



COVERAGE INSIGHTS

Provided by Connor & Gallagher OneSource

Factors to Consider When Estimating Maximum Loss of Business Income

Business interruption insurance can offer much-needed financial protection when an organization's usual business activities are disrupted by covered perils (e.g., fires, theft, vandalism, heavy wind and hailstorms). Sometimes called business income insurance, this form of coverage can be purchased as a supplement to commercial property insurance or secured through a business owner's policy—a bundled insurance package featuring property and liability coverage.

The amount of business interruption insurance an organization needs varies based on its industry, operations and risks. To ensure ample coverage, an organization should work with trusted insurance professionals to calculate its business income exposure. An important consideration for determining this exposure is the estimated maximum loss of business income (EML). This value refers to a projection of the largest possible loss an organization may incur from a covered peril under a specific policy. By calculating an accurate EML, an organization can secure a business interruption policy tailored to its unique risks and minimize out-of-pocket costs when disaster strikes.

Several factors must be considered during EML calculations. This article outlines key components an organization should keep in mind when determining this value.

Business Income Worksheet

Calculating an organization's EML starts with completing a business income worksheet. This form, which is typically provided by the organization's

insurer or available through Insurance Services Offices Inc., helps estimate annual business income for the upcoming 12-month policy period, thus providing the information needed to select an appropriate coverage limit (the maximum amount that the insurer will pay toward a claim).

Utilizing this worksheet requires an organization first to determine its business income for the last 12 months with historical data compiled from the past year's financial records. Relevant data includes the organization's total revenue for the year, annual expenses and operating costs, and taxes. With this data, an organization can leverage the following equation for business income:

- Subtract annual expenses and operating costs from total revenue to calculate the year's earnings before taxes.
- Deduct taxes from the previous amount to determine annual net income. This number is equivalent to the year's business income.

Upon calculating its business income for the last year, an organization can use this number as a baseline to estimate its business income for the next 12 months. This value could be similar to the prior year's business income, with some adjustments to reflect possible changes in the coming year (e.g., a projected increase in sales).

Noncontinuing Expenses

Some of an organization's expenses are fixed in nature, meaning they will remain constant even when business operations cease. Common examples of fixed costs are rent, interest payments and



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insurance premiums. Other expenses, however, may pause in conjunction with business disruptions. These costs, known as noncontinuing expenses, may include various raw materials, certain utilities and specific components of payroll (e.g., salaries for hourly employees). By identifying noncontinuing expenses, an organization can detect areas where it could experience reduced costs during business disruptions, paving the way for more accurate EML calculations and potential savings.

Period of Restoration

One key factor in determining the overall value of any business interruption-related loss is the period of restoration, which refers to the total length of an operational disruption. In most cases, the period of restoration is measured from the start date of a loss (e.g., when property damage occurs) until the affected organization fully recovers (e.g., when property repairs are completed).

As it pertains to EML calculations, an organization needs to consider the maximum anticipated period of restoration for a covered peril. This period can be determined based on a range of elements, such as the type and scope of property damage that could be inflicted and the average rebuilding time for such damage. Because the recovery process for a business disruption can vary, it's also important for an organization to add some extra time to its maximum anticipated period of restoration, establishing a safety net in the face of unanticipated delays.

Peak Periods

An organization will likely experience fluctuations in revenue and profits throughout a given year based on consumer trends and seasonal patterns. For example, a retail company that primarily sells beachwear and swimming apparel probably makes more sales in the spring and summer months than in the latter half of the year. These high-performing months, often referred to as peak periods, must be considered during EML calculations. After all, a business disruption that occurs during a peak period carries more severe consequences and ultimately generates a larger loss than a disruption that takes place in the off-season. As such, an organization should be sure to take peak periods into account when conducting EML

calculations and consider the additional impacts of business disruptions during these critical times.

Extended Business Income Loss

Even after the period of restoration ends and property damage from a covered peril has been fully repaired, an organization may need more time to resume its normal operations and start generating its usual business income. In other words, there could be a brief adjustment period between an organization's property being restored, operations reaching their expected volume and customers returning to the business. During this time, the organization may continue to experience negative impacts on its revenue and profits; this is called extended business income loss.

With this in mind, it's imperative for an organization to factor extended business income loss into its EML calculations by carefully estimating the amount of time it will take to resume typical operations and regain support from its original customer base. Above all, this estimate should allow for gradual revenue and profit recovery rather than an immediate shift to business as usual.

Anticipated Changes in Costs and Profits

In some cases, a business disruption may occur in between policy periods. For example, a covered peril could take place days before an organization's business interruption policy renews, with the period of restoration extending into the following policy period. These scenarios can pose challenges for EML calculations, as an organization's business income can easily fluctuate between policy periods and, subsequently, generate different EMLs. This issue is especially prevalent if an organization is currently undergoing or planning to make significant changes to its operations. In light of these scenarios, it's best for an organization to consider the possibility of a business disruption spanning policy periods when conducting EML calculations, therefore anticipating any changes in operating costs and profits throughout the period of restoration and ensuring its coverage accounts for these potential variations.

Extra Expenses

Depending on the nature of a business disruption, an organization may be able to continue some or all of



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its normal operations during the recovery process by utilizing an alternative location and renting essential tools and equipment. Although doing so can help the organization minimize the overall impact of the disruption and expedite its recovery, this also comes with extra expenses, such as temporary lease payments, utilities for the alternative property and marketing efforts to encourage customers to visit the new business location. If an organization plans on continuing its operations in this manner after a covered peril, any anticipated extra expenses stemming from such plans should be reflected in its EML calculations.

Potential Errors

Business disruptions are often hard to predict and can range in severity. As a result, errors are always a possibility in EML calculations. If these errors cause an organization to underestimate its EML, they could prompt underinsurance concerns and lead to substantial out-of-pocket expenses following a covered peril. That's why it can be valuable for an organization to consider a variety of contingency factors (e.g., construction setbacks, broken supply chains, adverse weather and incomplete recovery plans) during EML calculations and regularly review and update these calculations. Additionally, it might make sense for an organization to increase its EML by a set percentage to compensate for any remaining errors and further mitigate the risk of underestimates.

Coinsurance Requirements

A coinsurance clause, which is included in many commercial insurance policies, requires a policyholder to maintain a minimum amount of coverage. If the policyholder submits a claim and an inspection reveals that their coverage doesn't meet the minimum amount, the insurer will penalize the policyholder by paying a reduced percentage of the claim.

When purchasing business interruption insurance, an organization should make it a priority to secure a policy limit that matches either its EML or the minimum amount of coverage required by the coinsurance clause—whichever value is higher. If an organization neglects to address this clause, it could be more vulnerable to coinsurance penalties and face

considerable financial challenges amid business disruptions.

Conclusion

Business interruption insurance is an essential form of coverage that can make all the difference in helping an organization successfully navigate disruptions and minimize the fallout from these events. Understanding the primary factors involved in EML calculations and coordinating with trusted insurance professionals to ensure accurate projections can equip an organization with the knowledge and resources needed to purchase sufficient business interruption coverage, create a more personalized policy and avoid potential underinsurance complications.

Contact us today for more insurance solutions.