

MICHAEL EHRENFELD COMPANY

INSURANCE NEWSLETTER

Business Income Coverage: "Cash Flow" Protection

Although Business Income coverage is intended to protect the flow of income critical to the viability of a business, it does not always receive the attention it should.

This has been due in part to a history of complex policy forms. Agents and insureds have sometimes been reluctant to discuss this coverage in detail because of its' complexity, and this is still true today even though policy forms have become more simplified. But while it is a coverage that takes some thought and time to calculate proper limits, it is impossible to overstate the importance of Business Income coverage.

Several good worksheets are available to help in determining appropriate Business Income limits.

For many years going by the title of "Business Interruption", this coverage insures the disruption in cash flow when the operations of a business are interrupted by a covered cause of loss, such as a fire. While a business may have adequate coverage on their equipment and buildings at the time of a major loss, without adequate Business Income limits to to pay continuing expenses, the business could fail. Loss of profits could be critical to the plans of a publicly traded company, or one looking for investors, preparing an initial public offering, or even trying to get a loan from a bank.

Determining the amount of insurance to be carried under a Business Income policy is basically a prediction. More specifically, it is a prediction of the future income and expenses that would continue, and the portion of annual production that might be lost following an insured loss, (major fire, etc.).

There are three basic steps in determining the proper amount of Business Income coverage to carry. *First*, determine the length of time that it would take to repair or replace damaged property after a major loss. This is called the period of restoration. A separate estimate should be made of the time between the end of the period of restoration and when the business is back to its' pre-loss production levels. For example, there may be a loss of the customer base while property is being repaired and it may take some time after the repairs are completed to recover those customers. The *second* step is to determine the amount of income that would be lost during the two time periods calculated in step one. The *third* step is to determine which expenses would continue, which would not continue, and how much profit would be lost during the period of restoration. For

instance, mortgage payments, bank loans, etc., would likely continue whereas utilities, payroll, etc., would likely decrease or stop during the shutdown. Payroll is an area to pay close attention to because some policies exclude coverage for certain classifications of payroll, and if you could not readily replace the workforce after a long period of restoration then you may wish to cover all payroll. Once these three estimates have been made a determination of the amount of coverage can be calculated.

Shown below is a schedule of projected earnings, expenses and profits for a fictitious business that will serve as an illustration. In this example, the company is a highly seasonal operation, with earnings peaking during the months of July through October. It has been determined in step one that in the event of a loss, the period required to restore the buildings and equipment would be four months. Step two determines the maximum loss of income that might be incurred by the company during a four month period. In looking at the income by month it is clear that the greatest loss for a four month period would be from July through October. The income during that period is estimated to be \$180,000. Step three calculated expenses that would continue, those that would not, and profit during the critical four month period. From that we can determine the amount of insurance needed for the four month shutdown as \$160,000,

Month	Income	Expenses Not Continuing	Continuing Expenses	Profit
January	\$15,000	\$5,000	\$5,000	\$5,000
February	\$15,000	\$5,000	\$5,000	\$5,000
March	\$15,000	\$5,000	\$5,000	\$5,000
April	\$15,000	\$5,000	\$5,000	\$5,000
May	\$15,000	\$5,000	\$5,000	\$5,000
June	\$15,000	\$5,000	\$5,000	\$5,000
July	\$45,000	\$5,000	\$20,000	\$20,000
August	\$45,000	\$5,000	\$20,000	\$20,000
September	\$45,000	\$5,000	\$20,000	\$20,000
October	\$45,000	\$5,000	\$20,000	\$20,000
November	\$15,000	\$5,000	\$5,000	\$5,000
December	\$15,000	\$5,000	\$5,000	\$5,000
Totals	\$300,000	\$60,000	\$120,000	\$120,000

(continuing expenses and profit for the four month period).

With this information you and your agent can then determine which coverage forms and endorsements are best for your specific circumstance.