Natural Disaster Resource

Business Interruption Insurance and the Importance of Pre-Loss Value Reporting

What happens if a wildfire or other natural disaster damages or destroys business property and operations are temporarily suspended?

Business interruption coverage is intended to financially compensate an insured company for the lost income it would have experienced if an insured loss had not occurred. "Income" includes profits, continuing expenses and expenses incurred to reduce a loss.

Before providing this coverage and at every renewal, however, the commercial insurance carrier typically requires the insured company to complete a "declaration of values" worksheet. How a company completes this worksheet can have positive or negative impacts on the business if a covered loss occurs during the life of the policy.

Business Interruption Worksheets

Completing a business interruption worksheet is a useful—often mandatory—process for an insured business. First, it helps the business understand and strategize around what it wants to insure.

Second, it helps the policyholder understand the full value of the business so that it can meet any coinsurance provisions in the property policy in the event of a loss. Not every policy contains a coinsurance provision, but for those that do, it means that the business owner must insure the property for a specified percentage of its full value. If the owner purchases less insurance than the declared value and a loss occurs, a coinsurance penalty will be applied to the business interruption claim. That is, the business will receive only a percentage of the business loss sustained, not the full amount, even if the loss is lower than the policy limit

Coinsurance Clause Example.

The insured business's policy contains a 100% coinsurance clause. The policyholder's annual insurable value is $1MM dollars, but the company obtains only $750K in business interruption insurance. Therefore, the policyholder will recover only 75% of any business interruption losses sustained.

Third, having an accurate understanding of the business's true value upfront can help the claim process begin on solid footing. If values reported after a loss are wildly different from those predicted before the loss (e.g., a business purchases $100MM in business interruption insurance but makes a claim for $300MM), the adjuster team will have cause for suspicion and the process likely will begin with distrust.

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Look Forward, Not Just Backward, When Determining Business Values

While business interruption insurance worksheets are not standardized across carriers, they all serve the same basic function: to help the insured and the insurer evaluate what the business is likely to achieve over the next 12 months. Both parties need to understand the expected income for the coming year as well as the expected fixed costs. What happened last year may be very different from what happens in the coming year. Consider the following:

Expected Revenue

Has the company acquired or sold a business or product line? Is the company offering new services? What changes have taken place recently, and how will they negatively or positively affect revenue in the coming year?

Fixed Expenses

These known quantities include costs that continue even if a business isn't operating as it normally would be. Some examples include property taxes, rent and salaries.

Semi-Variable Expenses

These costs have a variable component and a fixed component. The cost of electricity for a manufacturer, for example, is semi-variable in that the portion of the electricity cost used to operate the production equipment is variable, but the portion of the electricity cost used for lighting and air conditioning the facility is a fixed cost. A company should calculate the value of the fixed components and add them to the declaration of values worksheet.

Most worksheets assume a 100% loss and a 12-month period of duration. Work with an experienced broker or other advisor to determine whether this is a realistic assumption for the specific restoration that would be undertaken.