

# The Basics of Business Interruption Insurance

The CPA Solution, LLC

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## **Basic Concepts**

Many businesses and companies purchase business interruption insurance in addition to their commercial property policies. Business interruption insurance is often misunderstood by policy holders from a coverage standpoint as well as understanding the complexities surrounding the claim submittal process. Preparing claims and understanding coverage requires a solid understanding of accounting principles as well as the ability to interpret insurance terminology.

The history of business interruption insurance dates back to over a couple hundred years ago. In its earliest form, ship owners often purchased the coverage in order to recover lost profits on freight shipments or chartering activities. Terminology for business interruption insurance varies but you may also hear it referred to as business income, profits insurance, or earnings insurance.

In basic terms, business interruption insurance protects businesses against losses that arise due to a shutdown of a business as a result of damage caused by a covered event, such as a fire, hurricane, or other natural disaster. Commercial property insurance may cover the cost to rebuild the physical property but entities should also have business interruption coverage to pay for lost profits, operating expenses, and extra expenses while restoring operations.

The net result or goal of business interruption coverage is to make the business whole should a covered event occur. The financial statements for the business should report the same financial results as they would if the covered event had not occurred (excluding any consideration surrounding deductibles, length of coverage, etc.). The amount of reimbursement, in part, is based on business income which is generally defined as:

Net income (before taxes) plus continuing normal operating expenses incurred (including payroll)

An example:

A business suffers a fire at its manufacturing facility that stops all operations for a three month period. During the three month period, the business continues to pay salaries, utilities, rent, and other fixed costs necessary for operations to restart. In order for the business to become whole, the business is entitled to reimbursement for net income as well as operating expenses paid during the recovery period.

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## **Extra Expense**

Businesses often purchase in conjunction with basic business income an additional coverage for extra expenses. Extra expense coverage provides reimbursement for additional expenses incurred (above the normal monthly expenses) as a result of the covered event. The extra expenses must be necessary in order to resume operations of the business. A common example would be the rental of equipment in order to continue operations at the businesses effected location. The concept surrounding extra expense coverage is to make the business whole and reimburse for additional operating costs incurred as a result of the covered event .

## **Documentation**

The preparation of a business interruption claim can be quite detailed and require a tremendous amount of effort. The amount of documentation required will generally depend on the amount of claim and degree of detail requested by the adjuster. The Insurance Company may be able to provide a format for the actual calculation or one may be obtained from the Insurance Services Office (ISO). Industry standards often refer to a bottom-up (Net Income) or a top down approach (Lost sales).

We recommend gathering and/or preparing the following documents as part of the claim process:

- Description of the business operations
- Description of products and/or services offered
- Business Plan
- Tax Returns ( 3 – 5 years)
- Payroll Records (2 years)
- Sales Data (3 – 5 years)
- Budget / Forecasts for future periods
- Monthly Profit & Loss Statements (Historical 3 – 5 years & Current Year to Date)
- Audited Financial Statements (3 – 5 years)
- General ledger (available for review)
- Depreciation schedule (previous year)
- Extra Costs (should include a summary sheet by categorical detail, supporting receipts, and should be segregated within the accounting system)
- Industry trade data , geographical data

It is vitally important that the accounting system and underlying data is properly recorded, up to date, and accounts are properly reconciled to supporting documents. A review of the claim will generally begin by reviewing the historical financial statements of the business.

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## **Summary**

The above information is generalized and is intended to provide some of the basic fundamentals surrounding business interruption insurance. In addition to reviewing the basic concepts we recommend the following items:

- Consider the likelihood of a covered event affecting your business?
- How long would it take to resume business operations after suffering a loss?
- Review your current business interruption policy – pay special attention to the following:
  - What type of events and property are covered
  - How does the policy define business income interruption
  - What event(s) must occur to trigger the policy
  - Time periods – how much time must pass to start coverage, how long is coverage provided
  - Overall, understand the limits of insurance (Dollar amount of coverage and length of time it will pay) and specific definitions indicated within the policy
- Do you have Extra Expense Coverage? What types of limits are imposed?
- Do you need other types of coverage associated with Business Interruption?
  - Contingent business interruption coverage
  - Civil authority coverage
  - Extended Business Income
  - Alterations & New Buildings

It is certainly recommended that you discuss your needs with your insurance agent in determining the proper amount and type of coverage for your specific business.

## **About The CPA Solution, LLC:**

The CPA Solution is a premier provider of non traditional accounting services such as Fraud Prevention and Detection, Forensic Accounting and Fractional CFO services. Website: [www.cpaidea.com](http://www.cpaidea.com)