

Module 8

Business Income and Extra Expense Claims

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Module 8 Chapter 8

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Learning Objectives

- ❑ Obj I – Determining Coverage
- ❑ Obj II – Accounting Concepts
- ❑ Obj III – How Property Losses Affect the Balance Sheet and Income Statement
- ❑ Obj IV – Determining the Amount of Business Income Lost
- ❑ Obj V – Continuing, Noncontinuing, and Extra Expenses
- ❑ Obj VI – Homeowners Loss of Use Claims

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Determining Coverage

Objective I

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Coverage Review Process

- ❑ Questions to ask during the process:
 - ❑ Is the claimant covered?
 - ❑ Does the claimant have an insurable interest?
 - ❑ Did loss occur within policy period/location?
 - ❑ Is the property covered?
 - ❑ Is the cause of loss covered?
 - ❑ Which financial consequences are covered?
 - ❑ Do any additional coverages apply?
 - ❑ Have policy conditions been met?
 - ❑ Do laws affect coverage?

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Insurable Interest

- ❑ The claims rep. first determines if person/entity making the claim is the named insured.
 - ❑ Sometimes the documents of organization will need to be referenced.
- ❑ A claimant must have an insurable interest.
 - ❑ A condition that would cause the individual to suffer a loss if an insured event occurred.
 - ❑ For business income and extra expense losses, the financial loss suffered reduces the claimant's net income.

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Policy Period and Location

- ❑ To collect under a business income policy, losses will be covered under the policy in effect when the direct physical loss occurred.
 - ❑ Even if suspension of operations continues into a subsequent policy period.
- ❑ Period of restoration is the period during which business income losses are covered.
 - ❑ Begins 72 hours after the physical loss.
 - ❑ Ends when property is restored to use.

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Covered Losses

- ❑ The insurer will pay for the actual loss of business income.
 - ❑ Claims rep must establish that the insured did sustain the claimed amount of income lost.
- ❑ Books and records must be reviewed.
 - ❑ Insured must provide records to the insurer as often as may be reasonably required.
- ❑ The business income loss must occur because of the necessary suspension of operations during the period of restoration.

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Insuring Agreement

- ❑ Business income coverage options:
 - ❑ Business income including rental value – pays for both loss of rental income from tenants and insured's own loss of income.
 - ❑ Business income other than rental value.
 - ❑ Rental value only.

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Insuring Agreement

- ❑ The Extra Expense insuring agreement covers expenses the insured incurs to avoid suspension of operations.
 - ❑ Moving to a temporary location.
 - ❑ Increased rent at a temporary location.
 - ❑ Rental of substitute equipment.
 - ❑ Cost of substitute services.

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Additional Coverages

- Additional coverages include:
 - Civil Authority – insures loss of business income that results when damage is to property other than the insured’s property.
 - Alterations and New Buildings – provides coverage for loss of income resulting from a delay in starting operations.
 - Extended Business Income – extends regular coverage to include losses that continue after the period of restoration ends.
 - Interruption of Computer Operations.

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Policy Conditions

- Policy conditions include:
 - Appraisal – similar to property form.
 - Duties in the Event of Loss – similar to property form.
 - Loss Determination – explains the factors that can be considered to determine the loss.
 - Coinsurance – based on a projection of income and expenses for 12 months beginning with policy inception.

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Optional Provisions

- Optional provisions include:
 - Maximum Period of Indemnity – alternative for organizations unlikely to sustain a business interruption of more than four months.
 - Monthly Limit of Indemnity – limits the amount recoverable during any month of business interruption.
 - Business Income Agreed Value – suspends the Coinsurance condition.

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Practice

- ❑ Under a Business Income Coverage Form, the period of restoration ends:
 - ❑ A. 72 hours after the direct physical loss.
 - ❑ B. When the policy expires.
 - ❑ C. When the property is restored to use with reasonable speed.
 - ❑ D. 90 days after the direct physical loss.

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Accounting Concepts

Objective II

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Basic Accounting

- ❑ Adjusters must understand basic accounting principles to evaluate business income losses.
 - ❑ Must be comfortable analyzing revenue and expense amounts.
 - ❑ Complex losses may require the use of a forensic accountant.
- ❑ Basic elements of accounting are the same for all organizations.
 - ❑ Balance sheet and income statement.

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Balance Sheet

- ❑ The balance sheet reflects a company's owners' equity for a specific point in time.
 - ❑ Lists everything the company owns (assets) and the company owes (liabilities).
 - ❑ Owners' equity is shown on the liabilities side of the balance sheet because a business does not own its net worth.
- ❑ Accounting equation:
 - ❑ $\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$

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Income Statement

- ❑ The net income (or loss) for a company is calculated on the income statement.
 - ❑ Reflects profitability over a period of time.
 - ❑ Income statement reflects revenues and expenses.
- ❑ Almost all organizations prepare an annual income statement.

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Revenue

- ❑ Revenue represents the gross income generated from the organization's operations.
 - ❑ Includes sales of merchandise and amounts received for the performance of services.
- ❑ Revenue does not include:
 - ❑ Purchase or sale of major assets.
 - ❑ Gains from investment activities.
 - ❑ Other unrelated receipts and expenditures.

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Expenses

- ❑ Expenses represent certain cash outflows and non-cash costs, such as depreciation.
 - ❑ Expenses can be related to sales directly, such as cost of goods sold or commissions.
 - ❑ In manufacturing, the cost of goods sold includes the cost of materials to make the product, labor, and overhead.
 - ❑ Expenses may be general in nature, such as rent and electricity.

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Expenses

- ❑ Capital investments and expenditures are not operations.
 - ❑ Appear on income statement gradually over time, normally as a depreciation expense.
- ❑ Depreciation expense spreads out the expense of a large purchase over time.
 - ❑ May be calculated based on useful life.

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Net Income

- ❑ Gross profit represents the net income from sales of products.
 - ❑ Sales less cost of goods sold.
 - ❑ Gross profit margin is the percentage of sales remaining after deducting cost of goods sold.
- ❑ Net income represents gross profit, less general operating expenses.
 - ❑ Includes office expenses and depreciation.
 - ❑ Net income can be negative whenever expenses exceed revenue.

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Business Income Loss

- ❑ Insurance for business income covers loss of net income and continuing expenses during an interruption of operations.
 - ❑ Normal operating expenses may stop completely after a loss.
 - ❑ Alternatively, they may continue at the same, increased, or decreased rate.
- ❑ Adjuster must understand insured's business to determine if an expense will continue or not.

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Practice

- ❑ Which one of the following would be considered revenue for a manufacturing business?
 - ❑ A. Income received from an insurance claim.
 - ❑ B. Income from sale of investments.
 - ❑ C. Income from sale of real estate.
 - ❑ D. Income from operations.

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**How Property Losses
Affect the Balance Sheet
and Income Statement****Objective III**

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Balance Sheet

- ❑ The subject of most property claims is direct physical loss to property.
 - ❑ Affects assets on the balance sheet.
 - ❑ Assets include inventory, equipment, and real estate.
- ❑ After a loss, the balance sheet may show an Insurance Claim Receivable account.

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Income Statement

- ❑ Net income can decrease due to either decreased revenue or increased expenses.
 - ❑ Loss of business income can threaten organization's survival.
- ❑ Business income insurance is meant to keep the organization in nearly the same financial position as it would have been had no loss occurred.

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Revenue

- ❑ Many types of direct physical loss can cause a reduction in sales.
 - ❑ Duration of sales reduction depends upon amount of time required to repair property.
 - ❑ Customers may not return after a shutdown.
- ❑ Sales volume can fluctuate.
 - ❑ Some businesses have seasonal income.
 - ❑ An accountant may be needed to assist in the evaluation of sales.

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Expenses

- ❑ After a direct physical loss, normal business expenses can stop completely.
 - ❑ Could also continue at a decreased rate, higher rate, or the same rate.
 - ❑ Normal expenses are covered as continuing expenses during the period of restoration.
- ❑ The business may incur extra expenses.

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Expenses

- ❑ Even if a business completely shuts down for a period of time, some expenses will continue.
 - ❑ Workers may continue to be paid if business expects a short shutdown.
- ❑ Some expenses are related to sales and will decrease when sales decline.
 - ❑ Cost of goods sold.

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Calculating Losses

- ❑ There are several methods used to calculate net income losses.
- ❑ Common method used in insurance:
 - ❑ Reduction = Net income a business could reasonably have been expected to earn -less-
 - ❑ Net income a business actually earned in a period of interruption.

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Calculating Losses

	Expected	Actual
Revenue	\$100,000	\$0
Expenses	\$60,000	\$50,000
Net Income (Loss)	\$40,000	(\$50,000)

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Practice

- ❑ Which one of the following is an example of an extra expense that an organization might incur to mitigate the effects of a business interruption?
- ❑ A. Overtime labor.
 - ❑ B. Payroll of key employees.
 - ❑ C. Income taxes.
 - ❑ D. Advertising in the local newspaper.

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Determining the Amount of Business Income Lost

Objective IV

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Loss of Business Income

- ❑ Loss of business income is the net income that would have been earned plus the continuing normal operating expenses.
 - ❑ Many factors can be considered in determining a business income loss.
- ❑ To determine if an extra expense has occurred:
 - ❑ Expense must exceed normal operating expenses.
 - ❑ Expense must reduce the business income loss that would have been incurred.

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Evaluation of Trends

- ❑ Trend sheets are spreadsheets that show historical gross revenue data.
 - ❑ Series of days, weeks, months, quarters, or years.
- ❑ To estimate the expense for the loss, trend sheets should be created for various expenses.
 - ❑ After the expenses have been projected, the adjuster can begin the loss adjustment.

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Business Income Losses

- ❑ Two methods are common to determine amounts owed under the BIC form:
 - ❑ Net income plus continuing expense method.
 - ❑ Gross profit less noncontinuing expense method.
- ❑ The best method to use is a function of the size and complexity of the loss.

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Business Income Losses

- ❑ Net income plus continuing expense method most closely matches the policy language.
 - ❑ Arguably the easiest method to reconcile with actual incurred expense figures.
- ❑ Reconciliation is the process of matching the net income and continuing expense projections with the actual sales and expenses.
 - ❑ Must be done on a case-by-case basis with careful attention to a fair evaluation of the insured's loss.

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Negotiating Claims

- ❑ Adjusters should be comfortable developing a range of reasonable settlement possibilities.
 - ❑ Business income evaluations are a combination of interpretations and projections from available preloss data.
 - ❑ A business income loss could be considered a specialty loss because not all property loss adjusters handle this type of claim.

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Practice

- ❑ Darnall Glass Company had net income last calendar year in the amount of \$1,200,000, which was earned equally throughout the year. They have the same net income in the current calendar year. A fire in their building caused them to have to shut down operations for 5 months and 3 days. During the shutdown, they incurred total continuing expenses in the amount of \$400,000 (which included payroll costs of \$125,000). Darnall is insured under a Business Income Coverage (BIC) form. How much will Darnall receive from the BIC?
 - ❑ A. \$500,000.
 - ❑ B. \$775,000.
 - ❑ C. \$900,000.
 - ❑ D. \$1,600,000.

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**Continuing,
Noncontinuing, and Extra
Expenses**

Objective V

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Continuing and Noncontinuing

- ❑ Some expenses will continue during a period of shutdown.
 - ❑ Continuing expenses decrease net income.
 - ❑ Included in the amount of business income loss covered.
 - ❑ Noncontinuing expenses increase net income during a shutdown.
 - ❑ Not included in the amount of business income loss covered.

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Continuing and Noncontinuing

- ❑ Claims representatives often must estimate the covered amount of business income loss until it can be reconciled with the insured's records.
 - ❑ May be difficult to estimate which expenses will continue.
- ❑ Expenses that may continue:
 - ❑ Payroll and rent.
 - ❑ Utilities and taxes.
 - ❑ Advertising and professional fees.
 - ❑ Depreciation.

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Extra Expenses

- ❑ Extra expenses are necessary expenses incurred during the period of restoration.
 - ❑ Not considered continuing expenses.
 - ❑ Arise only after an event.
- ❑ Extra expenses can help reduce a business income loss.
 - ❑ Some organizations are willing to incur extra expenses even if they do not reduce losses.
- ❑ A claims rep may need to estimate the amount of extra expenses.

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Extra Expenses

- ❑ Extra expenses include:
 - ❑ Renting temporary space or equipment.
 - ❑ Moving to a temporary location.
 - ❑ Utilities at a temporary location.
 - ❑ Costs of overtime labor.
 - ❑ Costs of temporary labor.
 - ❑ Costs of materials from a temporary supplier.

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Insuring Agreement

- ❑ Extra expenses are covered under the following ISO Coverage Forms:
 - ❑ Extra Expense Coverage Form – covers extra expenses in full, subject to the policy limit.
 - ❑ Business Income (and Extra Expense) Coverage Form – covers extra expenses in full, subject to the policy limit.
 - ❑ Business Income (Without Extra Expense) Coverage Form – covers extra expenses only if they reduce the business loss.

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Insuring Agreement

- ❑ The Expenses to Reduce Loss coverage provides coverage for extra expenses only if the expenses reduce the business income loss.
 - ❑ Only applies to Business Income (Without Extra Expense) Coverage Form.
 - ❑ Cost of extinguishing a fire is not covered.
- ❑ Rate for the BIC (and Extra Expense) form is not much greater than the rate for the BIC (Without Extra Expense) form.

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Loss Determination Condition

- ❑ The Loss Determination condition indicates that the amount of extra expense consists of all expenses in excess of normal expenses.
 - ❑ Also includes necessary expenses that reduce the amount of income that would have been otherwise lost.
- ❑ The insurer deducts from the total expenses the salvage value of any temporary property used by the insured.

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Practice

- ❑ Which one of the following would be covered as an extra expense under the Business Income (and Extra Expense) Coverage Form?
 - ❑ A. Continued payroll.
 - ❑ B. Normal operating expenses.
 - ❑ C. Real estate taxes.
 - ❑ D. Rental of substitute equipment.

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**Homeowners Loss of Use
Claims**

Objective VI

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Loss of Use Expenses

- ❑ Homeowners can experience an increase in expenses due to property damage to a home.
 - ❑ May also lose rental income.
- ❑ Coverage D under ISO homeowners forms covers the following Loss of Use expenses:
 - ❑ Additional living expenses.
 - ❑ Fair rental value.
 - ❑ Loss of use due to civil authority.

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Additional Living Expenses

- ❑ Additional Living Expenses coverage applies only when a loss that would otherwise be covered by the policy has occurred.
 - ❑ Living expenses resulting from flood damage to a home are not covered.
- ❑ The home must be “not fit to live in.”
- ❑ Payment will be made for the shortest time required to repair or replace the damage.
 - ❑ If homeowner moves, payment will be made for shortest time required to settle elsewhere.

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Additional Living Expenses

- Additional living expenses must:
 - Be necessary to minimize loss.
 - Represent increases above normal living expenses.
 - Have been incurred – insured should retain all receipts.
 - Advance payments can still be made.
 - Be necessary to maintain insured's standard of living.

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Fair Rental Value

- Coverage D applies to lost rental income of the residence premises.
 - A homeowner may rent a portion of their home to a tenant.
 - Provides coverage even if the portion of the home was not rented at the time of the loss, provided premises was "held for rental."
- Claims representative would need to analyze rental prices in the local market.

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Fair Rental Value

- Many insurers are modifying their policies to exclude various home-sharing loss exposures.
 - Home-Sharing Host Activities Endorsement is added to exclude coverage for home-sharing.
 - Broad Home-Sharing Host Activities Coverage Endorsement can be added to provide coverage for home sharing activities.

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Fair Rental Value

- ❑ Fair Rental Value loss settlements don't require claims reps to review numerous expenses.
 - ❑ Also don't require verifying that the insured actually incurred a loss.
 - ❑ Insured is deemed to have suffered a loss if property held for rental is "unfit to live in."
- ❑ Claims reps can use rental websites to estimate the rental value of a property.

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Civil Authority

- ❑ Coverage applies when loss of use results from a declaration by a civil authority.
 - ❑ Police, fire, or civil defense department.
- ❑ Civil authority may prohibit homeowner from occupying their home.
 - ❑ May occur if neighbor's property is damaged.

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Practice

- ❑ Miguel is claims rep assigned to a case involving Additional Living Expenses & Fair Rental Value. Which of the following methods should he use to determine the Fair Rental Value?
 - ❑ A. Add together the amount of extra and necessary expenses the homeowner incurs during the period of restoration.
 - ❑ B. Determine the amount for Additional Living Expenses and add 25%.
 - ❑ C. Use online rental calculators and rental listings to determine a fair price.
 - ❑ D. Ask the homeowner for previous lease agreements from the past 24 months.

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