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ARTICLES: THE 411

Business Income Worksheets: Simplified!

A Tutorial for the Confused

By Robert M. Swift, CPCU, CIPA, CBCP

Business Income (BI) worksheets are an integral part of the insurance selection process because they easily determine an organization's financial risk/exposure to loss. If "agreed amount" coverage is requested, insurance companies must have a signed worksheet in file from the insured per state regulations. Additionally, the worksheet ensures that the underwriter will receive proper pricing on the policy and by completing one, the insured will know how to calculate their loss.

Business Interruption Consultants, Inc. has completed over a thousand worksheets for all types of organizations and the issues are always the same: "This worksheet does not fit our business." "We calculated a negative amount." "Where is payroll covered?" "What about spread of risk?" etc. In response, we have simplified the worksheet completion process by developing sixteen industry-specific interactive worksheets on our website, **www.BISimplified.com**, that calculate the totals for you…eliminating the guesswork.

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

Using the interactive worksheets on **www.BISimplified.com**, several scenarios may be used allowing the insured to understand what the financial impact would be. Additionally, completing a worksheet for each location focuses attention on their biggest risk. As a result, they are better equipped to choose the proper insurance limit that best suits the organization. The BI worksheet is almost never used at the time of loss, partly because hardly anyone completes them, so the penalty for worksheet error is either over- or under-insurance.

about the author

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is a business interruption specialist with more than thirty years' experience worldwide in the insurance and risk management field. His services include Business Income consultations and appraisals as well as insurance policy review. Through his company, Business Interruption Consultants, Inc., he has developed a unique, Web-based BI resource, www.BISimplified.com that includes sixteen automated, industry-specific worksheets with detailed instructions.

Mr. Swift is an accredited instructor for the Institute for Business Continuity Training and is in demand by numerous professional organizations as a frequent public speaker.

He is a member of the CPCU Society, the Disaster Recovery Institute, the Risk and Insurance Management Society, the National Society of Insurance Premium Auditors, and a past member of the Insurance Institute of London.

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

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

Since the ISO Business Income Worksheet is a one-size-fit- all form, you cannot choose the appropriate worksheet for your business as you can on **www.BISimplified.com**, but for this explanation, we will use the ISO form. It has four columns, the first two are for the current fiscal period and the second two are for the projected fiscal period. It is the calculation in the right hand column that determines the exposure, as it is future income that needs to be protected.

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

INCOME

Page One is the cover sheet that indicates who completed the form.

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

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

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

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

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

Now determine if you are excluding **ordinary payroll**. Be very careful! This is a common cause for undue distress and increased loss. Keep in mind, you may not exclude more months of payroll than the recovery period. For example, for a six month recovery period, you may not exclude twelve months of payroll.

Also, if you are choosing a recovery period of less than five months, you cannot exclude ordinary payroll at all. In any event, the worksheet requires a subtraction of all payroll (do not forget to include taxes, benefits, WC premium, union dues, etc.) and then add back the largest amount of payroll to be insured for either ninety or one hundred eighty days. Remember, you are pre-settling the loss and there will be no coverage for the excluded payroll outside the chosen period. So if ninety days payroll coverage is chosen, a loss that goes beyond the ninety days would not cover the additional payroll expenses. Without sounding like a broken record, the Business Contingency Plan will determine how much payroll coverage is required. After subtracting ordinary payroll to arrive at your business income limit, you add the extra expenses to get the **combined** business income and extra expense value for the worst case scenario.

Missing from the ISO form is the last calculation that would determine the coinsurance rating factor. It is necessary to take the annual business income basis on page four and apply the estimated recovery period as a percentage of a year. Since six months equals 50%, then select 50% of your annual business income basis and add the extra expenses to determine the total business income and extra expense policy limits. For further clarification: $5,000,000 is the 100% business income amount times a six month recovery period equals $2,500,000 (50%). Add $3,000,000 extra expenses needed for the recovery period to $2,500,000 for a total of $5,500,000.

EXTRA EXPENSES

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

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

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

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

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