BE INFORMED! How Do I Value Business Interruption Exposures?

The traditional focus of net income exposure valuation is the net income; the so called “bottom line” of the income statement. However, this net income value may not be the “real” net income value the organization faces. Determination of net income is affected by the type of accounting methodology used. An organization will often use Generally Accepted Accounting Practices (GAAP) for one purpose, Internal Revenue rules for another purpose, and management accounting principles for their own internal use. All three can result in different net income purposes. Which one is the “real” net income?

One problem of valuing the net income exposure is determining which source of financial information should be used. Using a financial statement can be a good first start, but only if you know the type of accounting system under which the financial statement was prepared. Financial statements created by following GAAP present standardized information in standardized formats, but these rules may not reflect the real net income exposure the organization faces.

Another problem is measuring the extent of the interruption or disruption. Since insurance contracts are annual, it is easy to focus on an annual amount of net income exposure. However, most interruptions are not twelve months in length. Further, the interruption is frequently more of a disruption or a decrease in activity rather than a total cessation. The challenge is to attempt to determine the duration and the extent of the interruption or disruption. Income losses have a tendency to follow Murphy’s Law; the loss will happen at the worst possible time. For organizations that have seasonal variations in activity either in sales or production, the estimation of the value of the interruption must consider when the interruption would occur. Naturally, the most conservative estimate would assume the interruption would occur at the worst possible time.

In short, BI exposures are a paradox, both easily identified and totally unknown, both easily quantified and totally unquantifiable. Yet the successful handling of BI exposures, a natural by-product of every economic transaction, is key to the survival and success of any organization.

Article from *ROUGH NOTES*, Risk Manager’s Forum, *Valuing Business Interruption Exposures*, by Rich Rudolph, PhD, CPCU, ARM, ARP, APA, AIAF, AARN.

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