

Introduction to Business Interruption Insurance

Module 5: Increased Costs and Savings

Increase in Cost of Working

There is an automatic provision for increased costs in the wording of the Insured Gross Profit item, which is highlighted below:

“Item 1: Gross Profit

*The insurance under this Item is limited to the loss of Gross Profit due to (a) reduction in turnover and (b) **increase in cost of working** and the amount payable as indemnity under this Item shall be:*

- (a) in respect of reduction in Turnover, the sum produced by applying the Rate of Gross Profit to the amount by which the Turnover during the indemnity Period, in consequence of the Damage, falls short of the Standard Turnover;*
- (b) in respect of increase in cost of working, the additional expenditure (subject to the provisions of Memo 2 of this Item) necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover which but for that expenditure would have taken place during the Indemnity Period in consequence of the Damage, but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided.”*

This policy “benefit” is as much included for the insurer, as for the insured. It is to encourage the insured to take all reasonable steps to minimise the claim in respect of reduction in turnover and undertakes to reimburse the costs incurred, subject to certain limits. Because it is automatically included in the specification of the Insured Gross Profit item nothing additional has to be done to ensure that your client has cover for increased costs.

On the other hand, when it comes to submitting a claim, nothing is automatic. All the fine print is important.

Again, the concept is simple.

There are only three ways to avoid or diminish a business interruption claim and two of them relate to the increased costs.

- 1 The severity of the interruption can be lessened.
- 2 The duration of the interruption can be shortened.

**Increased costs are incurred to:
Reduce the severity of the interruption loss, or
Reduce the duration of the interruption.**

In Module 3 I gave an example to illustrate the claim in respect of reduction in turnover. It also illustrates the claim for increased costs and so I remind you of the circumstances.

A business suffered severe fire damage on 30 June 2003, which destroyed the finishing stage at the end of its No.1 Production Lines. Smoke and water affected other equipment.

The undamaged production line (No.2) resumed after 10 days and immediately went on to additional overtime at its finishing stage to handle a portion of the output of the No1 line, which could operate all production stages except finishing.

The business maintained some sales in the first month from undamaged stock of finished goods and thereafter from the output achieved by both production lines feeding into the finishing stage of the No.2 line. However sales were seriously affected for the six months it took to reinstate the damage.

By diverting production from the No.1 line to the finishing stage of the No.2 line and working additional overtime on finishing stage, not only was the loss during the six months reduced, but the ongoing loss of sales was reduced (fewer frustrated customers going elsewhere) and the total reduction in turnover was kept to \$3,600,000.

The cost of the additional productive overtime was \$300,000 of extra Direct Wages and it cost \$60,000 to set up the temporary diversion of the No.1 Production Line to the No.2 line's finishing stage and then reverse it after No.1 line's finishing stage had been repaired.

This example sounds like a great deal for the insurers.

The Adjusted Standard Turnover was calculated to be \$9,715,000. You will recall from Module 3 that this is the turnover that would have been achieved but for the damage, during the nine month maximum Indemnity Period.

What I have not told you until now is that \$6,600,000 or a little over two thirds of this would have been produced on the No.1 Production Line. Therefore during the six months it took to repair the fire damage the potential loss of turnover was in the region of \$4,400,000 ($\$6,600,000 \times 6/9$ months). (In the example there is a small seasonal variation and the Adjusted Standard Turnover is calculated at \$6,290,000.)

In addition, there is the potential for a greater ongoing loss from customers making long-term alternative supply arrangements.

I will show you again, the calculation of lost sales but I have summarised it by quarter and you can see that in the first six months while the No.1 line was being diverted at the finishing stage into the No.2 line, the loss of sales totalled only \$2,825,000.

Quarter	Historical Standard 2002/2003	Adjusted Standard plus 13.4%	Maintained Turnover 2003/2004	Reduction in Turnover
July-Sep	\$2,778,000	\$3,150,000	\$1,550,000	\$1,600,000
Oct-Dec	\$2,769,000	\$3,140,000	\$1,915,000	\$1,225,000
Subtotal	\$5,547,000	\$6,290,000	\$3,465,000	\$2,825,000
Jan-Mar	\$3,020,000	\$3,425,000	\$2,650,000	\$775,000
TOTAL	\$8,567,000	\$9,715,000	\$6,115,000	\$3,600,000

I say, “only \$2,825,000” because the potential loss of sales was at least \$4,200,000 (two thirds of the Adjusted Standard Turnover for July to December; $\$6,290,000 \times 2/3 = \$4,200,000$).

This is an example of increased costs reducing the severity of the loss during the interruption period.

We will now consider each of the elements in the definition of Clause (b) of the Insured Gross Profit item because the increased costs of labour and mechanical alterations to the production lines must conform to **every** criterion if they are to be payable.

(b) in respect of increase in cost of working,

the additional expenditure

Yes! It is additional expenditure and not just an allocation of fixed overheads or an increased cost ratio.

(subject to the provisions of Memo 2 of this Item)

Memo 2 is only relevant if some fixed expenses have been listed as uninsured working expenses. It only rarely has any practical application but you should know that if your client elects to deduct some of the fixed costs from Insured Gross Profit (i.e. listing them as uninsured) not all the increased costs will be payable in a claim.

necessarily and reasonably incurred

It is usually self-evident that costs are reasonably incurred because your clients are extremely unlikely to incur additional expenditure unreasonably. However, the “necessarily” adverb is stricter and the danger is that necessity can be judged with the advantage of hindsight. This is very similar to issues relating to the economic limit, which I will come to shortly.

*for the sole purpose of avoiding or diminishing the reduction in turnover,
which but for that expenditure would have taken place during the Indemnity Period*

I will address these two qualifications together because increased costs are almost invariably incurred to minimise the loss of sales but the sting in the tail is that they must be sales that would have been lost solely within the Indemnity Period.

The timing issue for increased costs under this Clause (b) is not when they were incurred but when the loss of sales would have occurred but for that expenditure.

In our example the additional wages and mechanical work reduced the loss of sales during the first six months of the indemnity period but if the diversion of Line 1 into the finishing stage of line 2 had been necessary for the entire 9 month indemnity period and the costs of reinstating the normal workflow had been incurred immediately thereafter (i.e. in month 10, outside the maximum indemnity period) they would still have been payable in full because they minimised the reduction in turnover in the first 9 months (i.e. within the indemnity period).

in consequence of the Damage,

They minimised a shortage of turnover that was in consequence of the fire damage; i.e. “Damage” as defined.

but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided.”

These phrases define what is called the “Economic Limit”.

It is sometimes called the “dollar for dollar limit” and the saying about “not throwing good money after bad” springs to mind in this context.

Let us consider our example claim scenario in which the potential loss of sales in the first six months of the indemnity period was \$4,200,000 ($2/3 \times \$6,290,000$). The increased costs of overtime wages and mechanical alterations to the production lines achieved a \$1,375,000 direct reduction in the loss of sales from \$4,200,000 to \$2,825,000.

Quarter	Historical Standard 2002/2003	Adjusted Standard plus 13.4%	Maintained Turnover	Reduction in Turnover
Jul-Sep	\$2,778,000	\$3,150,000	\$1,550,000	\$1,600,000
Oct-Dec	<u>\$2,769,000</u>	<u>\$3,140,000</u>	<u>\$1,915,000</u>	<u>\$1,225,000</u>
Subtotal	\$5,547,000	\$6,290,000	\$3,465,000	\$2,825,000
Jan-Mar	\$3,020,000	\$3,425,000	\$2,650,000	\$775,000
Total	<u>\$8,567,000</u>	<u>\$9,715,000</u>	<u>\$6,115,000</u>	<u>\$3,600,000</u>

Is this reduction in the lost sales of \$1,375,000 a measure of the benefit to the insurers in reducing the severity of the interruption and therefore reducing the size of the claim under Clause (a), *"in respect of reduction in Turnover ..."*?

No!

The claim in respect of reduction in turnover is *"the sum produced by applying the Rate of Gross Profit to the"* reduction in turnover. The benefit to insurers is 30% of \$1,375,000, or \$412,500.

This is the Economic Limit:

Shortage of Turnover Avoided	x	Rate of Gross Profit	=	Economic Limit
\$1,375,000	x	30%	=	\$412,500

If the insured had not diverted the output of the No.1 Production Line through the finishing stage of the No.2 line and had not worked the overtime there would have been no claim for the increased costs of \$360,000 but the claim in respect of reduction in turnover would have been greater by \$412,500. The insurers have a net gain from the increased costs.

If, however, the increased costs had totalled \$560,000 the insurers could logically claim to have been disadvantaged and on the economic principle of not throwing good money after bad, would, with the advantage of hindsight, suggest that the increased costs were uneconomic and they would invoke the economic limit to peg the claim for increased costs to \$412,000.

This is what they would have had to pay if the insured had done nothing to minimise the severity of the interruption while repairs were taking place.

The insurer's interests are limited to the maximum Indemnity Period.

In judging increased costs the insurers have the advantage of hindsight.

The insured's interests are in the long-term survival of the business.

Therefore a BI policy does not provide adequate insurance for increased costs unless it includes an item for Additional Increased Costs of Working.

The range of increased cost initiatives is huge, limited only by the creative enterprise of the insured who seeks to survive in the long term by minimising the loss during the short term Indemnity Period. In this, they can be enormously helped by the experience of the loss adjusters.

The illustration deals with costs incurred to reduce the severity of the interruption during the time required to reinstate the damage. There could also be costs to reduce the duration of the interruption by accelerating the reinstatement program. For example, replacement machinery could be airfreighted from its European or Japanese supplier. A project engineer could be hired to do a critical path analysis and implement an accelerated rebuilding program. Incentives might be paid to the rebuilding contractor to complete the job within a target period. A damaged item of plant might be replaced if it is quicker to do so than to repair it. Or temporarily repaired until the new replacement arrives.

The illustration also calculates the economic limit as if the amount by which the shortage of turnover was reduced was solely the direct turnover value of the additional production in the 6 months during which the No.1 line was diverted into the finishing stage of the No.2 line. For simplicity it has ignored the fact that the shortage of turnover avoided in the first 6 months of the Indemnity Period has a potential impact on the remaining 3 months of the 9 month maximum Indemnity Period. By achieving more on-time deliveries in the first 6 months, fewer dissatisfied customers would have taken their business elsewhere, thus minimising the ongoing loss in the 7th to 9th months.

This additional shortage of turnover avoided should also feature in the assessment of the economic limit.

- 1 Increased costs are an automatic provision of the Insured Gross Profit item. You don't have to select any options or calculate an appropriate sum insured.**
- 2 However, this automatic cover is limited in two respects, which necessitate the inclusion in all BI policies of an item for Additional Increase in Costs of Working.**
- 3 Firstly, the costs must be incurred to minimise lost sales during the Indemnity Period.**
- 4 Secondly they must be to the economic advantage of the insurers, for which a judgement is made on the results rather than on good intentions however realistic they might have been at the time.**

The item for Additional Increase in Costs of Working will be dealt with in the second stage of this series of training modules.

Savings in Insured Expenses

The final words of the Insured Gross Profit item are:

“less any sum saved during the Indemnity Period in respect of such charges and expenses of the Business payable out of Gross Profit as may cease or be reduced in consequence of the Damage.”

In the context of the claim resulting from lost sales, you will recall I said that the insured is correctly indemnified if it is reimbursed for the loss of sales less an adjustment for all expenses that are saved. It is then able to pay all the expenses that are not saved and will have the same profit left as it would have achieved but for the damage.

I also said that by applying the Rate of Gross Profit to the reduction in turnover, the calculation of claim is reduced to allow for savings in the uninsured expenses. These are the expenses that are directly variable with sales and will therefore be saved in proportion to any reduction in turnover.

There are other expenses, however, which might be saved in the circumstances of a particular business interruption. Savings are more likely in these expenses when the interruption is severe or long term. For example, if there is damage to a tenanted building there will be an abatement of rent in terms of the lease. Also, the insured might decide to reduce advertising to avoid the long-term loss of credibility with its customers

that would occur if it continued to offer what it could not deliver because of the damage and business interruption. There might also be savings in repairs and maintenance.

These savings (rent, advertising, R & M) are not automatic. They are not in ratio to the reduction in turnover. Therefore rent, advertising and repairs & maintenance should not be listed as uninsured expenses. If they are saved, such amounts are deducted in terms of this "savings adjustment" to preserve the intention of the policy to provide an indemnity but this will be the case only in the more severe interruptions. If they are not saved there is no deduction.

Review

In my introduction to the section on increased costs I stated that there were only three ways to minimise a consequential loss of profit. One is to reduce the severity of the loss. The second is to reduce the duration of the loss, and the third, which might be another issue of the severity, is to maximise the savings in expenses, which we have now also addressed.

Brett Fawcett
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