Filing a Business Interruption Claim: Properly Calculating the Business Income Loss

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Prepared for the Canadian Institute of Actuaries
Presenters

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Shareholder & Managing Director – Filler & Associates
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Learning Objectives

1. Define certain policy terms
2. Learn the basics of a proper calculation of “business income” and the two approaches to loss calculation
3. Identify relevant supporting documents
Coverage Triggers

- “Covered Cause of Loss”
- At an insured location
- For an incident that occurred during the policy period
Timeline

Period of Restoration

Time of Loss

Income

Extended Business Income
What the Insurer Will Pay

We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration". The "suspension" must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations. The loss or damage must be caused by or result from a Covered Cause of Loss.

(Per ISO Policy CP 00 30)
What the Insurer Will Pay (continued)

• The purpose is to make the insured whole, by…

• Determining how much revenue would have been generated and what expenses would have been incurred but for the event
Terms to Define (per ISO Policy CP 0030)

- Business Income
- Operations
- Period of Restoration ("POR")
- Extra Expense
- Extended Business Income
- Limits of Insurance
- Appraisal
- Loss Determination
Business Income (And Extra Expense) Coverage Form

Various provisions in this policy restrict coverage. What is and is not covered.

Throughout this policy the words "you" and "your" refer to the Policyholder and "we", "us" and "our" refer to the Company providing this policy.

Other words and phrases that appear in quotation marks throughout this policy are defined as indicated.

A. Coverage

1. Business Income

Business Income means the:

a. Net Income (Net Profit or Loss before income taxes) that would have been earned or incurred; and

b. Continuing normal operating expenses incurred, including payroll.

For manufacturing risks, Net Income includes the net sales value of production.

Coverage is provided as described and limited by the terms of this policy, the endorsement(s), and the declarations page of the policy.

BATES GROUP
Operations

F. Definitions

1. “Finished stock” means stock you have manufactured.

“Finished stock” also includes whiskey and alcoholic products being aged, unless it is a Coinsurance percentage showing Business Income in the Declarations.

“Finished stock” does not include stock manufactured that is held for sale on the premises of any retail outlet insured under the Business Income Coverage Part.

2. “Operations” means:

a. Your business activities occurring at the described premises; and

b. The tenantability of the described premises, if coverage for Business Income including “Rental Value” or “Rental Value” applies.

3. “Period of restoration” means the period of time that:

a. Begins:

b. Continuing normal operating expenses.
Period of Restoration ("POR")

• The time period for which the insurer will pay Business Income and Extra Expense

• Seasonality – effect on sales forecast

• The time required to rebuild, repair or replace the damaged or destroyed property

• Cannot exceed 12 months

3. "Period of restoration" means the period of time that:
   a. Begins:
      (1) 72 hours after the time of direct physical loss or damage for Business Income Coverage; or
      (2) Immediately after the time of direct physical loss or damage for Extra Expense Coverage; caused by or resulting from any Covered Cause of Loss at the described premises; and
   b. Ends on the earlier of:
      (1) The date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or
      (2) The date when business is resumed at a new permanent location.
Extra Expense

“Necessary expenses you incur during the "period of restoration" that you would not have incurred if there had been no direct physical loss or damage to property caused by or resulting from a Covered Cause of Loss.”

Will be paid if such extra expense reduces the business income loss by shortening the period of interruption, increasing revenue, or reducing costs.

Examples:

- Construction
- Overtime
- Lease for temporary location
- Equipment rental
- Advertising for temporary location
- Legal
Extended Business Income (Extended Period of Indemnity)

“(1) Business Income Other Than “Rental Value”

If the necessary suspension of your "operations" produces a Business Income loss payable under this policy, we will pay for the actual loss of Business Income you incur during the period that:

(a) Begins on the date property is actually repaired, rebuilt or replaced and "operations" are resumed; and

(b) Ends on the earlier of:

   (i) The date you could restore your "operations" with reasonable speed, to the level which would generate the business income amount that would have existed if no direct physical loss or damage occurred; or

   (ii) 30 consecutive days after the date determined in (1)(a) above.”
Limits of Insurance

“The most we will pay for loss in any one occurrence is the applicable Limit of Insurance shown in the Declarations.”

For Example:
• Actual loss sustained – 12 months
• Actual loss sustained – 12 months + (30 to 60 days)
• Monthly limit of indemnity – capped monthly amount
• Agreed value – predetermined loss coverage
Appraisal

“If we and you disagree on the amount of Net Income and operating expense or the amount of loss, either may make written demand for an appraisal of the loss. In this event, each party will select a competent and impartial appraiser.

The two appraisers will select an umpire. If they cannot agree, either may request that selection be made by a judge of a court having jurisdiction. The appraisers will state separately the amount of Net Income and operating expense or amount of loss. If they fail to agree, they will submit their differences to the umpire. A decision agreed to by any two will be binding. Each party will:

a. Pay its chosen appraiser; and

b. Bear the other expenses of the appraisal and umpire equally.

If there is an appraisal, we will still retain our right to deny the claim.”
“The amount of Business Income loss will be determined based on:

(1) The Net Income of the business before the direct physical loss or damage occurred;

(2) The likely Net Income of the business if no loss or damage had occurred, but not including any Net Income that would likely have been earned as a result of an increase in the volume of business due to favorable business conditions caused by the impact of the Covered Cause of Loss on customers or on other businesses;

(3) The operating expenses, including payroll expenses, necessary to resume "operations" with the same quality of service that existed just before the direct physical loss or damage; and

(4) Other relevant sources of information, including:
   (a) Your financial records and accounting procedures;
   (b) Bills, invoices and other vouchers; and
   (c) Deeds, liens or contracts.”
Loss Determination (continued)

3. Loss Determination
   a. The amount of Business Income loss will be determined based on:
      (1) The Net Income of the business before the direct physical loss or damage occurred;
      (2) The likely Net Income of the business if no physical loss or damage had occurred, but not including any Net Income that would likely have been earned as a result of an increase in the volume of business due to favorable business conditions caused by the impact of the Covered Cause of Loss on customers or on other businesses;
      (3) The operating expenses, including payroll expenses, necessary to resume "operations" with the same quality of service that existed just before the direct physical loss or damage; and

   c. Resumption Of Operations
      We will reduce the amount of your:
      (1) Business Income loss, other than Extra Expense, to the extent you can resume your "operations", in whole or in part, by using damaged or undamaged property (including merchandise or stock) at the described premises or elsewhere.
      (2) Extra Expense loss to the extent you can return "operations" to normal and discontinue such Extra Expense.

   d. If you do not resume "operations", or do not resume "operations" as quickly as possible, we will pay based on the length of time it would have taken to resume "operations" as quickly as possible.
Insured’s Duties in the Event of Loss include:

“(1) Notify the police if a law may have been broken.

(2) Give us prompt notice of the direct physical loss or damage. Include a description of the property involved.

(3) As soon as possible, give us a description of how, when, and where the direct physical loss or damage occurred.

(4) Take all reasonable steps to protect the Covered Property from further damage and keep a record of your expenses necessary to protect the Covered Property, for consideration in the settlement of the claim....
Insured’s Duties in the Event of Loss include (continued):

(5) As often as may be reasonably required, permit us to inspect the property proving the loss or damage and examine your books and records. Also permit us to take samples of damaged and undamaged property for inspection, testing and analysis, and permit us to make copies from your books and records.

(6) Send us a signed, sworn proof of loss containing the information we request to investigate the claim. You must do this within 60 days after our request. We will supply you with the necessary forms.

(7) Cooperate with us in the investigation or settlement of the claim.

(8) If you intend to continue your business, you must resume all or part of your ‘operations’ as quickly as possible.”
Relevant Documents and Information for Loss Calculation:
Understand the Business and its Operations and the Nature of Extra Expenses

- Insurance Policy
- Financial Statements
- Tax Returns
- Sales & Expense Projections and Budgets
- Source Documents like Invoices, Receipts & Contracts
- Interviews with Owners & Employees
- Accounting System Reports
- Industry & Economic Research
Two Methods of Calculating a Business Interruption Loss: Same Result

**Bottom Up Approach:**
- Net Income (Forecast)
- Continuing Expenses
- Extra Expenses

**Top Down Approach:**
- Revenue/Sales not Made
- Non-continuing Variable Expenses
- Extra Expenses

Policy language requires the Bottom Up Approach, but….
Two Methods of Calculating a Business Interruption Loss, continued

Bottom Up Approach:
• Usually for longer periods of interruption – months or quarters
• More detailed (forecasting)
• Review every expense during the POR
• Review cash disbursements to determine what expenses were actually incurred and paid

Top Down Approach:
• Usually for shorter periods of interruption – days or weeks
• What level of revenue would have been achieved (forecasting)
• Determine fixed v. variable expenses
• What level of variable expenses would have been incurred (regression analysis)
CASE STUDY
BUSINESS INTERRUPTION LOSS CALCULATION

Required Professional Skills and Expertise

- Ability to efficiently obtain an understanding of the business and the industry
- Interpret the business financial statements and develop appropriate financial forecasts
- Apply accepted methodologies to prove Business Income and Extra Expenses
- Communicate often with retaining counsel, claim representative or public adjuster
Case Study

Business:
The ABC Hardware Store
Augusta, Maine

Period of Interruption:
February 9, 2011 through July 31, 2011
(approximately 6 months)
# 2010 Results of Operations (Profit & Loss)

<table>
<thead>
<tr>
<th>Description</th>
<th>2010 Historical</th>
</tr>
</thead>
<tbody>
<tr>
<td>GROSS RECEIPTS</td>
<td>$1,009,803</td>
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<tr>
<td>NET SALES</td>
<td>987,927</td>
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</table>

**LESS:**

- COST OF MERCHANDISE SOLD: 718,245 (72.7%)
- FREIGHT IN: 5,013 (0.5%)
- CONSUMABLE SUPPLIES: 504 (0.1%)

**DEDUCT PURCHASE DISCOUNT:** 8,106 (0.8%)

**COST OF GOODS SOLD:** 715,656 (72.4%)

**GROSS PROFIT:** 272,271 (27.6%)

**OPERATING EXPENSES**

- Salaries: 50,000 (5.1%)
- Payroll taxes: 60,000 (6.1%)
- Property taxes: 12,100 (1.2%)
- Group insurance: 4,000 (0.4%)
- Advertising: 15,000 (1.5%)
- Repairs and maintenance: 3,500 (0.4%)
- Depreciation: 8,000 (0.8%)
- Professional fees: 6,000 (0.6%)
- Telephone: 4,000 (0.4%)
- Utilities: 5,600 (0.6%)
- Licenses and dues: 2,200 (0.2%)
- Travel: 3,200 (0.3%)
- Meals and entertainment: 1,800 (0.2%)
- Rent: 28,800 (2.9%)
- Postage: 2,400 (0.2%)
- Auto expense: 1,950 (0.2%)
- Interest: 5,200 (0.5%)
- Computer supplies: 2,200 (0.2%)
- Insurance: 3,000 (0.4%)

**Total operating expenses:** 219,750 (22.2%)

**NET INCOME:** $52,521 (5.3%)
Period of Interruption:

Expected v. Actual Results of Operations (Profit & Loss)

<table>
<thead>
<tr>
<th>BEFORE FIRE</th>
</tr>
</thead>
<tbody>
<tr>
<td>GROSS SALES $478,710</td>
</tr>
<tr>
<td>NET SALES 468,339</td>
</tr>
<tr>
<td>GROSS PROFIT 100,372</td>
</tr>
</tbody>
</table>

Operating Expenses:
- Salaries: 20,000
- Payroll: 70,000
- Payroll taxes: 6,270
- Group insurance: 2,000
- Advertising: 8,000
- Repairs and maintenance: 1,900
- Depreciation: 4,000
- Professional fees: 2,200
- Telephone: 2,200
- Utilities: 2,200
- Licenses and dues: 1,000
- Travel: 1,200
- Meals and entertainment: 950
- Rent: 14,300
- Postage: 1,200
- Auto expense: 950
- Interest: 2,200
- Computer supplies: 1,200
- Insurance: 1,200
- Total operating expenses: 112,445

NET INCOME: $16,627

<table>
<thead>
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- Professional fees: 2,200
- Telephone: 2,200
- Utilities: 2,200
- Licenses and dues: 1,000
- Travel: 1,200
- Meals and entertainment: 950
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- Postage: 1,200
- Auto expense: 950
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- Computer supplies: 1,200
- Insurance: 1,200
- Total operating expenses: 112,445

NET INCOME: ($14,528)
### CASE STUDY

**Period of Interruption:**
- **Amounts to Include in Claim**

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<table>
<thead>
<tr>
<th></th>
<th>BEFORE FIRE PROJECTED INCOME STATEMENT</th>
<th>AFTER FIRE RESULT</th>
<th>AFTER FIRE RESULT</th>
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<td>LESS:</td>
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<td>COST OF MERCHANDISE SOLD</td>
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<td>DEDUCT PURCHASE DISCOUNT</td>
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<td>OPERATING EXPENSES</td>
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<td>Interest</td>
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<td>Computer supplies</td>
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<td>Insurance</td>
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<td>Total operating expenses</td>
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<tr>
<td>NET INCOME</td>
<td>$16,627</td>
<td>$(32,360)</td>
<td>$(48,987)</td>
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### Period of Interruption:

Amounts to Include in Claim, continued

<table>
<thead>
<tr>
<th>Description</th>
<th>BEFORE FIRE PROJECTED INCOME</th>
<th>AFTER FIRE RESULT</th>
<th>AFTER FIRE</th>
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<tr>
<td><strong>GROSS SALES</strong></td>
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<td>$ -</td>
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<tr>
<td><strong>LESS:</strong></td>
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<tr>
<td>Returns and allowances</td>
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<td><strong>COST OF MERCHANDISE SOLD</strong></td>
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<td><strong>GROSS PROFIT</strong></td>
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<tr>
<td><strong>OPERATING EXPENSES</strong></td>
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<tr>
<td>Salaries</td>
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<tr>
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<tr>
<td>Payroll taxes</td>
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<tr>
<td>Group insurances</td>
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<tr>
<td>Advertising</td>
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<td>Repairs and maintenance</td>
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<td>Telephone</td>
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<td>Licenses and dues</td>
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<td>Meals and entertainment</td>
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<td>Rent</td>
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<td>Postage</td>
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<td>Computer supplies</td>
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<tr>
<td>Insurance</td>
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<td>400</td>
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<tr>
<td><strong>TOTAL OPERATING EXPENSES</strong></td>
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<td>32,360</td>
<td>80,085</td>
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<tr>
<td><strong>NET INCOME</strong></td>
<td>$16,627</td>
<td>$(32,360)</td>
<td>$(48,987)</td>
</tr>
</tbody>
</table>

**OPERATING EXPENSES**

- Salaries: $26,000
- Payroll: $31,000
- Payroll taxes: $6,270
- Group insurances: $2,050
- Advertising: $8,000
- Repairs and maintenance: $1,800
- Depreciation: $4,100
- Professional fees: $2,500
- Telephone: $2,200
- Utilities: $2,300
- Licenses and dues: $1,000
- Travel: $1,700
- Meals and entertainment: $950
- Rent: $14,500
- Postage: $1,300
- Auto expense: $975
- Interest: $2,700
- Computer supplies: $1,200
- Insurance: $1,500

**NET INCOME**

- Before fire income: $16,627
- After fire loss: $(32,360)
- After fire claim: $(48,987)
- Total operating expenses: $112,445
- Total operating loss: $31,155
## Business Income Loss: Bottom Up Approach

### Calculation of Actual Loss Sustained

#### Bottom Up Approach

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Loss:</strong></td>
<td></td>
</tr>
<tr>
<td>Net Income as Projected</td>
<td>$16,627</td>
</tr>
<tr>
<td>Continuing Expenses During Period of Interruption</td>
<td>32,360</td>
</tr>
<tr>
<td><strong>Claim for Actual Loss Sustained</strong></td>
<td>$48,987</td>
</tr>
</tbody>
</table>

#### Partial Loss:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Net Income as Projected</td>
<td>$16,627</td>
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<tr>
<td>Continuing Expenses During Period of Interruption</td>
<td>91,971</td>
</tr>
<tr>
<td><strong>Less Gross Profit Earned</strong></td>
<td>108,598</td>
</tr>
<tr>
<td><strong>Claim for Actual Loss Sustained</strong></td>
<td>$31,155</td>
</tr>
</tbody>
</table>
### CALCULATION OF ACTUAL LOSS SUSTAINED TOP DOWN APPROACH

**TOTAL LOSS:**
- **NET SALES DIFFERENCE** $468,339
- **LESS COST OF GOODS SOLD NOT INCURRED (SAVED)** $(339,267)$
- **LESS SAVED OPERATING EXPENSES** $(80,085)$
- **CLAIM FOR ACTUAL LOSS SUSTAINED** $48,987

**PARTIAL LOSS:**
- **NET SALES DIFFERENCE** $187,336
- **LESS COST OF GOODS SOLD NOT INCURRED (SAVED)** $(135,707)$
- **LESS SAVED OPERATING EXPENSES** $(20,474)$
- **CLAIM FOR ACTUAL LOSS SUSTAINED** $31,155
The payment of the calculated Business Income loss makes ABC Hardware Store whole.

<table>
<thead>
<tr>
<th>RESTORATION OF THE INSURED</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL LOSS:</td>
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<tr>
<td>PAYMENT TO THE INSURED</td>
</tr>
<tr>
<td>PAY CONTINUING EXPENSES</td>
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<tr>
<td>NET INCOME AS EXPECTED</td>
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<tr>
<td>PARTIAL LOSS:</td>
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<td>PAYMENT TO THE INSURED</td>
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<tr>
<td>KEEP GROSS PROFIT EARNED</td>
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<td>NET INCOME AS EXPECTED</td>
</tr>
</tbody>
</table>
For questions and comments, please contact:

A. Christine Davis, CPA, CFF, CVA, CGMA
Managing Director – Forensic Accounting, Economic Damages & Financial Crimes

cdavis@batesgroup.com
(415) 416-5961