8 – Handling Business Income and Extra Expense Claims

**1 – Determining Coverage for Business Income and Extra Expense Claims**

**Objective**: Summarize the considerations involved in determining whether a claim for loss of business income and/or extra expense is covered under the applicable policy.

When determining coverage for business income and extra expense losses, claim reps address many of the same considerations they do when determining coverage for direct property losses; however, they must also address additional considerations.

**Is the Claimant Covered?**

The claim rep begins the coverage determination by establishing that the claimant is covered under the policy. Is the person or entity making the claim listed on the policy as the named insured? For instance, an organization may have established multiple limited liability corporations (LLCs) and assumed that all were automatically covered under the policy.

**Does the Claimant Have and Insurable Interest?**

To recover under the policy, the claimant must have an insurable interest in the damaged property **at the time of the loss**. **To satisfy the insurable interest requirement for direct physical losses, the claimant must derive a monetary benefit or advantage from the preservation and continued existence of the property or suffer a monetary loss from its destruction. For business income and extra expense losses, the financial loss suffered by the claimant reduces the claimant’s net income**.

**Did the Loss Occur Within the Policy Period?**

**Property Insurance policies generally apply on an occurrence basis. The direct physical loss or damage claimed must have occurred during the policy period in order to be covered. If the insured suffering direct physical loss has business income and extra expense insurance, loss of business income and extra expenses resulting from the direct physical loss will (assuming other policy provisions are satisfied) be covered under the policy in effect when the direct physical loss occurred**.

If the resulting suspension of operations and period of restoration continue into a subsequent policy period. The policy in effect at the time of the direct physical loss will apply to the entire business income and extra expense loss, even if that policy expires before the period of restoration ends. The expiration date of the policy will not shorten the period of restoration.

**The period of restoration begins 72 hours after the physical** loss occurs and ends when the property is (or should have been) restored to use with reasonable speed. (With regard to **extra expense coverage, it begins immediately after the physical loss occurs**.)

**Does the Business Income Loss Meet the Coverage Requirements?**

The policy specifies the requirements that must be met for business income coverage to apply. The requirements are located in the various sections of the policy, such as the business income insuring agreement, definitions, and conditions.

The Business Income Insuring agreement in the Business Income (and Extra Expense) Coverage Form contains a **definition of “business income” that has 2 elements**:

* **The first is net income, before taxes, that would have been earned or incurred** had there been no suspension of operations; the net income can be either a profit or loss.
* **The second element is the organization’s normal operating expenses, including payroll**, that continue during the suspense of operations.

The policy states that the insurer will pay for the actual loss of business income. The claim rep must establish that the insured did, in fact, sustain the claimed amount of business income lost. To make this determination, the claim rep must review the organization’s books and records. The policy conditions, under the duties in the event of a loss, require the insured to provide its books and records to the insurer for review as often as may reasonably be required and to allow the insurer to make copies.

The business income loss must occur because of the necessary suspension of the insured’s operations during the period of restoration. Suspension of operations means either the slowdown or the cessation of the insured’s business activities.

The Business Income (and Extra Expense Coverage Form provides 3 options for business income coverage:

* Business income including rental value
* Business income other than rental value
* Rental value only

Rental value applies to the rental income the insured would have received if operations were not suspended.

The claim rep must determine whether a suspension of operations has actually occurred and review the policy definition of “period of restoration”, which specifies when the period of restoration begins and ends. **The period of restoration definition is very important because business income and extra expense are payable only during the period of restoration (unless extensions are provided by the Extended Business Income additional coverage or the Extended Period of Indemnity optional coverage). The policy requires the insured to use reasonable speed to repair, replace, or rebuild the damaged property.**

**The suspension of operations must be caused by a direct physical loss of or damage to property at the premises described in the policy, including personal property within 100’ of the premises**. The policy does not state that the damaged property must be covered property; it states only that the property must be on the described premises. The direct physical loss of or damage to property must result from a covered cause of loss. The claim rep must review the applicable causes of loss (basic, broad, or special) and any endorsements that might add or delete covered causes of loss.

**Are the Claimed Extra Expenses Covered?**

The claim rep must understand what extra expenses are, whether they were necessary, and the insured payable value. The Extra Expense insuring agreement provides this definition:

*Extra expense mean 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.*

The insuring agreement gives the claim rep guidance by providing descriptions of the types of extra expenses that are covered. The insured must establish the need for the extra expenses and document the amount incurred.

The Business Income and the Extra Expense insuring agreements are subject to a single limit of insurance. That limit is the most the insurer will pay for loss in any one occurrence. Therefore, **payments for extra expense will diminish the amount available for business income payments.**

**Do Any Additional Coverages or Coverage Extensions Apply?**

As with other property policies, business income forms can provide additional coverages or coverage extensions. These are supplemental insuring agreements providing limited coverage for specific types of business income losses and amounts. **The Business Income (and Extra Expense) Coverage Form includes these four additional coverages:**

* **Civil authority** – incurred by the insured caused by action of civil authority that does not allow access to the described premises when property at a location within one mile of the described premises is damaged by a covered cause of loss.
* **Alterations and New Buildings** – Extends business income and extra expense coverage to new buildings or structures, alterations, or additions at the described location.
* **Extended business Income** – **covers business income loss occurring for up to 60 days after the damaged property has been repaired and operations have resumed**, but not beyond the date the insured could have restored its business income to the amount that would have been earned if no direct physical loss had occurred.
* **Interruption of Computer Operations** – Pays up to $2,500 in any one policy year for loss of business income resulting from interruption of computer operations under very restricted coverage provisions.

The coverage form also grants a Newly Acquired Locations coverage extension, but only if 50% or greater coinsurance is indicated in the policy declarations. The coverage amount is limited, and the acquisition and its value must be reported to the insurer within 30 days.

**Payments made under Civil Authority, Alterations and New Buildings, and Extended Business Income do not increase the stated limits**. The amounts of insurance state in the Interruption of Computer Operations and Newly Acquired Locations are payable in addition to the policy limit.

**Have All Policy Conditions Been Met?**

The Business Income (and Extra Expense) Coverage Form contains an Appraisal condition and Duties In The Event Of Loss Condition that are very similar to the same conditions in the direct physical loss forms. **Conditions that are unique to the Business Income (and Extra Expense) Form include the Loss Determination and Coinsurance Conditions**.

**The Loss Determination condition explains what factors can be considered to determine the amount of business income loss and the amount of extra expense. It also makes clear that the element of time for resumption of operations is important**.

The insured is expected to resume operations as quickly as possible. The amount of business income loss payable will be reduced to the extent the insured can resume operations in whole or in part by using damaged or undamaged property at the described premises or elsewhere. The amount payable for extra expense is reduced to the extent the named insured can return operations to normal and discontinue extra expense.

To encourage the insured to resume operations in a timely manner, the form states that payment will be “based on the length of time it would have taken to resume operations as quickly as possible”. This is the same time period allowed if the insured elects not to resume operations.

**The Coinsurance Condition, as in direct physical loss forms, is an insurance-to-value provision that can affect the amount payable for a loss**. However, in the Business Income (and Extra Expense) Coverage Form, **the coinsurance basis is not the value of covered property, but a business income value determined by the insured. The business income value is calculated as the sum of net income and operating expenses that would have been earned or incurred (had no loss occurred) at the described premises for the 12 months following the inception or last anniversary date of the policy, whichever is later**. In essence, the insured is required to make a projected estimate of its future net income. If the insured underestimates the coinsurance basis and buys an inadequate amount of insurance, the amount of business income loss recoverable by the insured could be reduced by the calculation described in the Coinsurance Condition.

**Do Any Optional Coverages or Endorsements Affect Coverage?**

The Optional Coverages section of the coverage form includes 3 optional coverage that the insured can purchase to omit or suspend the Coinsurance Condition:

* Maximum Period of Indemnity
* Monthly Period of Indemnity
* Business income Agreed Value

The insured selects only one of the three options. The claim rep must be familiar with the option selected, because it determines the coverage time frame and payable amounts.

**A fourth optional coverage, Extended Period of Indemnity, extends the Extended Business Income additional coverage from 60 days up to 2 years.** A number of time periods are available in 30-day increments.

Many endorsements are available to modify business income and extra expense coverage. Some endorsements grant additional coverage, some restrict coverage, and some modify coverage to meet the needs of specific business types. The claim rep should always review the declarations page for endorsements and read the applicable endorsements that affect coverage before determining the insured payable amount.

*Examples of Business Income and Extra Expense Endorsements*

* *Payroll limitation or Exclusion (CP 15 10*
* *Business Income From Dependent Properties – Broad Form (CP 15 08)*
* *Extra Expense From Dependent Properties (CP 15 34)*
* *Business income Changes – Educational Institutions (CP 15 25)*
* *Business Income Changes – Beginning of the Period of Restoration (CP 15 56)*
* *Utility Services – Time Element (CP 15 45)*
* *Ordinance or Law – Increased Period of Restoration (CP 15 31)*
* *Civil Authority Increased Coverage Period (CP 15 32)*
* *Food Contamination (Business Income and Extra Expense) (CP 15 05)*

**2 – Accounting Concepts for Evaluating Business Income Losses**

**Objective**: Explain how an organization’s balance sheet and income statement can be useful in evaluating business income losses

Claim reps assigned to business income claims must understand some fundamental accounting concepts related to business income losses.

**The 2 basic financial statements for any organization are the balance sheet and the income statement. From them, a claim rep can determine an organization’s revenue, expenses, cost of goods sold, gross profit, and net income**. By comparing the organization’s financial information with information from the claim investigation the claim rep can evaluate the business income loss that the organization has sustained because of the covered event.

**The Balance Sheet Snapshot Assets – Liabilities = Owner’s Equity (net worth)**

**An organization’s balance sheet answers the questions, “Where do we stand right now?” The Balance sheet is a simultaneous listing of everything that the organization owns and everything that it owes at a particular moment in time. What it owns are called assets, and what it owes are called liabilities**.

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** |  | **Liabilities** |  |
| Cash | $75,000 | Accounts Payable | $50,000 |
| Accounts Receivable | $100,000 | Bank Loan | $150,000 |
| Inventory | $325,000 | Mortgage | $800,000 |
| Plant & Equipment | $1,500,000 | **Total** | **$1,000,000** |
| Real Estate | $1,000,000 |  |  |
| **Total** | **$3,000,000** |  |  |

**In this case, the Owner’s Equity (net worth) is $2M = 3M (Assets) - $1M (Liabilities)**

Owner’s equity is negative whenever liabilities exceed assets. A business with negative owner’s equity may be eligible for bankruptcy. Because of how owner’s equity is calculated, the balance sheet will always balance.

**The Income Statement Revenues – Expenses = Net Income**

An organization’s income statement answers the question, “How did we do during a particular time period? such as a year, month, or quarter. **While the balance sheet lists the organization’s assets and liabilities at a given moment, the income statement describes the organization’s experience over time**.

|  |  |
| --- | --- |
| **Revenues from Gross Sales** | **$1,500,000** |
| Cost of Goods Sold | ($700,000) |
| **Gross Profit** | **$800,000** |
| Operating Expenses |  |
| Employee Wages | $300,000 |
| Depreciation | $100,000 |
| Interest | $100,000 |
| Utilities | $50,000 |
| **Total Operating Expenses** | **$550,000** |
| **Net Income** | **$250,000** |

Some organizations have a fiscal year different from the calendar year, and their fiscal year is some other 365-day period of their choice. Example a college or private school would use school term.

The consequences of **a business income loss primarily affect the income statement**. The main elements of the income statement are revenue and expense. An organization’s operations generate revenue, usually from sales, and incur expenses to create such revenue. Normally, revenue should exceed expenses. However, it is not unusual to find a business that shows minimal net profit annually.

**Revenue**

The money generated by an organization’s operations is its revenue. **A for profit business usually generates revenues by selling its products or services. Not-for-profit organizations might generate revenue from dues, memberships, contributions, or sales.** A business’s revenue depends on the number of sales it makes and the prices it can charge, both of which are affected by competitive pressures.

**Only money generated by the organization’s operations is counted as revenue**. Operations do not include the purchase or sale of major assets, investment activities, or other unrelated receipts and expenditures. So, for example, **if a manufacturing business sold a piece of real estate, the money received would not be part of its revenue. The proceeds would appear on the manufacturer’s balance sheet, but not on its income statement. The asset “real estate” would decrease from the previous balance sheet, and the asset “cash” would increase**.

Likewise, when a business settles an insurance claim, the money it receives from the insurer is not revenue. **For accounting purposes, settlement of an insurance claims substitutes one asset, cash, for another asset, insurance claim receivable, on the business’s balance sheet**.

**Expenses**

All organizations incur expenses to generate their revenue. For the purposes of evaluating business income claims, every operating expense can be categorized as either an **expense directly related to sales or a general operating expense.**

**An expense directly related to sales is one that increases or decreases in direct relationship to sales, such as the cost of goods sold, commissions, or the cost of the materials used to ship goods that have been sold**. If there are no sales, these types of expenses are not incurred.

A general operating expense is one that is necessary to run the business but bears no direct relationship to the volume of sales, such as a retail store’s cost for heating or air conditioning. Whether sales are booming or nonexistent, the cost of heating or air conditioning is necessary each day. **Understanding and recognizing the difference between an expense directly related to sales and general operating expense is important in evaluating coinsurance compliance and is useful in determining which expenses are likely to continue after a loss**.

A **key distinction** among businesses is that some sell services and others sell goods. Professionals in service businesses-such as barbers, dry cleaning, insurance agents, physicians, and accountants-normally do not sell any significant tangible product. Thus, their businesses do not manufacturer or purchase tangible goods for resale, and generally their income statements do not show a specific cost of goods sold expense. But there are almost always some expenses directly related to sales even if they are not labeled as such (materials and supplies consumed, for example).

**Cost of Goods Sold**

**The type of business dictates the expenses that are included in the cost of goods sold**. In retail, the cost of goods sold is usually the business’s cost to purchase its merchandise and the cost of shipping. In manufacturing, the cost of goods sold includes the cost of the materials to make the product, the labor involved, and the overhead to make the product. In the service business the cost of goods sold is minimal because no physical product is being sold.

**Unlike most other operating expenses, the cost of goods sold corresponds directly to sales**. Calculating the cost of good sold is an accounting procedure for appropriately recognizing as an expense the cost of purchasing inventory. Inventory is an asset that appears on the balance sheet until it is sold. Directly showing the purchase as periodic lump sums to represent expense on the income statement would skew the income statement because the purchase of inventory and the resale of it are not perfectly timed.

The cost of goods sold expense that appears on the income statement is calculated according to this formula:

Beginning inventory

+ Additions to inventory

= Amount that could have been sold

* End inventory (amount not sold during the year)

= Cost of goods sold

If there are no sales, the ending inventory is equal to the sum of the beginning inventory plus all additions to inventory. Under this formula, there can only be a cost of goods sold if there has been a sale that lowers the ending inventory from the amount that could have been sold. Once an item of inventory is sold, its cost appears as an expense on the income statement by operation of the cost of goods sold formula.

**Some small businesses may list merchandise purchased as a general operating expense though doing so is not strictly in keeping with generally accepted accounting principles (GAAP). When such a listing is found, the claim rep must account for the cost of goods sold according to cost of goods formula to properly evaluate the loss**.

The most likely sources of error in computing the cost of goods sold are the beginning and ending inventory figures. Valuing an inventory in which goods have been added and withdrawn at various times and at various prices is complex. The methods are not discussed here, but the claim rep must be sure that the same method was used to evaluate the beginning inventory and the ending inventory.

**Gross Profit**

**The difference between a business’s revenue and its cost of goods sold is its gross profit.** From gross profit, a business must cover all other operating expenses and try to earn net income. Gross profit expressed as a percentage of gross sales is sometimes called **the gross margin. $800K / $1.5M = 53%** Similarly, the gross profit expressed as a percentage of the cost of goods sold is sometimes called **mark-up ($800K / $700K = 114%)**

Similar to the treatment of revenues, not all money spent by a business is counted as operating expenses. Purchases of land, buildings, or equipment are called capital expenditures. These capital expenditures appear on **the balance sheet** but do not appear as one-time lump sums simply very large operating expenses, showing such large expenditures as a one-time lump sum expense on an income statement would skew the income statement. Capital investments and expenditures are not operations.

For this reason, **capital expenditures appear on the income statement gradually over time**, **normally as a depreciation expense**. A depreciation expense spreads out the expense of a large purchase over time and may be calculated based on the item’s life expectancy, or more arbitrarily for accounting convenience, according to GAAP.

**Depreciation is a common operating expense**. As an operating expense depreciation lowers the business’s net income for tax purposes. Whether depreciation qualifies as a continuing expense (covered under business income insurance) depends on the facts of the particular loss.

**Net Income**

**The difference between all operating revenue and all operating expense is called net income**. Net income is often expressed using this formula

**All operating revenue (money received for goods or services)**

* **All operating expenses (money paid for merchandise, rent, and insurance)**

**= Net Income**

In the simple income statement the net income was computed as gross profit less total operating expenses (800K – 550K = $250K), which is all revenue less all expense. The same result can be reached using the figures from the simple income statement? $1,5M - $700K – 550K + $250,000 **Net income is colloquially known as the bottom line because net income appears as the bottom item in a listing of revenue and expenses.**

|  |  |
| --- | --- |
| **Revenues from Gross Sales** | **$1,500,000** |
| Cost of Goods Sold | $700,000 |
| **Gross Profit** | **$800,000** |
| Operating Expenses |  |
| Employee Wages | $300,000 |
| Depreciation | $100,000 |
| Interest | $100,000 |
| Utilities | $50,000 |
| **Total Operating Expenses** | **$550,000** |
| **Net Income** | **$250,000** |

**Net income is the most precise term to use for the difference between all revenue and all expenses. Claim reps must be careful not to confuse net income (all operating revenue less all operating expenses) with gross profit (all operating revenue less cost of goods sold).**

**3 – How Property Losses Affect the Balance Sheet and Income Statement**

**Objective**: Explain how an organization’s balance sheet and income statement can be useful in evaluating business income losses.

**Damage to an organization’s property is recorded in changes to its balance sheet and can result in a cessation or slowdown of the sale of goods**. This will last through the period of restoration, expenses directly related to the sale of goods may decrease or cease altogether. Operational expenses, meanwhile, will most likely continue to some extent, and the organization may incur additional expenses and extra expenses that assist in a speedy restoration.

**How Property Losses Affect the Balance Sheet Assets – Liability = Owner’s Equity**

The subject of most property insurance claims is direct physical loss to property, and these losses affect the assets on an organization’s balance sheet.

**Typical assets include cash, inventory, machinery and equipment, and real estate and improvements, which are items affected by insurance claims for direct physical loss**. For example, a retail store’s entire inventory valued at $200K was destroyed by a fire, a covered cause of loss. Before the loss, assets on the balance sheet included Inventory - $100K. Immediately after the loss, the balance sheet would be adjusted to inventory - $0. But would include a new asset “Insurance claim receivable - $100K. This is because the amounts that other persons or organizations owe to the store are assets to the store, including any amount that the retailer’s insurer owes the retailer for a claim. After the claim is paid, the retailer’s balance sheet would show “Insurance claim receivable - $0”, but “cash would increase by $100,000. See below:

Example: **Before Loss**

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** |  | **Liabilities** |  |
| Cash | $50,000 | Accounts Payable | $75,000 |
| Accounts Receivable | $50,000 | Bank Loan | $50,000 |
| **Inventory** | **$100,000** | Mortgage | $200,000 |
| Building | $500,000 | **Total** | **$325,000** |
|  |  |  |  |
| **Cash** | **$700,000** | Owners’ Equity | $700 - $325= $375,000 |

**Immediately After Loss**

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** |  | **Liabilities** |  |
| Cash | $50,000 | Accounts Payable | $75,000 |
| Accounts Receivable | $50,000 | Bank Loan | $50,000 |
| Inventory | **$0** | Mortgage | $200,000 |
| **Insurance claim Recvable** | **$100,000** | **Total** | **$325,000** |
| Building | $500,000 |  |  |
| **Cash** | **$700,000** | Owners’ Equity | $700 - $325= $375,000 |

**After Claim Settlement**

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** |  | **Liabilities** |  |
| **Cash** | **$150,000** | Accounts Payable | $75,000 |
| Accounts Receivable | $50,000 | Bank Loan | $50,000 |
| Inventory | **$0** | Mortgage | $200,000 |
| Insurance claim Recvable | **$0** | **Total** | **$325,000** |
| Building | $500,000 |  |  |
| **Cash** | **$700,000** | Owners’ Equity | $700 - $325= $375,000 |

**An insured loss to a building would be accounted for in a similar way**. Coverage problems or limitations aside, insurance claims convert other types of assets on the balance sheet into cash. Thus**, typical insurance claims for direct physical losses affect only an organization’s balance sheet.** However **physical damage to property that takes time to repair can affect an organization’s income statement if the damage disrupts the organization sufficiently enough to cause a decrease in revenue, an increase in expense, or both**.

**How Property Losses Affect the Income Statement (the difference between Revenue and Expenses)**

**Because net income is the difference between revenue and expenses, net income can be reduced by either lower revenue or increased expenses**.

**Loss of net income can threaten any organization’s survival. Insurance for loss of business income responds to this exposure by covering an organization’s loss of net income and continuing expenses during a full or partial suspension of its operations. Business income insurance is meant to keep the organization in nearly the same financial position as it would have been in had no loss occurred**.

**Effects on Revenue**

**Many types of direct physical loss can reduce sales, and thus revenue**, including damage or destruction of the organization’s **real or personal property, such as inventory**. The duration of any **disruption of sales** depends on how long it takes for the organization to replace its damaged inventory, repair or rebuild damaged premises, and win back customers who have transferred their loyalties elsewhere during the repairs or rebuilding. An organization can continue to experience loss of income until it has repaired any physical damage and it has regained its old customers or acquired new customers.

**Calculating loss of revenue is not difficult when a business’s sales are level and do not fluctuate.** However, most businesses are dynamic. Product lines come and go, as do competitors. Sales volume can also fluctuate (rise and fall cyclically) over time. Some businesses have seasonal fluctuation, some have annual fluctuation, and some have monthly fluctuation. Most businesses also show some overall trend of rising and falling sales in addition to their regular fluctuations. These **fluctuations and trends in sales can be observed by analysis of gross sales over a period of days, weeks, months, or years**. A claim rep with basic spreadsheet proficiency can evaluate the fluctuations and trends, or the rep may choose to hire an accountant to assist in the evaluation of gross sales trends and projections.

**Effects on Expenses**

Direct physical losses can affect expenses in various ways**. A business’s normal operating expense can stop, continue at a decreased rate, continue at the same rate, or continue at a higher rate during the period of restoration**. The normal operating expenses that continue during the period of restoration are covered at the rate at which they are incurred (subject to policy limits and terms) during the period of restoration as continuing expenses.

In the ISO Business Income (Without Extra Expense) Coverage Form, this coverage is provided by the Expenses to Reduce Loss additional coverage. **if the organization has purchased true extra expense coverage, most extra expenses are covered regardless of whether they reduce the busines income loss**. **True extra expense coverage is provided by the Extra Expense insuring agreement in the ISO Business income (and Extra Expense) Coverage Form and by the ISO Extra Expense Coverage Form**.

**Some businesses are unable to remain in operation after a loss**. However, **a business that shuts down temporarily is unlikely to eliminate its expenses completely**, especially if the shutdown is expected to be brief. A business that expects to reopen soon is unlikely to lay off its workforce, because the cost of hiring and training new employees would exceed any savings from a layoff. Plus **expenses, such as those for utilities, professional services, and insurance**.

**Some expenses, like the cost of goods sold and commissions, are directly related to sale**s. These expenses will stop or continue at a rate directly related to sales that are still possible thus, not continuing expenses.

**The cost of goods sold and expenses directly related to sales are sometimes referred to as uninsurables because there is not need for business income insurance to cover them.** These kinds of expenses cannot continue unless there is a sale, and if a sale occurs, it pays for these kinds of expenses. The gross revenue from partial sales will pay for the cost of the uninsurable expense incurred – therefore not covered.

**There is no definitive list of expenses that will or will not continue**. The rep will often have to examine the insured’s business records to make this distinction. Example, a contract for advertising

**A claim rep must keep in mind that the replacement of damaged inventory (ending inventory) is covered under the insured’s direct loss coverage, such as the Building and Personal Property Coverage Form, not under its business income form**. However, if the insured is required to pay **additional freight charges to expedite the delivery of new inventory, the additional freight can be covered under the Expenses to Reduce Loss additional coverage to the extent that expedited delivery reduces the business income loss**. If the insured has true extra expense coverage, the additional freight charges would be paid regardless of whether they reduce the business income loss.

**Methods for Calculating Business Income Losses**

**The amount of a business income loss can be calculated using different methods. Most business income coverage forms used in the United States now express the insurer’s promise to pay actual loss of business income sustained. Those coverage forms define business income as the sum of the net income (net profit or loss before income taxes) that would have been earned or incurred plus continuing normal operating expenses incurred, including payroll**. The same is **gross profit that would have been earned and subtracting noncontinuing expenses.**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Company A | Company B | Company C |
| Gross Profit Lost | **$3,100,000** | **$2,100,000** | $300,000 |
| Noncontinuing Expenses | **600,000** | **600,000** | 600,000 |
| Continuing Expenses | 2,000,000 | 2,000,000 | **2,000,000** |
| Net Profit | 500,000 | 0 | 0 |
| Net Loss | 0 | (500,000) | **($2,300,000)** |
| Covered Business Income Loss | **$2,500,000** | **$1,500,000** | 0 |

Company A’s insured’s net profit of $500,000 is added to continuing expenses of $2,000,000 for a covered business income loss of $2,500,000. The same result is obtained by subtracting $600,000 in noncontinuing expenses from the $3,100,000 gross profit that would have been earned.

Company B has no net profit during the loss period. Instead, it has a net loss of $500,000. Any interruption of its business will only increase the amount of its net loss. The insured’s net loss (expressed as a negative $500,000) is added to continuing expenses ($2,000,000) for a covered business income loss of $1,500,000. The same result is obtained by subtracting $600,000 in noncontinuing expenses from the $2,100,000 gross profit that would have been earned.

Company C is a new company that has incurred a large volume of start-up expenses without earning revenues anywhere close to covering its expenses yet. It is estimated that the gross profit Company C would have earned during the period of restoration is $300,000. In this scenario, the business income insurer pays nothing because the net loss (expressed as a negative $2,300,000) plus the continuing expenses ($2,000,000) is less than zero. Likewise, the gross profit that would have been earned ($300,000) minus noncontinuing expenses ($600,000) is less than zero.

**4 – Determining The Amount Of Business Income Lost**

**Objective**: Given a description of a business income loss, determine the amount of business income lost

**Business income is calculated as the net income that would have been earned plus the continuing normal operating expenses incurred**.

**To determine the projected business income loss during the period of restoration, the claim rep organizes the business’s pre-loss historic data and projects revenue and expenses. Additionally, the claim rep must determine normal operating expenses that will and will not continue during the period of restoration**.

Frequently, the claim rep will use the services of an accountant with expertise in business insurance. Evaluating the loss **when the insured is in a dynamic business environment of growth or decline creates additional challenges, requiring mutual communication and compromise between the claim rep and the insured**.

**Loss Determination Condition**

**The Insurance Services Office, Inc (ISO) business income coverage forms include a Loss Determination condition listing factors the insurer will consider when determining the amount of business income loss**:

* **The insured’s net income before the loss occurred**
* **The likely net income if no loss 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”. You cannot collect for demand (hotel room) based on current hurricane
* **Operating expenses, including payroll necessary to resume operations at the pre-loss level**
* Other relevant sources of information, including (but not limited to) the insured’s financial records, bills, and invoices

**This coverage restriction aligns with the spirit of business income insurance**: to compensate the insured only for income that would have been earned had no direct physical loss occurred.

**Evaluating Revenue Trends**

**Evaluating revenue trends is essential to calculating a business income loss. The claim rep or accountant creates trend sheets by organizing a business’s historical gross revenue data in a series of days, weeks, months, quarters, or years. The chose of time period depends on the facts of the loss**.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 20X0 | 20X1 | **% Change** | 20X2 | **% Change** | 20X3 |
| January | $50,000 | $52,000 | 5% | **$55,125** | **5%** | **57,881** |
| February | $50,000 | $52,000 | 5% | $55,125 | **5%** | **57,881** |
| March | $50,000 | $52,000 | 5% | $55,125 | **5%** | **57,881** |
| April | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| May | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| June | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| July | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| August | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| September | $50,000 | $52,000 | 5% | $55,125 | 5% |  |
| **October** | $60,000 | $63,000 | 5% | $66,150 | 5% |  |
| **November** | $70,000 | $73,500 | 5% | $77,175 | 5% |  |
| **December** | $80,000 | $84,000 | 5% | $88,200 | 5% |  |
| **Gross Rev** | **$660,000** | **$693,000** |  | $727,650 | **Projected loss** | **$173,643** |

A simple trend sheet for 3 years before the January 1 20X3, date of loss that does its heaviest business during the last 3 months of the year. The busy season is clearly the last quarter of the year because the revenue is highest in October, November, and December and is otherwise flat. Comparing the annual figures from year to year shows steady growth of 5%.

**$693,000 / $660,000 = 1.05 or 5% (1.05 – 1 = .05 X 100 = 5% which you don’t really need to do)**

The same comparison applied month to month shows that the 5% growth is steady over the entire year. Claim reps often use month-to-month depictions to explain their evaluations to insureds.

For the January through March 20X3 period the gift store would have earned $57,881 each month ($55,125 x 1.05 = $57,881) if no loss had occurred. The gross loss of revenue is projected to be $173,643 ($57,881 X 3 months = $173,643). See 20X3 above.

**After the loss of gross revenue has been projected, the business’s historical expenses must be analyzed through income statement worksheets to determine the net income and continuing expenses**.

**Evaluating Expenses**

**To project or estimate the necessary expenses, trend sheets should be created.**

Example, if rental expense is $5,000 per month for twelve months, it is easy to project that during a 3-month loss period, it will be $15,000

Utilities may be based on actual consumption.

Because projecting expenses can be complicated, most claim reps rely on accountants. However, claim reps should be able to ask informed questions about factors considered.

**After expenses have been projected, the claim rep can begin the loss adjustment**. **Two (2) methods are commonly used to determine the amount of business income loss under business income coverage forms:**

* **Net income plus continuing expenses** matches policy language used in current ISO
* **Gross profit less noncontinuing expenses** matches pre ISO forms.

**The two methods are interchangeable**.

**Illustration of Methods**

This worksheet demonstrates both the Net Income Loss Plus Continuing Expenses, **and** the **Gross Profit Less Noncontinuing Expenses.** Assume all expenses are evenly prorated throughout the year and did not increase over year 20X2. Wages, Insurance, and interest will continue at 100%; depreciation will continue at 50%. Rent and expenses for utilities will not continue at all. Keep in mind that expenses are simplified for illustrative purposes, and in many claims, some of these assumptions will not be true.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | Percent of Gross Sales |
| Revenue from Sales | $173,643 |  |  |  | 100% |
| Cost of Goods Sold | 69,458 |  |  |  | 40 |
| ***Gross Profit*** | 104,185 |  | **$104,185** |  | 60 |
| **Operating Expenses** |  | **Continuing** | **Noncontinuing** | **Percent continuing** |  |
| Wages | 62,500 | 62,500 | - | 100% | 36.0 |
| Rent | 9,000 | - | 9,000 | 0 | 5.2 |
| Depreciation | 2,700 | 1,350 | 1,350 | 50 | 1.6 |
| Insurance | 1,875 | 1,875 | - | 100 | 1.1 |
| Interest | 3,000 | 3,000 | - | 100 | 1.7 |
| Utilities | 6,000 | - | 6,000 | 0 | 35 |
| Total Operating Expense | 85,075 |  |  |  | 49.0 |
| Projected Loss net Income | 19,110 | **19,110** |  |  |  |
| Total Continuing Expenses |  | **68,725** |  |  | 39.6 |
| Total Noncontinuing Expenses |  |  | **(16,350)** |  | 9.4 |
| **Net Income Plus Continuing Expenses** |  | **87,835** |  |  | 50.6 |
| ***Gross profit* Less Noncontinuing Expenses** |  |  | **87,835** |  | 50.6 |

The Income Statement worksheet for the gift shop shows that the continuing expenses will amount to $68,725 and that the net income lost is $19,110. The Net Income plus continuing expense would be 19,110 (Projected Loss Net Income) **plus** $68,725 (Continuing Expense) = $87,835.

The Gross profit less noncontinuing expenses method equals the same amount (**the two methods are interchangeable**). $104,185 Gross Profit **minus** $16,350 (noncontinuing expenses) = $87,835

**Reconciliation**

After the 90-day loss period has passed, the insured may find that some utilities or that not all wages continued as expected. They might have maintained partial operations/sales activity during the loss period.

**The process of reviewing actual incurred expenses and partial sales against projections done before the end of the loss period is called reconciliation (the process of matching the net income and continuing expenses projections with the actual sales made and expenses incurred during the loss period). Reconciliation is often needed for large or complex losses but may be waived for small or uncomplicated losses.**

The income statement worksheet shows projected gross loss of revenue of $173,643. If it had been open for partial operations and made sales of $20,000, the projected sums change. The actual cost of goods sold changed, reflecting partial sales. The difference between the projected lost net income and the net income actually lost is $12,000, the amount of gross profit on $20,000 of sales.

|  |  |  |
| --- | --- | --- |
|  | **Projected** | **Actual** |
| Revenue from Gross Sales | $173,643 | $153,643 |
| Cost of Goods Sold | 69,458 | 61,458 |
| **Gross Profit** | **104,185** | **92,185** |
| **Total Operating Expenses** | **(85,075)** | 85,075 |
| **Loss Net Income** | **19,110** | **(7,110)** |

All of the gift shops continuing and noncontinuing expenses stayed the same, so the amount of covered business income can now be computed with the actual figures (from the prior calculation) in either of these ways.

**$7,110 (Net Income**) + $68,725 (Continuing Expenses) = $75,835

**$92,185 (Gross Profit**) – ($16,350 (Noncontinuing expenses) = $75,835

**In this example, $75,835 is the amount of business income lost by the insured – but this is not necessarily the amount of business income that will be payable for the claim**. The payable amount of business income loss under the policy could be reduced by applying the limit of insurance the coinsurance provision, or other coverage restrictions. Conversely, it could be increased through one or more of the additional coverages in the form.

**5 - Continuing Expenses, Noncontinuing Expenses, and Extra Expenses**

**Objective**: demonstrate how continuing expenses, noncontinuing expenses and extra expenses differ from one another; how continuing expenses and noncontinuing expenses affect the amount of business income lost; and the extent to which extra expenses are covered under common business income and extra expense coverage forms.

When an insured has to shut down its operations because of direct physical loss to property on the premises, the insured can incur both normal operating expenses and extra expenses during a partial or total suspension of operations.

When handling business income and extra expense insurance claims, the claim rep must be able to distinguish between the insured’s normal operating expenses that will continue during the shutdown (continuing expenses) and those that will not continue (noncontinuing expenses). The claim rep must also understand how the continuing expenses and extra expense incurred during the shutdown will affect the amount of the claimant’s covered business income loss and whether the claimant’s insurance covers the extra expense incurred during the shutdown.

**Continuing and Noncontinuing Expenses**

During a suspension of operations, some of the insured’s normal expenses will continue, and others will not. **Each dollar of continuing expenses during a suspension “reduces” the business’s net income for that period by one dollar, thus increasing the amount of business income loss that the insured’s business income insurance will cover**.

**\*\* Each dollar of noncontinuing expenses, meanwhile, “increases” the net income for that period by one dollar, which “decreases” the amount of business income loss that the insurer pays**. \*\*

Business income insurance, which covers the actual loss of business income that the insured sustains, defines **business income as the net income that would have been earned had no physical loss occurred plus continuing normal operating expenses incurred, including payroll**. **Therefore, in a business income claim, continuing expenses are included in the amount of business income loss covered, and noncontinuing expenses are not**.

Once a suspension of operations has ended, the claim rep can determine the amount of business income actually lost by examining the insured’s books and records. The claim rep (or accountant or another analyst working with the rep) must often estimate the covered amount of business income loss until it can be reconciled with the insured’s records of the amount of business income actually lost during the period of restoration.

At the beginning of a shutdown, determining which normal operating expenses will continue and which will not continue can be difficult. A careful analysis and discussion with the insured’s financial officer can help the analyst project an accurate estimate. During a shutdown, normal operating expenses may continue in full, in part, or not at all.

|  |  |
| --- | --- |
| **Type of Expense** | **Factors to Consider in Analyzing Whether Expenses will Continue** |
| Payroll | * Which employees are needed while operations are suspended? * Do they have key employees that would be hard to replace? * Would the local labor market make id difficult to hire back EE’s? * Is the company part of a union contract? * Does the company have a severance policy/discourages layoffs? |
| Heat, Light, Power | * Does the company use a large amount of heat, light, or power * Is the company obligated to pay a minimum charge per month |
| Lease or rental exp | Do any applicable lease or rental agreement provide abatement of rent |
| Interest expense | This will continue except that the mortgage interest on a destroyed building will cease until the new loan goes into effect |
| Taxes | * Property taxes usually continue * Sales tax is not an expense; it is a sum the insured collects * Employer contributions for SS and Unemployment continue only to the extent that employees are paid during the interruption * Exposure analysis for setting insurance limits is done on a pre-tax basis because business income loss payments will be subject to income tax |
| Advertising | * If ads already contracted cannot be canceled, they will continue * Even if ads can be canceled, a company may choose to maintain it * I the business relocates to a temporary location while its regular location is being repaired, advertising may actually increase |
| Franchise and license fees and royalties | * If based on sales or production, such expense would cease * If a minimum level or flat is guaranteed, such expense could continue |
| Postage and telephone | * Theses expenses could continue in full for a short shutdown * During a prolonged shutdown, these expenses would probably be reduced or discontinued, then resume after reopening |
| Professional fees | * Fees for accounting and legal services normally continues * Extra legal fees and accounting services may be needed as a result of the loss |
| Insurance expense | * Coverage on property that is destroyed can be eliminated, and the premium for property Insurance on a reporting form will be reduced if lower values are reported * Workers compensation premiums based on payroll and liability premiums based on payroll or sales will be reduced commensurate with any reduction in payroll or sales caused by the interruption |
| Depreciation | * Although it does not represent a current outflow of cash, depreciation expenses does reduce net income of an ongoing businesses * Depreciation ceases on property that is totally destroyed * Depreciation on property that is not destroyed generally continues unless the charge is linked to usage – example, a die that can only be used on a certain number of times before being discarded or remade |

**Extra Expenses**

The Insurance Services Office, Inc (ISO) Business Income (and Extra Expenses) Coverage Form contains this definition:

***Extra expense means 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***.

Although the insured incurs extra expenses during the period of restoration, they don’t qualify as continuing expenses because they’re incurred as a result of an accidental event, so **they aren’t considered normal operating expense**. Therefore, extra expenses can’t be included in the amount of business income loss payable under business income coverage.

However, **extra expenses that the insured incurs during the period of restoration can reduce the amount of business income an insured’s business loses**. Example, A business may incur extra expenses to keep part of its operating going, thus reducing the amount of income it would lose. But reducing the amount of business income lost is not the only reason an insured might incur extra expense. Hospitals

Just as the claim rep must often estimate the amount of business income loss the insured will incur during the period of restoration, the rep may also need to estimate the amount of extra expenses the insured will incur during the period of restoration. **Example of Potential Extra Expenses**

* **Renting, buying, and/or maintaining temporary equipment or business space**
* **Moving to a temporary business space**
* **Cost of labor to set up new business space**
* **Notifying customers of temporary location**
* **Utilities at temporary location**
* **Cost of work performed by temporary staff or service providers**
* **Cost of obtaining stock/materials from new or temporary suppliers**

**Extra Expense Coverage**

Extra expenses are covered, to different extents under these ISO Coverage Forms:

* Business Income (and Extra Expense) Coverage Form (CP 00 30)
* Extra Expense Coverage Form (CP 00 50)
* Business Income (Without Extra Expense) Coverage Form (CP 00 32)

Many insurers provide extra expense coverage under proprietary coverage forms that differ from the ISO forms. Business income and extra expense claims of small to midsize businesses are often made under businessowners policies rather than commercial property coverage forms described here. The ISO Businessowners Coverage Form, includes additional coverages for both business income and extra expense..

**The Business Income (and Extra Expense) Coverage Form and the Extra Expense Coverage Form both contain an Extra Expense insuring agreement stating that the insurer will pay extra expenses – other than expenses to repair or replace property – for either of these reasons**:

* **To avoid or minimize the suspension of business and continue operations at either the described premises or at temporary or replacement premises**. (cost to rent, move and equip a temporary location)
* **To minimize the suspension of business if the insured cannot continue operations. (cost to hire another business/contractor to complete orders/obligations, you are unable to fulfill**)

In addition, both forms state that **the insurer will cover extra expenses incurred to repair or replace any property, but only to the extent that the repair or replacement reduces the amount of loss that would otherwise have been payable under the coverage form**. An example of an extra expense incurred to repair property is paying overtime wages to expedite repairs. This extra expense could reduce the amount of business income lost by restoring the property and enabling the insured to resume operations sooner. An example of an extra expense incurred to replace property is purchasing showcases and shelving to displace merchandise at a temporary location. This extra expense could reduce the amount of business income by enabling the insured to continue sales at the temporary location during the period of restoration.

In contrast with extra expenses incurred to repair or replace property, all other extra expense that fall under the bullets above are covered, regardless of whether they reduce the busines income loss.

**Loss Determination Condition**

**The Loss Determination Condition contained in both the Business Income (and Extra Expense) Coverage Form and the Extra Expense Coverage Form states that the amount of extra expense consists of all expenses in excess of normal operating expenses**. Normal operating expenses are those that would have been incurred by operations during the period of restoration if no physical loss had occurred. The covered amount of extra expense also includes all necessary expenses that reduce the amount of income that would’ve otherwise been lost during the period of restoration.

**From this total, the insurer will deduct the salvage value of any property bought for temporary use during the period of restoration.** For example, say the insured buys a trailer to be placed outside the damaged building for use as a temporary office. Although the purchase price is includable extra expense, the insurer will have the right to deduct the salvage value of the trailer once operations are resumed. Without this provision, the remaining value of property purchased to reduce a busines income loss would result in a profit to the insured.

**Expenses to Reduce Loss (Without Extra Expense) Coverage**

The Business Income (Without Extra Expense) Coverage Form **doesn’t include an Extra Expense Insuring agreement**; instead, it includes the Expenses to Reduce Loss additional coverage.

**If the insured sustains a business income loss, this additional coverage pays any “necessary expenses you incur, except the cost of extinguishing a fire, to avoid further loss of Business Income”. The insurer’s payment for the sum of business income loss and expenses to reduce loss “will not be more than the business Income loss that would have been payable under this Coverage Form…. If the expenses to reduce loss had not been incurred.” For example: if the insured’s total covered business income loss would’ve equaled $50,000 had no expenses been incurred to reduce that loss, the insurer’s payment for the business income loss and the extra expenses that were actually incurred to reduce the loss will not be more than $50,000**.

**6 – Homeowners Loss of Use Claims**

**Objective**: Explain how to handle claims made under Coverage D – Loss of Use in a homeowners policy

**The Insurance Services Office, Inc (ISO) homeowners policy forms, Coverage D – Loss Of Use covers**, under a single limit, three types of loss that can occur when a residence can not longer be living in because of a direct physical loss. In the policy, **the losses are titled Additional Living Expense, Fair Rental Value, and Civil Authority Prohibits Use.**  Most non-ISO homeowners and dwelling policies contain similar coverage. In addition to understanding what is covered under Coverage D – Loss Of use, claim reps must be prepared to adjust the types of losses that could be claimed under this coverage.

**Additional Living Expense**

This is how the coverage for Additional Living Expense is applied under Covered D:

*If a loss covered under Section I makes the part of the “residence premises” where you reside not fit to live in, we cover any necessary increase in living expenses incurred by you sot that your household can maintain its normal standard of living.*

***Payment will be for the shortest time required to repair or replace the damage or, if you permanently relocate, the shortest time required for your household to settle elsewhere****.*

This coverage applies only when a loss that would otherwise be covered by the policy has occurred. Because the ISO homeowners forms do not cover flood damage, loss of use resulting from flooding would not be covered under Coverage D.

An important phrase in **this provision is “not fit to live in”. The determination that the insured premises are unfit to live in is subjective. Making this determination requires assessing both the physical damage and the insured’s lifestyle**. **The inability to use utilities, such as water or electricity would render the premises unfit to live in.** Even relatively minor smoke damage can render the premises uninhabitable for a day or so because of the odor. It is not unusual for a claim rep to have to determine whether a home is fit to live in, and it must be done carefully.

**Fair Rental Value**

**A homeowner may rent part of a residence to others**. If that rented part is damaged, the homeowner might lose rental income. This is how Coverage D’s Fair Rental Value applies to such situations:

*If a loss covered under Section I makes that part of the “residence premises” rented to others or held for rental by you not fit to live in, we cover the fair rental value of such premises less any expenses that do not continue while it is not fit to live in.*

***Payment will be for the shortest time required to repair or replace such premises****.*

**The part of the premises doesn’t have to be rented to a tenant at the time of the loss in order for the insured to be compensated for fair rental value**. If part of the premises is being “held for rental” when the physical loss occurred, the insured can still be compensated for the fair rental value of that portion.

**Coverage D – Loss of Use doesn’t apply to every rental property that an insured might own, but instead only to rentals of the residence premises, which the policy defines as the place where the insured resides and which is shown as the residence premises on the policy declarations. So this coverage typically applied to a room rented (or held for rental) to boarder or to one floor of a residence in which the insured occupies the rest of the property**.

Applicable to all the Coverage D provisions, but especially to Fair Rental Value, is this limitation: “We do not cover loss or expense due to cancellation of a lease agreement”. After damage to rental premises, an existing lease might terminate, either by law or its own provisions. The insured might not be able to find a new tenant until well after the premises are repaired and would lose rental income while the premises are vacant. Nevertheless, **the insured can recover only for losses that occur while the premises are not fit to live in.**

Because of the prevalence of home rental through home-sharing network companies, such as Airbnb and HomeAway, many insurers are modifying their homeowner’s policies to exclude various home-sharing loss exposures that are not anticipated in the base rates for homeowners insurance. For example, **for each ISO homeowners form, a corresponding Home-Sharing Host Activities Amendatory Endorsement is available to make changes related to these arrangements. When this endorsement is attached to the homeowners policy, this additional provision applies to Fair Rental Value**:

*However, we do not cover any fair rental value arising out of or in connection with “home-sharing host activities”*

An insured may need to purchase additional or separate coverage to protect his or her property and/or obtain coverage for loss of rental income. ISO has endorsements that insurer can use specifically address exposures related to home sharing and short-term rental arrangements. For example, the ISO homeowners endorsement titled **Broad home-Sharing Host Activities Coverage Endorsement is available for insureds who are willing to pay an additional premiums** to obtain coverage for fair rental value and other losses arising out of home sharing.

**Civil Authority Prohibits Use**

**Sometimes an insured cannot use his or her home even though t hasn’t been damaged. In case of damage to a neighboring property, Additional Living Expense and Fair Rental Value Losses are covered** by this provision:

*If a civil authority prohibits you from use of the “residence premises” as a result of direct damage to neighboring premises by a Peril Insured Against, we cover the loss as provided in 1. Additional Living Expense and 2. Fair Rental Value above for no more than two weeks.*

This provision applies when loss of use results from a declaration by a civil authority (such as a police, fire, or civil defense department) that the insured may not occupy the premises.

**Determining Settlement**

Loss settlement for additional living expenses are determined differently from those for fair rental value. **Settlements for additional living expense require claim reps to analyze many specific items**, whereas settlement for **fair rental value** require reps to analyze **rental prices in the local market**.

Under either approach, **the period of time for which an insured can recover loss payment is limited to the “shortest time required to repair or replace” the damage. The “shortest time” standard might seem to call for a best-case scenario analysis, but the claim rep can consider factors such as weather, the severity of the loss, and the difficulty of adjusting the loss. For additional living expenses, if the insured chooses to relocate permanently, the period of time for which an insured can recover loss payment is limited to the shortest time required to settle elsewhere**.

Recovery is not limited by the expiration of the policy.

**Adjusting Additional Living Expenses**

**To be payable, additional living expenses must be necessary, represent increase above normal, have been incurred, and be necessary to maintain the insured’s normal standard of living**.

**Necessary Expenses**

**The requirement that the expenses be necessary emphasizes the insured’s duty to minimize loss**. An insured shouldn’t rent an apartment as temporary living under a year-long lease when month-to-month rentals are available. Likewise, an insured who faces a longer commute to work form a new temporary location cannot rent a car just to prevent putting additional miles on her car. Instead, be compensated for the additional use of her car.

**Expenses must also be necessary in the sense that they were a direct consequence of the covered damage to the residence premises**. While the insured dwelling is being repaired, the insured might coincidentally decide to join a health club next to the temporary apartment, the expense of the health club is not related to the damage to the residence premises.

**Increases Only**

**Following damage to the residence premises, an insured remains responsible for his or her normal living expenses, since they would’ve been incurred even if the damage hadn’t occurred**. So any normal expense, such as a regular mortgage payment, isn’t covered. Additional Living Expenses covers only increase in living expenses brought on because of the covered damage to the residence premises. If an insured normally spends $200 a week for food, but after the loss has to spend $300 because he has no kitchen to use, the $100 increase would be covered.

On the other hand, homeowners won’t have to pay certain normal living expenses when their premises have been vacated. For example, expenses for electricity, fuel, oil, and natural gas, when billed on an as-used basis, are normally reduced while the premises are being repaired.

**Incurred Expense**

**To be payable under Coverage D, the insured’s increased expenses must actually be incurred**. The claim rep must verify that claimed expenses were incurred by comparing the insured’s expenses during the loss of use period with those incurred in a similar period before the loss.

The claim rep should advise the incurred immediately after a loss to retain all receipts that document expenditures during the repair period, including receipts for all normal living expenses. The rep must also decide whether it was the loss or another situation that caused the increase.

The requirement that expenses be incurred the adjuster can make advance payments for additional living expenses. **Making advance payments is one of the most valuable and important services that claim reps perform**. People who have lost their homes are in desperate circumstances. But a claim rep who makes advance payments must explain to the insured that those payments will be deducted from any final settlement and that the final settlement will be based on expenses actually incurred.

**Normal Standard Of Living**

**Additional Living Expenses includes only expenses necessary to maintain the insured’s normal standard of living. Interpreting what “normal standard of living” is for a particular insured can be challenging**. The claim rep should be careful not to insult the insured by insisting or assuming that all the meals during the repair period should be bought at a fast-food restaurant instead of a more expensive casual restaurant. At the same time, if the insured has been dining at a fire-star restaurant event night since the loss occurred, the rep should verify whether that’s the insured’s normal standard of living.

**Some expenses will be common for one insured but extraordinary for another**. An insured who normally entertains would bear the additional expense of entertaining out. This is a compensable increased expense for an insured whose lifestyle includes formal entertaining. Other factors to examine when determining the lifestyle of the insured can include the number of family members and their employment, social and professional memberships, and health considerations.

**Adjusting Fair Rental Value**

Loss settlements under Fair Rental Value don’t require a claim rep to review numerous expenses, and they don’t even require verifying that the insured actually incurred a loss. The insured is deemed to have suffered a loss when property held for rental is unfit to live in, even if it was unoccupied before the loss.

Claim reps can use rental websites and online calculators to estimate the rental value of properties. Reps can also consult with local real estate brokers who handle residential rental properties.

**The amount payable can be calculated by estimating the reasonably expected period of restoration and deducting the projected noncontinuing expenses for that period from the fair rental value for that period**.