would not continue under contract,
- Variable energy costs

So-called ordinary payroll – payroll for other than managers and other essential employees directly involved in rebuilding the business – typically would not continue. For businesses concerned about losing trained employees while there is no work, ordinary payroll coverage is available to continue paying salaries and benefits.

Although non-continuing expenses are not covered in claim settlements, most expenses, should be included in the business income worksheet and factored into the BI value used to set limits and premiums.

• What factors could influence the time it could take for your company to recover after a major event such as a large fire?

The “period of restoration” is the period of time after a loss necessary to get the business open again. It can be a key factor in helping to determine the appropriate amount of BI coverage: the selected period, expressed as a percentage of a full year, is multiplied times the 12-month projected net profits and continuing expenses to arrive at the initial BI limit of insurance.

There are no standard rules for determining duration, but buyers should keep in mind that in the event of a large natural catastrophe such as an earthquake or hurricane, limitations on such necessities as labor, materials and infrastructure services can slow the recovery process. Zoning changes since the original facility was constructed could slow or derail plans to rebuild. On the other hand, some factors can accelerate recovery. Companies with well-conceived business continuity plans in place, for example, most likely will recover more quickly from a loss.

Other considerations
A number of factors can influence how severely a business will be impacted by a loss and how quickly it will recover. In some cases other related time element coverages can be enormously valuable.

• Following a fire or other catastrophic occurrence, would your company be able to resume some or all of its operations at a temporary location?

If a company can continue to operate at an alternative location while the permanent location is rebuilt, the impact of the loss event can be significantly reduced. However, it is likely that additional costs will be incurred to procure, set up and operate the alternative location. Extra expense coverage should be considered for this eventuality.

• How much revenue would be lost if a major supplier suddenly was unavailable or if key customers were unable to buy from your company?

Companies relying on a few key suppliers could be in serious trouble if one or more of those suppliers were forced out of business by a fire or a natural catastrophe. Similarly, the loss of a key customer could be disastrous. Companies with vulnerabilities to key suppliers or customers should consider contingent business interruption coverage.
The importance of accurate BI values

Needless to say, no business wants to discover that, after experiencing a devastating loss, it did not purchase enough insurance to make it whole. With BI insurance, it is doubly important that companies buy the correct amount of coverage because of the coinsurance clause found in most policies. Coinsurance is essentially a penalty for underinsuring. The rationale is that a higher premium would have been necessary for the same amount of coverage if it was known that the policyholder did not have the required BI limits.

Insurance buyers cannot be expected to be experts in business interruption insurance, but it is important that they are knowledgeable about the coverage and how BI values are calculated. Knowledgeable buyers can facilitate the process of determining adequate BI values for a company and will be better prepared to work with their broker and underwriter to be sure they are well protected.

Checklist of considerations in setting BI values

- When is the last time you estimated the amount of business interruption protection needed by your company?
- Does your business income worksheet reflect the current value of all relevant sources of income and expense?
- What internal and external factors will impact revenues and expenses over the next year?
- Did you complete the worksheet properly, reporting current revenue projections and non-continuing expenses?
- Does your estimate for the time it will take for your business to recover take into account factors that could delay rebuilding such as shortages of labor and materials following a natural catastrophe?
- Can your company resume operations at a temporary location?
- Is your company vulnerable to the loss of key suppliers or customers?

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