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Lost Business Income

In a perfect world, lost business income would be a straightforward calculation upon which the insured and the insurer would agree. Because calculation of lost business income is based on "what-ifs" -- as in, what if the fire, windstorm, water break, or so on hadn't happened -- it necessarily involves assumptions with respect to what might have been.

The essential purpose of business-income protection is to put the insured in the same place, financially speaking, that he would have been had no loss occurred. Many factors can muddy the water in terms of calculating lost business income. Among those that come to mind are inadequate or incomplete records and unrealistic expectations on the part of the insured.

Taking a step back for a moment, lost business income results from the interruption of normal business operations because of direct physical damage of property under a covered cause of loss. The business either shuts down or continues operations in a reduced capacity. In most instances, revenue falls or stops while at least some expenses continue. The insured seeks compensation under the lost business income provisions of its policy.

Lost business income is typically defined as the net income that would have been earned if no physical loss or damage had occurred plus necessary and continuing operating expenses, such as payroll, taxes, and rent. This approach is called the net income method.

The same result can be achieved using the gross profit method. The gross profit method means lost gross earnings less any non-continuing expenses. Any income from partial operations offsets the calculated loss, whether the net income or gross profit method is used.

Get Off to a Good Start

Good interviewing skills come in handy and can help the loss adjustment get off to a good start. Some key questions to ask:

- Is the business completely shut down, or is it able to operate on a limited basis?
- Is the business continuing to pay its employees? Which ones? What are they doing?
- Is there any other source of revenue for the business?
- Does the insured have another location where business can be directed?
- What steps can the insured take to mitigate its loss?

Sometimes a business can rent equipment to keep operating or relocate temporarily and generate some sales while repairs are underway. For example, if a towing company has a truck damaged, you might ask if a truck can be rented while the damaged vehicle is repaired. If a nail salon is closed due to a fire, can the owner rent space at another salon until the business reopens? Get the insured thinking about what can be done right away to keep business going and retain clients.

Requesting Records

Records typically kept in the ordinary course of business will provide the information necessary to establish a business income loss. The following records should be requested:

- Complete copies of the business' income tax returns for one or more years prior to the loss.
- A record of sales prior to the loss for a period sufficient to provide an accurate sales history and to identify sales trends.
- Monthly income statements from the start of the fiscal year in which the loss occurred through the end of the loss period.
- A record of expenses incurred after the loss, such as a cash disbursements or an expense journal.
- A copy of the payroll register for the loss period and for a representative period of time before and after the loss period.
- A complete copy of the building lease.
- Copies of bank statements for each month of the current year through the end of the period of restoration.

Too often, the quality of records provided by small businesses is less than desirable. Many adjusters (and forensic accountants) have had the unfortunate experience of being presented with a shoebox of receipts as a record of sales. Most businesses do not keep their records with the idea that the records may be needed at some point in order to prove an insurance claim. Ask if the insured uses an accountant and, if so, what services the accountant provides. Ask permission to contact the accountant and obtain records from them. It can be enormously helpful.

Sales Analysis

The lost business income calculation starts with lost sales. A good starting point for analysis is a careful examination of the business' sales history. If the loss period is less than 30 days, look at daily sales for 30 days immediately before and after the loss. That should give you an idea of what sales should have been had no loss occurred. If the business is down or limited for a month or more, it's helpful to look at monthly sales for the 24 months prior to the loss date.

Prepare a spreadsheet to show sales history, either on a daily or monthly basis. Consider whether there are any trends over time. In other words, do sales follow a seasonal trend, with the best sales occurring during the summer? Have year-to-year sales been trending upward or downward? Trend analysis can be used to identify historical patterns that may indicate future performance. Sometimes, however, no real patterns or trends are evident. In that instance, a simple average of past sales may be the best approximation of sales that would have taken place if not for the loss.

Projected, Actual, and Lost Sales

Once you have made a projection for what sales might have been but for the loss, the next step is to compare that projection with what actually happened. If the business is closed altogether, the sales you project during the loss period are entirely lost. If the business is not completely shut down and is able to continue generating some sales, then the actual sales generated are subtracted from the projected sales to arrive at lost sales.

For example, a convenience store may have to shut down its gas pumps due to storm damage, but it still keeps the store itself open, possibly with reduced hours. In that event, income from partial operations needs to be subtracted from projected sales to arrive at lost sales.

Before concluding that missed sales are lost sales, consider whether sales that didn't happen during the downtime are delayed sales rather than lost sales. For example, it's clear to see that when an independent taxi driver loses a couple days of work because of an accident, the fares that he would have had on those days are gone forever. But a dentist whose office is closed a week for a water break may, in fact, be able to reschedule patients, so that revenue is delayed but not lost.

Cost of Sales and Operating Expenses

Revenue is only half of the equation when it comes to a business. Expenses are the other half. First, consider cost of sales. Direct costs of producing sales are the costs of sales. For the taxi driver, gasoline is a cost of sales. For the dentist, dental supplies are a cost of sales. For the convenience store, it's the cost of various items sold, including gasoline at the pumps. The cost of sales is subtracted from sales to arrive at gross profit.

To get to net income, project operating expenses and subtract them from the gross profit. Generally speaking, the operating expenses will include payroll, routine maintenance, advertising, and utilities. They are projected for the loss period, typically as an average of historical amounts. Once operating expenses are subtracted, you are down to net income.

Continuing Expenses

Lost business income pays for net income that would have been earned but for the loss, plus necessary and continuing expenses actually incurred during the period of restoration. The business' expense records -- such as check stubs, expense ledgers, and payroll registers -- will tell you what expenses were incurred. Most businesses continue to have some expenses, such as telephone, taxes, and professional fees, even if their doors are closed. Pay particular attention to the building lease. It may have a rent abatement clause.

Complete and reliable records are the starting point for any calculation. A clear understanding of policy provisions and realistic expectations on the part of the insured are also important. The insured will appreciate your guidance along the way. Lost business income protection can restore income and confidence as the business owner works to get her doors open again.

Lost Sales vs. Lost Income

Unrealistic expectations on the part of insured often come into play when discussing lost sales versus lost income.

Lost business income, contrary to popular misconception, does not equal lost sales. Consideration of lost sales alone does not take into account saved expenses. There is a cost of doing business, and if sales are reduced or eliminated, the cost of producing those sales is also eliminated. So the calculation of lost business income must take into consideration savings from expenses not incurred.

Here's a simple example: A beauty salon may lose sales of $20,000 due to business interruption, but only have a business income loss of $10,000, considering cost of sales and saved expenses.