

Introduction to Business Interruption Insurance

Uninsured Expenses in BI Policies

The Gross Profit items are the key components of most Business Interruption (“BI”) policies and because they are largely pre-printed, few decisions are required of brokers and insurers. Perhaps there are only three

- (i) What is the sum insured?
- (ii) How long is the maximum Indemnity Period?
- (iii) Which expenses are to be listed as “Uninsured (Working) Expenses”?

We now address in more detail, the 3rd of these, “Which expenses should be listed as Uninsured (Working) Expenses?”

The fundamental rule is:

The only expenses that should be listed as uninsured are those that, in each insured’s own unique cost structure, are so totally, directly variable that they will always be saved in proportion to any lost sales

Modern BI policies usually pre-print “Purchases” as the first in a list of uninsured expenses and allow others to be added to that list. Few brokers need to be reminded that only expenses that are directly variable with turnover or output should be on this list (i.e. uninsured). However I am frequently asked whether certain other expenses should be insured or uninsured and there are hidden traps in some that might appear to be totally variable.

At the core of most BI policies is the Gross Profit item, which insures the financial loss resulting from reduced turnover and increased costs. Because they are deducted from turnover to calculate the Rate of Gross Profit, uninsured expenses reduce the claim in respect of the reduction in turnover. I summarise its rather wordy specification as follows:

In respect of reduction in turnover, the sum produced by applying the Rate of Gross Profit to the reduction in turnover during the Indemnity Period, resulting from the Damage.

Purchases and other uninsured expenses are deducted from the turnover in calculating the Rate of Gross Profit and the effect of this is that the BI claim assumes they have been saved. For example, if the uninsured expenses are listed as purchases and outwards freight and these comprise, say, 70% of the sales value, then the Rate of Gross Profit is 30%. A BI claim for lost turnover of, say, \$360,000, would be:

Reduction in Turnover	x	Rate of Gross Profit	=	Loss of Gross Profit
\$360,000		30%		<u>\$108,000</u>

This will only indemnify the insured if 70% of the costs of the lost sales have actually been saved.

Reduction in Turnover	\$360,000	
Less Savings		
Material Costs	\$248,400	69%
Freight	\$3,600	1%
Loss of Gross Profit	<u>\$108,000</u>	

(You will see that I have used the term "Material Costs". This is equivalent to Opening Stock plus Purchases minus Closing Stock, which are used in the definition of Gross Profit in BI policies.)

If, when the insured lost \$360,000 of sales it did not save \$248,400 of materials plus \$3,600 of freight then the BI policy will not adequately indemnify it. It follows therefore that if your client wants to be correctly indemnified in all its BI claims, great or small, the only expenses that it should list as uninsured are those that, in its own unique cost structure, are so totally, directly variable that they will always be saved in proportion to any lost sales.

The safest and simplest option, which is suitable for most small to medium enterprises, is to list only purchases as uninsured. When you client calculates the Gross Profit as its sum insured (as distinct from the Rate of Gross Profit for a claim), it might slightly overstate the amount. But there will be no gaps in its cover. Of course you will correctly infer that the difference between insuring and not insuring freight would not bankrupt your client either in terms of the premium or in a claim. It would be more important to get it right if freight were, say, 10% of turnover.

The mistake your client might make if left to decide, is to nominate expenses as uninsured because they will be saved if the business is closed down. Rent is a good example although a bit extreme. Yes, rent will be saved if the business is shut because the premises are so badly damaged that they cannot be occupied. But turnover could be severely reduced by damage to machinery with no damage to the building and therefore no saving in rent.

I will show the effect, using the same data as above but assuming that Rent is 10% of turnover and that it is uninsured. The Rate of Insured Gross Profit is therefore reduced to 20% and the BI claim would be:

Reduction in Turnover	x	Rate of Gross Profit	=	Loss of Gross Profit
\$360,000		20%		<u>\$72,000</u>

But the actual loss was \$108,000, as above, because although rent is uninsured, it was not saved although \$360,000 of turnover was lost.

I will now comment on several expenses that sometimes cause problems:

Advertising is variable in that it can usually be incurred or not at the insured's option, i.e. it is a discretionary expense. During a significant business interruption in which your client has no goods to sell it will probably stop advertising. Why create demand that it cannot satisfy? However, any savings during the initial months of the interruption will probably be eroded by additional advertising later when production has resumed and the insured wants to regain its market share after the temporary absence.

The possibility of savings, even the probability of savings in a major interruption, does not imply that an expense should be uninsured. Advertising is in this category. It is not directly variable with sales or production and although it might be saved in a major interruption it should be insured.

Bad Debts: If bad debts are normal costs of your client doing business they should be uninsured because they will vary directly with sales. Suppliers to building-related trades would be in this category (particularly in 2008) with lots of small customers and typically a percentage of them not paying their accounts. However, if the bad debts shown in a client's Statement of Financial Performance are unusual they can be viewed as a "one-off" reduction in Net Profit, which is insured, rather than typical of the client's variable cost structure.

Depreciation. I hesitate to deal briefly with anything connecting depreciation and BI insurance. I have heard of, but not read, a thesis for a masters degree written on the subject of savings of depreciation in BI claims. Is it an expense (non-cash) or is it a tax deduction? Does it vary with production or over time? Will a saving in non-cash depreciation reduce the cash settlement of a BI claim? But whatever the complications in BI claims, one thing is very clear, which is that depreciation does not vary directly with turnover or output and it should never be listed in a BI policy as an uninsured expense.

Inwards Freight and Duty (i.e. on Imports): These are expenses associated with purchases and can therefore be safely listed as uninsured.

Outwards Freight might not be as variable as it appears. e.g. A bakery has two ovens, one baking buns and another baking bread. After a fire in the bun oven it still bakes bread and its contractor or its own delivery truck still makes the regular daily delivery trips to all the customers but with only partly full loads. There is a loss of sales (no bun sales) but no savings in delivery costs. Therefore, for this insured's cost structure outwards freight should be insured.

This is unusual and illustrates that the selection of insured/uninsured expenses is unique to each client's cost structure.

Outwork is the cost of sub-contracting part of a process, usually to a specialist, such as printing companies sub-contracting or "outsourcing" plate-making or a garment manufacturer outsourcing "cut, make and trim". It is the purchase of a service directly related to production (and sales) and like the purchase of materials it should normally be an uninsured expense because if the business is not making sales it will not be incurring these variable expenses.

Packaging -- Usually directly variable with sales and therefore uninsured.

Power (& Gas). There is always a fixed cost element in electricity costs (fixed reticulation charges and maximum demand charges in larger users), which should be insured. Factory heating and lighting is fixed and even boiler fuel is not completely variable in many industrial plants (the boiler has to operate at similar rates of fuel usage whether the factory is running at capacity or, say, 50% of capacity).

Repairs & Maintenance (R&M). If there is a major interruption and the factory's plant is damaged or just idle for a significant period there will be savings in R&M. But most claims are for "non-major" interruptions (I hesitate to call them "minor interruptions") in which R&M is not saved.

If your client decides to reduce its sum insured by designating R&M as an uninsured expense it should do so in the knowledge that it will be under-indemnified in "non-major" interruptions because sales will be lost without savings in R&M.

Royalties are usually directly variable with turnover (therefore uninsured) but sometimes there is a fixed annual minimum that should be insured.

Sales Commissions are, in normal circumstances, variable with sales levels but if a business interruption prevents the sales persons achieving budgets and earning the commissions they have come to rely on, they may resign. In most business interruptions they are paid compensation in lieu of commissions and no savings result. Sales commissions should usually be insured.

"Take or Pay" Clauses are not as common in NZ but they feature in contracts with utility suppliers (private power generators) in other countries. This is a fixed cost, contractual obligation on the purchaser of, say, electricity or natural gas, to pay for a minimum quantity, usually annually, even if it does not use that much. If the natural gas is a feedstock (as in an ammonia plant) the minimum annual cost is a fixed component in its raw material purchases and should be insured. If the electricity or natural gas is a fuel cost the "take or pay" obligation must be insured as a fixed component of the power or gas expense. Even a force majeure clause in the supply contract does not avoid the need to insure the fixed cost obligation because the circumstances of the business interruption might not fall within the force majeure conditions.

Tool Replacements, Indirect Materials, Crockery, Cutlery & Linen Replacement -- Tool replacements and indirect material costs in a factory are usually variable with activity levels and I would consider them to be candidates as uninsured expenses. The same applies to crockery, cutlery and linen in a restaurant.

Wages. Possibly the most difficult decision that you and your client will have to make is how to insure wages. I have written numerous papers on this subject and several are featured on this web site. I will therefore repeat here simply that wages are rarely variable with turnover unless they are paid as “piece rates” for throughput or output. I am a strong advocate for insuring them for the maximum Indemnity Period as part of the Gross Profit item. i.e. They are not uninsured expenses.

If the wages are paid to staff who are so quickly made redundant and so easily re-hired that they are effectively variable with sales or output, they might be categorised as uninsured expenses in the Gross Profit item. In this case they should be insured by a short-term wages item, such as “Wages in Lieu of Notice” for at least the notice period plus enough time for your client to assess its future after major damage and make a decision on the redundancies. In this situation, once the period of the “Wages in Lieu of Notice” item has expired your client will have to achieve savings in wages in direct proportion to the reduction in turnover or it will have an uninsured loss.

I hope I have covered all the expenses that you are not sure about. If there is any that you want to question, please email me at bfawcett@cl-nz.com and I will be delighted to answer you if I can.

Brett Fawcett
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